UNDERSTANDING INVESTMENTS

IN FIVE SIMPLE STEPS

Isn’t it time to get on top of your financial affairs?

We’ll make sure you get the appropriate advice based on your needs.

We provide professional financial advice on financial and tax planning, including tax efficient savings and investments, retirement planning, estate & inheritance tax planning.

To discuss your options, please contact us.

“YOU NEED TO KNOW WHAT YOU CAN REALISTICALLY ACHIEVE GIVEN YOUR CIRCUMSTANCES AND YOUR ATTITUDE TO RISK.”

There are five steps to this guide, as follows:

1. The Main Asset Classes
2. The Importance of Diversification
3. Know the Risks
4. Identify your Needs
5. Understanding your Capacity for Risk

STEP ONE:

THE MAIN ASSET CLASSES

Clients often kick off their initial consultation with us with questions like “Should we buy property?”, “Isn’t investing in stocks high risk?” Or “Should I just lock my money into a long-term savings account?”

This guide aims to give you the tools to answer those questions and more. It will inform you about the key concepts and terms in personal investment. It will give you the information to form the basis of your tailored personal investment strategy.

In our experience, one of the biggest fears people have about investing is that they will be sold something unsuitable – something too risky, something that requires a lot of monitoring or something that won’t give them the return they’re looking for in the timeframe they have.

The key to making sure this doesn’t happen lies in you; there’s a bit of self-examination involved. You need to know what you can realistically achieve given your circumstances and your attitude to risk. But first, some basics.

UNDERSTAND THE MAIN TYPES OF ASSET CLASSES

In Investment Land, as most of us perceive it, understanding the various types of investments is the privilege of a select few – the Wolf of Wall Street, Gordon Gekko and their ilk. Not true; it’s pretty simple. There are principally five asset classes:

1. Cash
2. Equities
3. Bonds
4. Alternatives
5. Property

“PEOPLE WHO DON’T TAKE RISKS GENERALLY MAKE ABOUT TWO BIG MISTAKES A YEAR. PEOPLE WHO DO TAKE RISKS GENERALLY MAKE ABOUT TWO BIG MISTAKES A YEAR.”

Peter F. Drucker

“YOU SHOULD NEVER MAKE PREDICTIONS, ESPECIALLY ABOUT THE FUTURE.”

Samuel Goldwyn

1. Cash refers mostly to investment or savings accounts in banks and building societies. Generally speaking, you trade off access for ROI (return on investment); accounts with minimum thresholds and long notice periods for withdrawal attract better interest. While cash is traditionally seen as being a safe asset, recent examples of bank failure have thrown a shadow over this notion. Your cash is only as safe as the institution in which it is invested. More on counterparty risk later. Another point to remember about cash is that, while you will see its value grow over time, you need to take inflation into account to calculate your real return.

2. Equities are shares. Essentially, you buy a share in a publically traded company. Your return is tied up with the performance of that company; the greater the profit it makes, the higher the value of the company, and therefore the higher the value of your share of it. The company may pay out dividends which could be a source of regular income, or you can choose the right moment to sell your shares, making a profit. However, as the radio ads never fail to tell us, the value of shares may go down as well as up.

Equities offer the potential for high return on investment, but they also carry a higher degree of risk than other asset types. The equities markets are notoriously skittish, and even when a company is profit-making, any decision considered by the markets to place the profits at risk can quickly lead to a drop in the share price.

3. Bonds can be described as loans to a company or government for a fixed term. In return for the loan, the lender (or investor) gets a guaranteed return. This return is generally fixed, so, while it won’t shoot up if the company or government does very well, equally it will not – or should not – fall. We’ve all heard the term ‘Burn the bond-holders’ a thousand times since the state’s bank guarantee scheme in 2008, which advice, if followed, would have seen investors in Irish government bonds or Irish bank bonds not receiving their agreed returns.

Bonds are considered to be a lower-risk investment than equities because they are impervious to short-term swings in performance. It is the long-term ability of the company or government to repay the loan that is important. That is not to say there is no risk. Agencies such as Standard & Poor’s and Moody’s assess each bond and give it a credit rating that is worth consulting before making an investment.

4. Alternatives are becoming more important because they offer – you guessed it – alternatives to the traditional three asset types of cash, equities and bonds. They include hedge funds, private equity and **commodities** – you may have heard talk recently about the good performance of gold, for example, which is a commodity. Other commodities include coffee, orange juice, cocoa and soya beans, oil, gas and other metals. Because commodities are not usually subject to the same influences as equities and bonds, they offer a valuable means of spreading risk in an investment portfolio.

5. Property is arguably the type of investment with which we are most familiar here in Ireland. Our experience of the property bubble of the first part of the century has taught us one of the key drawbacks of property as an investment, namely that its real value is only known when the property is sold, leading to a degree of uncertainty in terms of ROI.

While it is useful to know the various asset types, it is just as important to choose the right mix for your investment strategy. The magic formula is known as your **asset allocation**.

STEP TWO:
THE IMPORTANCE OF DIVERSIFICATION

Why do you even need to have a mix of investments? You are probably thinking you are doing well to have one of the five asset classes. Having a mix is all about spreading the risk and anyone who invested heavily in property to the exclusion of other assets will understand only too well why it can be a mistake to put all your eggs in one basket.

If you have invested in a pension, a conversation you will want to have had with your pensions adviser is this very one. There are thousands of investments available so there is no need to be stuck in a fund that could potentially cost you dearly.

The best asset allocation is the one that will protect you against major loss. That doesn't mean holding shares in a lot of different companies. It means having some shares, some bonds and perhaps some cash on deposit; in other words, a range of investment across several of the asset classes as mentioned in the previous step in this guide.

CASE STUDY

A very sad story illustrates an investor's need to diversify their portfolio. This case in question is about a sales executive who got caught up in the frenzied property market in the early 2000s.

John was a fan of buying properties 'off the plans' to flip them 6 months later pocketing a tidy profit. However, he had become a self-confessed property guru and he then started to dabble in bank shares.

In 2008, John owned 13 residential investment properties and had bank shares worth €250,000.

The property crash of 2008 saw his share holding wiped out and his 13 investment properties collapse in value. John is heading for retirement with combined mortgages outstanding of €3.5 million on properties worth €2 million. Sticking to one of the basic fundamentals of investing - that is to diversify - may have insulated John from the property crash.

"HOW MANY MILLIONAIRES DO YOU KNOW WHO HAVE BECOME WEALTHY BY INVESTING IN SAVINGS ACCOUNTS? I REST MY CASE."

Robert G. Allen

STEP THREE:
KNOW THE RISKS

Counterparty Risk

Counterparty: this is one of those words that cause people outside financial services to switch off. Counterparty risk is the risk of monetary loss you may be exposed to if the counterparty (or intermediary) can't meet its obligations under the terms of the transaction. If you invest directly with an entity, there is no counterparty. This risk only arises if there is a go-between.

Interest Rate Risk

This type of risk affects bond-holders more so than equity investors and it relates to interest rates. Bonds can reduce in value as interest rates rise, therefore affecting the value of your investment. However this risk can be effectively reduced by holding bonds and fixed income investments of different maturities in a portfolio.

Longevity Risk

We are living longer than ever before and while this is a good thing, it has implications for our investment strategies. Longevity risk refers to the fact that you may outlive your investments. The thought of being 93, penniless and in full time nursing care in never an attractive proposition.

> "RISK COMES FROM NOT KNOWING WHAT YOU'RE DOING"
>
> Warren Buffet

Inflation Risk

You cannot assess the success of any investment without taking inflation into account. In order to pinpoint the real rate of return, strip out any fees or charges as well as the rate of inflation over the investment period. The figure you arrive at is the real rate of return..

Sectoral Risk

If you have concentrated your investments on one sector, for example construction, you are exposing yourself to the risk that demand for that sector may dry up, exposing you to risk even where you have balance in terms of your asset classes within that sector. It may be tempting to invest in a sector with which you are familiar – perhaps you operate in it yourself – because you feel you will have your finger on the pulse and can predict developments, but you'd be well advised to spread your investments across a range of sectors. Equities are especially vulnerable to sectoral risk.

Behavioural Risk

This is perhaps the most important risk of all. If we could all make logical investment decisions based on the best information available, we might all be millionaires. The trouble is, being human, we allow our emotions to play a role, sometimes a deciding role, in our investment choices. Think about how big a part emotions play in the purchase of a home, for example. There is also the psychological phenomenon of **loss aversion**, which suggests that we feel the pain of loss more than the euphoria of gain. You can see how this, plus our emotional brains, would skew our investment behaviour.

STEP FOUR:
IDENTIFY YOUR NEEDS

So, this brings us to one of the nubs of successful investment; knowing what you need your investments to do.

How old are you? At what stage of your career are you? What do you want to do with your money and when? These things are important to establish before you make any investment decisions.

Ok, so the first question is pretty easy. The others less so, but it's important to pin the answers down. If you don't know where you want to end up, how do you plan your journey?

If you want to spend your winters in Florida during your retirement and you are now 34 years old, you need not concern yourself too much with short-term fluctuations in the value of your investments. They can afford to go through several cycles of boom and bust (well, hopefully not bust) before you need to cash them in. As you get nearer retirement age, however, you will need to change your strategy to a more conservative approach that will be all about preserving the value of your funds.

If, on the other hand, you have a teenage child who will need to be funded through university education in a couple of years, your needs are more immediate and you may be best advised to opt for lower-risk investment options.

A third possibility is that you need a steady stream of income from investment. Achieving this will involve a degree of trial and error to achieve the right **asset allocation** to deliver your goals. You will also need to be prepared to devote more time to monitoring and administering your portfolio.

THE MIRACLE OF COMPOUNDING

If George Washington had taken just one dollar from his first presidential salary and invested it at 8 percent - the average return on stocks over the past 200 years - his heirs would have an investment worth $8 million today

"STUDY AFTER STUDY COMES TO THE SAME CONCLUSION – CHASING PERFORMANCE IS AN EXPENSIVE EXERCISE AND ONE THAT WILL END IN DEFEAT. AVOID IT."

STEP FIVE:
UNDERSTANDING YOUR CAPACITY FOR RISK

This is what makes every single investment portfolio unique; you. We've already talked about behavioural risk – how likely are you to make irrational decisions driven by emotions? You also need to consider your **tolerance to risk** and your **capacity for risk**.

You may have gathered that investments tend to reward those who take risks; the riskier the stake, the higher the interest or earning potential. But you'll also have realised that high-risk strategies are not for everyone. How do you feel about them?

The phenomenon of risk aversion makes us more afraid of losing money than gaining it. This, coupled with behavioural factors influenced by our upbringing and personality means that each of us has a particular tolerance to risk.

Does Investment Land sound like way too scary a place for you? Or perhaps you can't wait to get there because it sounds like a lot of fun. There's one thing you can be assured of; it's a land of a thousand options – the proverbial 'something for everyone'. So even if your tolerance for risk is low and you don't want to expose yourself to it, there are investment strategies that are relatively low-risk, but will still perform better than a bog standard savings account.

"THE GOAL IS CLEAR: GET THE MOST OF WHAT YOU REALLY WANT OUT OF YOUR LIFE."

Professional investors as a whole are responsible for about 90 percent of all stock market trading. Accept that you cannot outsmart the market. Control what you have the capacity to control and accept the market for what it is.

Conclusion

These steps form the basis of a personalised investment strategy. The guide is not written for investors to make decisions in isolation. We would always recommend that you seek out appropriate and professional advice. While, having read the guide, you may not quite be equipped to navigate the choppy waters of personal investment, you should at least be able to read the chart. If you need some help to join to dots, don't hesitate to contact The Money Advisers.

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