

# The ins and outs of investing

## Understanding the risks and rewards

Throughout our lives we're likely to be thinking about the need to save. In our early years it may be saving for a bike, or a holiday or a car. Later it'll be about buying a house or building up a pension. If we do save then we'll want to invest the money wisely, somewhere where it'll grow safely and where it'll be available for us when we need it.

This primer takes us through some of the things we should be thinking about when investing our money.

### A Windfall

Suppose that you have just won on the football pools or the national lottery and so you now have a large sum of money to invest.

Below are various options suggested to you. Your task is to decide how you might allocate your money across some or all of these options by analysing the strengths and weaknesses of each in terms of the rewards on offer and the risks involved.

- A Bank Deposit account
- Tesco shares
- Gold bars
- Index-linked National Savings certificates
- "Lucky Lad" in the 3.30 at Doncaster
- A home of your own
- A loan to a friend who would like to start a business
- Your own business

Your choice is likely to be based on the following kind of analysis:

### Bank Deposit Account

#### Rewards

Reasonable return but income and capital may be eroded by inflation.  
Predictable and regular cash income  
No capital growth.  
Not necessarily very tax efficient.

#### Risks

Low risk  
The investment is easy to turn back into cash.

### Tesco Shares

#### Rewards

Good return offering potential for both cash income in the form of dividends and capital growth (which may provide tax benefits).  
Major company and long-term income is fairly secure.

#### Risks

All shares are risky but Tesco is a major company and should be less risky than many.

The amount invested is easy to turn back into cash as there is a ready market in Tesco shares. However, the share price may fall and a capital loss sustained

### Gold bars

#### Rewards

Unknown. Highly speculative and dependent on global markets.  
No regular income. All reward comes through the potential increase in the value of gold.

#### Risks

High in the short-term, better in the long-term.  
Often seen as way of protecting yourself against currency fluctuations, inflation and political

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instability. Note: Gold has little intrinsic value; its value depends on there being a market but it is prized throughout the world and has a long history.

### **Index-linked National Savings Certificates**

#### *Rewards*

Reasonable return in the long-term.  
Part of the return is there to protect the capital from inflation; therefore the real return is quite low reflecting the safety of a Government backed investment  
Tax efficient.  
The return is higher the longer the money is invested.  
Income is not received without cashing in certificates.

#### *Risks*

Few risks.  
The capital is easy to withdraw.

### **Lucky Lad**

#### *Rewards*

Potentially high, depending on your expertise and the odds!

#### *Risks*

There is a great risk of having no income and losing all your capital.

### **A Home of your own**

#### *Rewards*

Reasonable return.  
No income as such but it avoids payment of rent.  
The investment needs to be looked after and maintained.  
Traditionally a good protection against inflation with high capital growth but subject to short-term fluctuation.  
Tax efficient.  
Large sums tied up without any cash being generated.

#### *Risks*

Low risk in the longer term but possibly costly if moving often.

### **A loan to a friend**

#### *Rewards*

As a loan, the reward comes through the interest not specifically the success of the business. A high risk loan may provide a high interest rate but the return is still likely to be fixed. Yet, the ability

to pay the interest is dependent on the success of the business.

No capital growth.

#### *Risks*

Capital may possibly be protected by security on the assets but this may not prove to be very valuable.

May not be easy to obtain back the capital invested if needed in the short-term.

### **Your own business**

#### *Rewards*

Potentially high dependent on success and your own expertise.

Potential for both income and capital growth.

#### *Risks*

High, but as management you have control of the affairs of the business.

### **So what are investors looking for?**

Having considered the above investment possibilities, we are now able to draw a few outline conclusions. The kinds of issues to consider will be along the following lines.

Any investor is looking for some form of reward whether it is profit, dividends, interest, capital appreciation or a mixture of all of them. The precise choice for any investor will depend on a number of considerations and they are likely to vary from one investor to another.

These considerations would include a person's willingness to take risks, their need to have a stream of income appearing in the form of cash, and also the time horizon over which they see the investment bearing fruit. For example, the needs of a young person who is planning to provide for a pension in forty years' time and can afford to take a long term view will be markedly different from a pensioner who needs a cash income to live on and whose time horizon is going to be much shorter.

Within that framework everybody obviously wishes to have as high a return as possible in relation to the amount invested and so investments will be compared with one another for their ability to provide a suitable return.

But it also seems reasonable that the higher the risk involved in an investment then the greater should be the reward. And so a straightforward comparison of investment returns will have to be tempered by consideration of the risk inherent in any investment and the attitude of the individual investor towards taking risks. This will depend on

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personal needs and personal preferences and everybody is different.

Some people will be very concerned about the security of their income, particularly those who need to generate a regular income from their investments. Others will look to ensure that their capital, that is their basic investment, remains intact as far as possible even if the return might vary. Yet others will be concerned about the ease with which they can withdraw or release the money they have invested especially if the investment has been used as a means of saving for a particular purpose, say paying school fees or putting a down deposit on a house.

In the latter circumstances it is unlikely that someone will want to lock up their money in investments where they cannot gain access to it easily or where the investment might fall in value significantly in the short term, even if in the longer term it is likely to show a good return.

### **Inflation**

Thinking about the best place to put our money should also encompass the ability of an investment and the rewards it offers to preserve its value in the face of changing purchasing power, in other words inflation. In such a case, possible high cash returns on, say, bank deposit investments compared with investing in shares would have to be put in the context of the gradual fall in purchasing power of the money tucked away in a bank.

This would have to be compared with the potential for companies to recover their cost increases through price increases and so maintain the real value of profits and, hence, dividends. As long as investors remain aware that part of their interest income is compensating them for the fall in value of their capital then all the options can be properly compared.

### **Investing is about the future**

Throughout our analysis we must have at the forefront of our minds that, much as we might like to, we cannot make decisions about the past, only about the future.

And so, however much we may look to past information to help us assess an investment, in particular accounting information, dividend payments, share price movements etc, what we are, in fact, trying to do is to use this information to help us make a judgement about the future. If the past information does not give us a guide to the future then it is not useful. In consequence, we should never be afraid to use any information whatsoever that we have, both financial and non-financial, both objective and subjective, to build up our knowledge and our confidence about an investment.

“Any information is good information if it gives us the right answer!”

### **Investing requires confidence**

If we do not have confidence that we will obtain an appropriate reward for the risk we are taking, why on earth should we part with our money? Confidence lies at the heart of all investing. A person must be willing to entrust an amount that they have or can borrow for the prospects of a greater but uncertain amount to be received in the future.

So, what kind of confidence should we be seeking? This confidence is required at various levels.

We must have confidence in the honest and fair operation of the investment market. This means that when we are considering investing we know that we are not at an automatic disadvantage because others have more information than we have. In addition, we must have confidence in the integrity of the management we are using to manage our affairs. This involves being confident that they are motivated to work on our behalf. It also involves having confidence in the financial information which comes out of the organisation.

Once we are happy with these, then what we would also wish to do is to understand and reassure ourselves on the prospects for the particular business we are investing in and the ability of the management concerned to make sound judgements relating to the opportunities and problems which present themselves within that business.

### **Taxation**

Finally, every investor should be considering the taxation aspects of their investments. Each investor's circumstances will be different and each will need to look at the effectiveness of his or her investments after all costs have been taken into account, including those of taxation.

### **Spreading the risk**

It is unlikely, even if we're able, that we would invest in one type of investment only. Firstly, we've got to balance our short and long term needs with the types of investment and, secondly, we should spread our risk. Even if we like investing in shares it would not be very prudent to invest all our money in one company only. Better would be to build up a portfolio of many shares, to protect us against the poor performance of any one company. “Not putting all our eggs in one basket” is a fundamental tenet of investing. There is more to come on this.