



Future Focus

March 2026

Welcome to the Autumn Edition of Future Focus – insights on building wealth for your clients

- **Talking point:** Passing wealth on to the next generation.
- **Investment centre:** Active management still deserves its place.
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STANLIB Multi-Manager Investment Team

Talking point

Passing wealth on to the next generation



Key points

- **Empower your children from a young age, with a hands-on experience, by giving them a practical understanding of managing wealth.**
- **Education builds the basic skills needed to understand investment concepts.**
- **Higher financial literacy helps instil a sense of responsibility towards wealth creation and ultimately wealth transfer.**

Introduction

At almost every event in the financial services industry, mention is made of the huge transfer of wealth between generations. A projected ¹\$18.3 trillion in wealth is expected to be transferred globally by 2030, the largest intergenerational transfer of assets in history.

A 20-year study conducted by wealth consultancy, ²*The Williams Group*, indicates that 70% of families lose their fortune by the second generation and 90% by the third — highlighting the need for proper planning and education. In South Africa the challenge is HUGE as financial education is lacking badly, increasing the risk of ‘wealth leakage’ in the transfer phase. Hence, the desperate need to educate our children, formally and informally, to preserve family wealth for generations to come.

In this article we briefly discuss how our children can learn to build a good relationship with money and not repeat the mistakes of the past, preparing them from a young age with the know-how to make independent financial decisions.

Financial education at HOME

Studies have shown that financial habits are formed early in life, and what children learn at home has a lasting impact on their financial decisions in adulthood. According to research from the ³National Endowment for Financial Education (NEFE) USA, children who learn about finances at a young age are more likely to have positive financial behaviours as adults, such as saving, budgeting, and avoiding high-interest debt.

Financial literacy goes beyond just managing money. It is about confidence, independence and understanding the economic forces that shape our world. By introducing financial conversations early, we can equip our children with the skills to navigate an increasingly complex financial landscape.

Talking about MONEY

Financial education does not need to be complex, nor does it need to be a series of formal discussions, it can be integrated into everyday conversations.

- **Basic skills**

Investing is a broad and sometimes overwhelming topic that can take many years to understand, so it is important to introduce the topic with your children early. But where do you start when it comes to teaching your child about investing?

Children are more than capable of understanding the concepts behind investments and do their own investing — if only they are taught. If you are unsure of where and how to begin, we suggest that from day one, you get practical by opening a small investment, such as a tax-free savings account (TFSA), for your child. This will allow both of you to track and monitor the investment. By monitoring the investment online, as they get older, your child will see how values change over time and in this way, they will get used to the frequent ups and downs in markets, while understanding and practically observing the impact of compound interest over time. They will also come to realise that consistency is what matters most in investments.

¹Vanguard – Navigating the great wealth transfer.

²<https://williambuck.com/news/business/general/from-riches-to-rags-why-family-wealth-disappears-without-a-plan/>

³National Endowment for Financial Education (NEFE) – “The Importance of Financial Literacy in the Home. This resource offers an in- depth look at why financial education should start early, providing research and practical advice.”

Talking point

Passing wealth on to the next generation (cont.)

- **Real-life scenarios**

One of the easiest ways to teach children about money is through real-life examples. Some of the most impactful lessons happen naturally during everyday routines and often stick longer than a one-time conversation or lecture. This may involve going to the local supermarket, discussing how much things cost and how it fits into the budget. Also, show your children their savings on a banking app to make the invisible nature of digital money more understandable. This help children to connect the concepts with their real-life experiences.

- **Small decisions**

Allow children to have a say in their own financial decisions, even those on a small scale can have a big impact. While parental guidance is essential, children should be given opportunities to make their own financial decisions within a controlled environment. By allowing them to manage their pocket money or earnings from small jobs, they learn valuable lessons about budgeting, prioritising expenses, and evaluating purchases. They also learn from their mistakes, learn to evaluate options, weigh consequences, and navigate challenges.

- **Life skills**

Teaching children about money and finances might not be the first thing that comes to mind when planning lessons or family activities. Financial literacy for children is a life skill as crucial as reading, writing, or maths. By empowering children with a solid understanding of money from a young age, we help them develop the confidence to make informed financial decisions on how they SPEND and SAVE their money. You can use money-themed games like Monopoly to teach earning, spending, and saving – and any wrongdoing may land you up in jail. Helping children at a young age to set financial goals — be it saving for a new laptop or running shoes — can teach them the value of patience and delayed gratification.

It is not always EASY

Starting these conversations is not always easy. We found that the key is consistency and honesty. When you are open about money, even if it is to admit that you do not have all the answers, it creates an environment where children feel comfortable asking questions and discussing their own thoughts about finances. Additionally, we can also learn together. We need to break our stigmas about money — shift away from seeing money as a source of fear — to allow us to approach the subject matter with a clean slate.

Conclusion

As parents we know that we have a role in shaping our children's financial future. By being honest about your own journey and creating a supportive environment is a great opportunity to connect with your children on a deeper level and help them to navigate the investment landscape — learning and gaining knowledge. Starting the conversation about money early, when your children are young, curious, and eager to learn, can only help them to make better financial decisions as they grow older and when wealth is eventually transferred.



“It is never too early to start talking about money, and it is never too late to begin learning together.”

Carlo Hector Investment Specialist

References

- University of Cambridge – “Financial Literacy and its Impact on Adult Life”. The study highlights how early financial education correlates with better financial outcomes later in life. Cambridge Study on Financial Literacy.
- Journal of Financial Counseling and Planning – “Parental Influence on Financial Literacy in Children”. This academic paper explores the impact of parental financial discussions on children's financial behaviours. Journal of Financial Counseling.

Investment centre

Active management still deserves its place



Key points

- **Rather than choose between active or passive, understand where each fits best and where to apply them intelligently within a coherent framework.**
- **When implemented with discipline and scale, active management remains a critical driver of long-term success. Market inefficiencies exist and skilled active managers can exploit them.**
- **Track record and governance determine whether active management adds or detracts value.**

Introduction

Over the past decade, the investment industry has witnessed a relentless compression in management fees, driven primarily by the growth of passive investing. Exchange-traded funds (ETFs) and index trackers have democratised access to diversified portfolios at fractions of a percentage point in annual cost. Recent announcements by leading global providers — cutting headline fees to single-digit basis points — have reignited debate about the role of active management, particularly for offshore building blocks within the global portfolios of South Africans.

...passive revolution

For investors, the argument seems intuitive: if one can gain exposure to global markets for next to nothing, why pay more? Yet as with many apparent 'no-brainers,' the reality is more complex.

...new fee frontier

The cheapest exposure is not always the most appropriate exposure. In this article we briefly discuss why active management remains a relevant investment approach when managing money.

Benchmark choice – the foundation of strategy

Before assessing active versus passive, we should ask a more fundamental question: what benchmark are we trying to capture or outperform?

Every investment process begins with a benchmark. It defines the opportunity set, the geographic and sectoral exposure; and the implicit risk-return profile. Only once the benchmark has been chosen does the method of implementation — active or passive — become relevant.

Take global equities as an example. Many South African investors compare passive and active solutions by referencing the S&P 500 Index because it dominated both headlines and returns in recent years. However, the S&P 500 Index represents only about 60% of global market capitalisation and excludes mid-and small-cap stocks, as well as the vast emerging market universe. The MSCI ACWI IMI, by contrast, includes almost 9 000 companies across 23 developed and 24 emerging markets, covering approximately 99% of the investable global equity universe.

Over longer periods, that broader exposure has historically generated higher absolute returns and better risk-adjusted performance than the narrower MSCI World Index (large- and mid-cap developed market companies only) or simplistic blends such as '70% S&P 500 + 30% Rest of World.' The choice of benchmark therefore has a material effect on outcomes. Investors who confine themselves to narrow indices may enjoy temporary strong returns when those segments lead, as US mega-caps have done recently, but they risk structural under-exposure when global leadership rotates.

It is worth noting the often-quoted SPIVA scorecard — highlighting percentage of US mutual funds beating the benchmark is low — fails to recognise the opportunity set in the global space. By way of an example, last year was an opportune time for active global managers to underweight the US in a weak dollar environment. Similarly, global managers could generate excess returns by allocating to outperforming European defence companies at the expense of their US counterparts. We believe the ability to pick shares within a global sector without regional constraints is an advantage. Global core managers delivered double the success rates of the equivalent US core funds.

Investment centre

Active management still deserves its place (cont.)

The hidden costs of 'cheap' passives

Replication costs rise with index complexity. A plain-vanilla US large-cap ETF may charge 3bps; but a truly global, all-cap fund — incorporating smaller companies, emerging markets, multiple currencies and trading venues — typically costs 15-20 bps. The higher costs reflect rebalancing expenses, liquidity differences, withholding taxes and the operational challenge of tracking thousands of securities. Consequently, the comparison often made between a 3bp US index fund and an actively managed global fund is misleading — essentially an apples-to-oranges comparison. A fair comparison would be between a global active fund and a global passive benchmark such as the ACWI IMI, which already carries a higher replication cost. If that broader benchmark outperforms simpler ones by 50bps per annum (a reasonable long-term estimate), then even after accounting for the 15-20 bps higher passive cost, the net benefit to the investor is roughly +30bps.

In addition, risks are not comparable. ETFs often engage in scrip lending to reduce fees. The income generated in these programmes offsets some of the costs. Equivalent active management vehicles might not be engaging in this and while the risks are not significant, the reality is passive could be taking on risk to reduce cost.

The broader point is that 'low cost' does not necessarily equal 'low total cost' or 'high efficiency.' The investor's objective is not to minimise fees in isolation but to maximise net risk-adjusted return after all costs. The passive revolution has been invaluable in highlighting costs but focusing on them exclusively risks overlooking where real value is created.

- **Where active managers add value**

The case for active management rests not on marketing rhetoric but on how markets work. Prices are set by humans and their algorithms, in environments characterised by information asymmetry, behavioural bias, and structural frictions. These imperfections create the very conditions that active managers exploit.

- **Market inefficiency and dispersion**

Even in liquid developed markets, dispersion between the best and worst-performing stocks remains wide. In recent years, the spread between the top and bottom deciles of global equities exceeded 80% annually, a fertile ground for skilled stock-pickers. Dispersion is even higher in smaller-cap, frontier and emerging markets, where research coverage is thin and capital flows are irregular. Here, information advantages and disciplined research can translate directly into alpha.

- **Behavioural bias and forced trades**

Passive investors, by definition, buy more of yesterday's winners as they grow in index weight and sell more of yesterday's losers as they shrink. This momentum-driven mechanic can lead to crowding in over-valued sectors. A very concentrated market lends itself to passive management. Conversely, as the market broadens out, active managers can exploit such flows and position themselves contrarily when valuations disconnect from fundamentals. The last decade favoured passive in the sense that it was the most concentrated market we have seen in the past century as shown below¹. The graph shows (in orange) the market concentration of the top 10 stocks in the S&P 500. Today, the top 10 shares account for approximately 40% of the S&P 500 market capitalisation and 33% of its profits. If this continues, passive will likely outperform. By contrast, active could deliver significant excess returns if the operating environment changes.



Sources: Compustat, CRSP, Kenneth French, Goldman Sachs Global Investment Research

¹ <https://www.ft.com/content/38c3ccd8-3aa0-4dbb-a832-0017c40996c>

Investment centre

Active management still deserves its place (cont.)

- **Flexibility and risk management**

Active management allows discretion in managing liquidity, concentration risk and valuation extremes. Passive vehicles must hold the benchmark regardless of valuation, governance, or geopolitical risk. Skilled active managers can trim exposures ahead of regime shifts, rotate across styles and regions, and manage position-sizing to protect capital in downturns. This agility has historically delivered superior downside protection during bear markets, an often-overlooked contributor to long-term compounding.

- **Structural tailwinds**

Active managers can also exploit long-term themes and structural inefficiencies: sustainability transitions, demographic change, technological disruption, or governance reform in emerging economies. Benchmarks are slow to adapt; active managers can move early.

We managed to add value

Sceptics correctly point out that, on average, active managers underperform after fees. The comparison of active vs passive is, however, often flawed. If one includes the same distribution costs embedded in active vehicles in their passive counterparts, then the narrative from the analysis would differ materially — many passive funds lag their benchmarks if the same costs are included. We believe the solution lies not in abandoning active management but in selecting the right active managers.

That is precisely where we believe our competitive edge lies. Our multi-manager and discretionary platform have 25+years of experience in identifying and combining outperforming managers across regions and styles. We have the resources, data and governance to separate skill from luck — something few advisers or DFMs can do at scale. Our process emphasises persistence of alpha, cultural alignment, capacity discipline and a deep understanding of how each manager generates return.

Our edge...
manager selection

The results speak for themselves: consistent outperformance of 2% p.a. across our global active mandates since inception, dated back to 19982. This success demonstrates that active management can add value, provided selection is disciplined, diversified, and continuously monitored.

A disciplined philosophy: benchmark → cost → skill

Our investment philosophy follows a clear sequence:

- **Define the benchmark:** decide which index best reflects the intended investment universe and client objective.
- **Assess the cost:** compare the true cost of passive replication against potential active value-add, including implementation and trading costs.
- **Select for skill:** allocate to active managers only where we have evidence of repeatable alpha, robust process and alignment of interests.

This disciplined approach ensures that every building block earns its place on a net-of-fee basis, aligning with the principle of fiduciary duty to the end investor.

Our value proposition rests on three pillars:

1. **Capability:** a global team operating from Johannesburg, Cape Town, London and Jersey, combining research depth with on-the-ground insights into managers worldwide.
2. **Consistency:** a 25+year heritage of discretionary multi-manager investing, delivering sustained outperformance through multiple cycles.
3. **Conviction:** the confidence and governance to blend active and passive appropriately, guided by evidence rather than ideology.

Infrastructure, data
access and analytical
rigour are all key

Conclusion

Active management, when executed with discipline, remains indispensable. It identifies opportunities, manages risk dynamically and integrates portfolio decisions in ways that passive products simply cannot.

Active with the right
process, still works...

The conversation around fees is important and overdue. Investors should always be conscious of costs, and passive funds have done the industry a service by forcing transparency. Yet cost is only one variable in the investment equation. The end goal is not the cheapest portfolio, but the most effective one — the combination of exposures, skills and governance that delivers the highest probability of meeting client objectives over time.

Kent Grobbelaar
Head of Portfolio Management (Global)

Manager insights

Macro in the micro

How macroeconomics shows up in equity portfolios



Key points

- **Macro and micro analysis are not competing lenses on an equity portfolio; they are two different ways of looking at the same underlying reality.**
- **In our survey, macro shows up in most managers' discussions, but rarely as the main driver of buy or sell decisions.**
- **Most of the equity managers in our survey remain fundamentally bottom-up in their approach, with the macro context typically intertwined at key points in the share-selection process.**

Introduction

Listening to market commentary can often feel like trying to follow a swirl of competing signals: policy rates, inflation, global trade, earnings seasons, capital expenditure plans, wage negotiations, government policy etc. It may sound as though every new statistic must somehow explain that day's market move. We wanted to step away from that noise and so recently, we conducted a survey among our equity managers asking how macroeconomic views show up in their portfolios. In this article we provide insights into our findings.

Same macro signal...different applications

Take a simple inflation print. For a central bank, it feeds into a decision on interest rates to spur or curb economic conditions. For a company, it could show up as changes in funding costs or consumer demand. And a bottom-up manager using a fundamental analysis approach, might translate that same signal into revised assumptions for margins, debt servicing or sector risks. For such a manager, identifying where the impact will land and how material it might be if it persists, often matters more than predicting the next inflation or interest rate print.

GDP works the same way. The number itself is the sum of thousands of firms hiring, producing and selling. For statisticians and policymakers, it is a score card for the health of the overall economy. For economists it feeds into forecasts of future growth. Equity managers, by contrast, are more interested in how these trends affect specific businesses and portfolios than in the precise path of every near-term data point.

What the survey adds is a clearer sense of how that happens in practice. It suggests that the role of macro in an investment process depends heavily on the manager's opportunity set, how their investment process is structured, and their investment time horizon. Understanding how these patterns interact can improve the dialogue between equity managers — who must live with both short- and long-term equity market cycles — and investors, who are often exposed mainly to macro narratives such as growth, inflation policy direction.

Overall, the survey points to macro living quietly within most bottom-up processes: informing and guiding, without overpowering or dictating final investment decisions.

From macro noise to context

In conversation, most managers speak easily about inflation risks, central bank reaction functions, consumer health, fiscal credibility or global liquidity. This does not automatically make them all top-down equity managers. In fact, when asked to describe their processes, a clear majority (51 of the 61 managers surveyed) are 'labelled' as primarily bottom-up investors. At face value, that description is fair. However, what stood out in many of the survey responses was that 'bottom-up' often signalled that the manager does not necessarily start with a house macro view to generate ideas, and sees limited value in trying to forecast every economic data print.

To make that more concrete, it helps to go back to basics. Equity is ultimately a claim on a stream of future cash flows. Those cash flows are typically earned in an economy shaped by growth, policy, prices, wages, credit and politics.

Manager insights

Macro in the micro

How macroeconomics shows up in equity portfolios (cont.)

To mention a few equity examples:

- A bank's earnings are tied to the interest rate and credit cycle; a retailer's volumes depend on real income and employment,
- A resource company's fortunes are tied to global demand, commodity prices and the currency; and
- More defensive shares, such as healthcare and food, are influenced by demographics, regulation and long-run spending patterns.

These examples make the point that aggregate macro trends like financial conditions and growth prospects, shape the operating environment in which bottom-up managers build portfolios.

In our findings, the real story is not whether macro matters but how it filters into the micro and how deliberately each manager builds that filtering into their investment process. We explore this in more detail in the survey results that follow.

What we asked the managers

To move beyond labels, the survey was designed around managers' behaviour on macro rather than their opinions about it. Managers were asked to describe their investment approach and style, to indicate which macro variables they follow and which sources of macro insight they rely on. We also asked them to comment on how they separate macro insight from noise and how often they see macro developments linking to sector or share outcomes.

Responses from the managers were treated as qualitative insights rather than a formal statistical sample. We used them as windows into practice, forming the basis for our analysis of where macro enters the process, how explicitly it is used, and the language managers use when they explain the balance between macro and micro.

Macro sits in the background as context rather than center stage.

From this analysis, two dimensions stood out:

- Formality: the extent to which managers described explicit macro frameworks, tools or overlays, from almost none to dashboards, house views, and scenario grids.
- Integration: the extent to which macro was described as integral to share, sector or portfolio decisions, as opposed to being simply an observation.

From this we derived four broad archetypes. They are not neat boxes but rather, a useful way of understanding how macro shows up within portfolios.

Four archetypes of macro use

Macro-light

At one end of the spectrum, you find macro-light stock pickers.

These managers track few, if any, explicit macro indicators. Several selected 'none' when asked which macro data they follow, and their written comments focused squarely on company fundamentals — business economics, capital allocation, management quality and valuation discipline. When prompted on macro, typical answers were that 'they do not forecast macro and regard most macro commentary as noise.'

Macro can largely be ignored.

This group is dominated by global quality or quality-growth investors running long-horizon portfolios. Their central belief is that durable franchises and reinvestment at high rates of return will wash out most of the volatility introduced by inflation cycles, rate moves or political news flow. For them, macro matters at extremes, such as when it threatens balance sheets, demand or the viability of a business model. For the rest of the time, it sits at the edge of the process as a background check rather than a regular input into idea generation or portfolio decisions.

Cycle awareness

A second group, which we refer to as cycle-aware stock pickers, show relatively low formality but much higher integration of macro into their micro analysis. These managers may not maintain dashboards or explicit macro-overlays, but have a clear mental map of where the cycle sits and its implications for their equity ideas. In their language,

Macro kept as a mental map

Manager insights

Macro in the micro

How macroeconomics shows up in equity portfolios (cont.)

for example, banks are sensitive to the rate cycle, retailers respond to employment and consumer confidence; and resource companies live and die by China and the commodity cycle.

For some of these managers, macro influences which sectors move up the research agenda or how quickly they are willing to underwrite recovery in cyclicals, how cautious they are in allocating capital near the top of a capital-expenditure or commodity cycle. Importantly, these managers tend to discuss macro, drawing on their experience rather than using formal tools.

Macro-framed

Macro-framed equity managers invest bottom-up but surround their research process with macro-aware guardrails. They tend to draw on multiple sources including sell-side economists, in-house macro commentary, policy releases and market indicators; and some refer to structured scenario work. The examples they provide emphasise risk framing more than idea generation.

Macro formalised as a risk overlay and set of guardrails.

Here, macro shapes ranges and constraints. It can inform maximum sector weights, suggest when to tighten exposure to interest-sensitive areas, help define downside scenarios for highly leveraged or cyclical stocks; or alter hurdle rates under different inflation or rate paths.

Macro-structured

Finally, there are macro-structured managers. These managers use explicit macro frameworks that influence their sector tilts, position sizes and, in some cases, valuation ranges. They refer to dashboards, scorecards and scenario models, and they describe specific actions under different macro conditions. For example, reducing cyclical exposure once certain leading indicators breach thresholds, or adjusting growth expectations when policy direction, currency regimes or real rates move in a meaningful way.

Macro tightly integrated into portfolio construction through frameworks.

Macro-framed managers use macro inputs to mainly build the fence around a fundamentally driven portfolio and steer how that portfolio is positioned through the cycle.

The four archetypes form a continuum rather than four rigid boxes — from macro-light stock pickers, through cycle-aware and macro-framed managers, to macro-structured integrators. None of these approaches is ‘right’ or ‘wrong’; each reflects a different mix of opportunity set, investment horizon and process discipline.

Conclusion — it is a continuum, not a contest

The survey reinforced a simple point — macro and micro analysis are not competing philosophies, but different vantage points on the same reality. Most equity managers remain fundamentally bottom-up in how they build conviction, spending most of their time on company research. Yet macro context is intertwined through that work more often than many labels suggest.

All four models are important and as a DFM we assess how managers with different approaches can be combined into a diversified portfolio, understanding the limits and benefits of macro data. Our key insight for investors is that ‘not forecasting macro’ does not mean ignoring it. In most of the investment processes that we examine, fundamentals drive conviction and macro defines the context in which those fundamentals evolve. Macro is in the micro, not as a replacement for stock-level judgement, but as a constant companion to it. A way of keeping one eye on the weather while you navigate the terrain.

Rembuluwani Ramuluvhana
Manager Research Analyst

Practice notes

Risk capacity... how much risk you can afford to take?

A three-part series on the three pillars of risk profiling.



Key points

- **Risk capacity is the financial ability to absorb losses without derailing your goals or needs.**
- **Risk capacity is determined by concrete financial circumstances like assets, income, debt, and time horizons.**
- **Risk capacity strengthens the integrity of a client's financial plan.**

Introduction

Client risk-profiling has been construed as a rather controversial concept over the years but has gradually matured into a well-understood and matured, multi-dimensional process that is comprised of three key components: **risk capacity (ability)**, **risk required (need)** and **risk tolerance (willingness)**. In this, the first of a three-part series, we briefly recap each component to assist advisers and their clients, starting with risk capacity. Understanding the nuanced difference between the three pillars of risk profiling is vital for know-how investing.

Definition

Assessing risk capacity is a cornerstone of holistic financial planning. A client's capacity to take on risk refers to their financial ability to withstand losses without derailing their lifestyle or long-term goals. It is **OBJECTIVE** and **MEASURABLE**. Risk capacity is financial — how much loss you can sustain — and sets the essential boundary for a sustainable investment strategy.

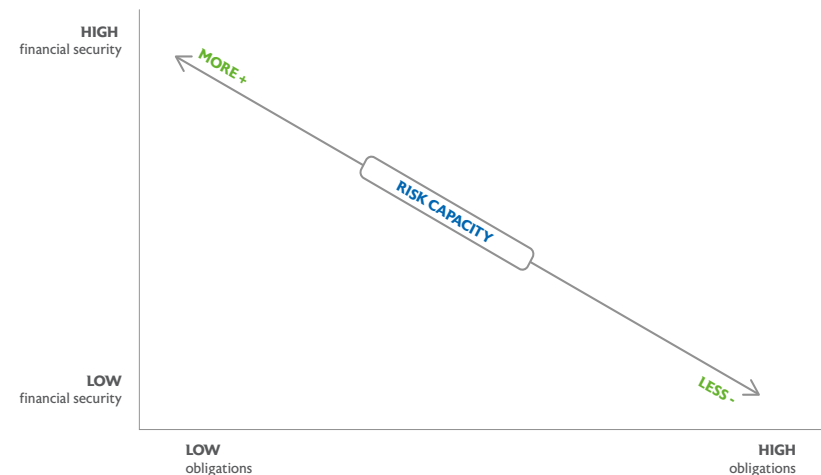
The concept ties directly to real-world financial constraints and timelines. For example, someone planning to buy a home in the next two years generally has less flexibility to take on investment risk than someone with no major short-term financial commitments. Even if both investors feel comfortable with market volatility, their capacity to withstand losses may differ significantly. Risk capacity also considers whether someone can maintain their lifestyle or fulfill their obligations if their investments decline in value. It acts as a financial boundary that helps determine how aggressive or conservative a portfolio can realistically be. This boundary may shift over time with changes in income, expenses or life events, but remains rooted in financial realities rather than preferences or opinions.

Determining risk capacity

Risk capacity involves a combination of objective assessments:

- **Time horizon:** longer time horizons allow for higher risk capacity because there is more time to recover from market downswings.
- **Income stability:** stable, predictable income allows for greater risk-taking.
- **Liquidity needs:** a high need for immediate cash (low liquidity) reduces capacity. Forced sales during a downturn are detrimental.
- **Financial obligations debt:** high debt levels or imminent large expenses reduce the capacity to absorb losses.
- **Savings pot:** disciplined savings over time compound in a meaningful investment/asset pool, allowing for greater risk-taking.

How to measure risk capacity



Practice notes

Risk capacity... how much risk you can afford to take? (cont.)



Risk capacity = (time horizon + income strength + asset base) – financial obligations



The stronger the positives and the smaller the obligations, the higher the capacity.

Measuring risk capacity involves analysing various aspects of a client's financial life to determine how much investment risk they can realistically afford. It relies on quantifiable data and financial modeling, rather than subjective judgment.

The length of time before funds are needed plays a key role. A longer time horizon allows for a wider range of outcomes, giving more room for a portfolio to recover from market downturns. Someone investing for a goal 25 years away, generally has a higher risk capacity than someone needing access to their funds in three years' time. Time horizon also influences how much liquidity and stability a portfolio may require. A portfolio that must generate income for living expenses or large upcoming purchases, has less room to absorb losses. Risk capacity drops when investors rely on their assets to fund near-term expenses, particularly if those expenses are fixed or unavoidable.

A steady or growing income stream can support a higher capacity for risk. And a high savings rate — asset base — can act as a cushion, helping replenish losses if markets decline.

Practical examples

Imagine you are in your early 40s with a stable income and a sizable emergency fund, with retirement still 20 years away. You contribute regularly to investment accounts and have no large near-term expenses. In this case, it is likely that your financial situation supports a higher level of investment risk — you can afford to ride out market downturns because you will not need to access your portfolio soon.

Now, picture a different phase of life: you are five years from retirement, helping a child through university and carrying a home loan. While your income may still be steady, the demands on your cash flow have increased and your time horizon has shortened. In this scenario, your risk capacity is likely to have decreased, even if your comfort with risk has not changed. These shifts show how risk capacity reflects your ability, not your willingness, to handle losses. It changes over time, depending on your life stage, financial goals and obligations. Recognising these shifts will help align your portfolio with your real financial situation.



Example 1: low risk capacity

- Age 58
- Retiring in two years
- No surplus income
- R4 million total savings
- Needs R3 800 000 to retire comfortably.

A 25% fall = R1 000 000 drop

Now capital = R3 000 000 → Retirement goal has been compromised.

This client has low risk capacity, regardless of their emotional tolerance.

Practice notes

Risk capacity... how much risk you can afford to take? (cont.)



Example 2: high risk capacity

- Age: 40
- Retirement age: 60 (20 years to go)
- Annual income: R1 200 000
- Annual expenses: R800 000
- Investable assets: R6 000 000
- Emergency fund: R400 000
- Bond outstanding: R1 million.

Step 1: calculate surplus income

$R1\ 200\ 000 - R800\ 000 = R400\ 000$ annual surplus
Strong surplus → positive for risk capacity

Step 2: emergency buffer

Monthly expenses = $R800\ 000 \div 12 = R66\ 667$
Emergency fund = R400 000
 $R400\ 000 \div R66\ 667 \approx 6$ months cover
Adequate liquidity → supports higher risk capacity

Step 3: time horizon

20 years to retirement → long horizon → expected to recover from volatility.

Step 4: stress test a market drop

Assume 60% equity exposure.
 $R6\ 000\ 000 \times 60\% = R3\ 600\ 000$ in equities.
If markets fall 25%: $R3\ 600\ 000 \times 25\% = R900\ 000$ temporary loss
Portfolio falls from R6 000 000 to R5 100 000.

Questions? Does this threaten retirement? Does it force lifestyle changes or not? Given the individual's strong income, ongoing contributions and long-term time horizon, ***it is likely that this person has a high capacity for risk.***

Protects your plan

The FAIS Act is very clear — advice must reflect a client's financial circumstances and not just their appetite for risk. Hence, determining/calculating a client's capacity for risk ensures compliance to the FAIS Act. It also prevents behavioural mistakes — clients who exceed their capacity are more likely to disinvest during market stress. Lastly, with risk capacity formulated, it strengthens the integrity of the client's financial plan.

The bottom line is that the appropriate level of investment risk should never exceed a client's financial capacity to withstand loss. It answers the question, "if markets fall by 20-30%, can I still achieve my goals without changing my plan?"

Conclusion

Risk is not something to avoid entirely but rather, something to manage intelligently. When risk capacity is clearly understood, expectations are realistic, portfolio volatility is easier to tolerate and emotional decision-making is reduced. Overall, it improves long-term investment discipline and ensures a financially sustainable investment strategy.



Risk capacity acts as the reality check between aspiration and affordability.

Albert Louw
Practice Manager



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