What assets do you want to invest in?

This section looks at the different sorts of assets - cash, debt, shares, property, commodities, hedge funds and alternative investments - that are available to you. each of these has different risk and reward characteristics. A lot of this may be self-evident to many of you; please forgive us if we have over-simplified things a bit. This note just covers the basics and may prompt more questions in your mind. If in doubt, please consult a financial adviser.

Cash

The simplest asset type is cash. Cash doesn't tend to appreciate in value, except relative to cash issued by other countries (exchange rate movements).

Think about inflation

One of the most important things to remember about investing in cash is that there can be long periods where the return you earn (interest) is less than the rate of inflation. ***Inflation erodes the real value of any investment over time***.

A bank deposit is a debt it owes you

When you put money on deposit with a bank or a building society, it is much the same as you lending the bank money (so we are starting to cross the line between cash and debt.

Banks can get into trouble, if you've got a lot of cash, spread it around

Your risk in this case is that the bank / building society is unable to pay you your money back. This is a relatively rare occurrence thank goodness and, in the UK at least, the government will refund you up to £85,000. However, if you have more than £85,000 in cash, you might want to think about depositing money with more than one bank / building society.

Long-term deposits should earn higher rates of interest

Generally the longer you lock up your cash for, the higher the interest rate you get (and this pattern is common to other investments).

Peer-to-peer lending is generally riskier than depositing money with a bank

Recently, peer-to-peer lending has been attracting attention. As the name implies, this is more obviously classified as debt than cash. Here, instead of lending the bank money, you are lending it to another person or a company. Of course this is just the sort of thing the bank would be doing with your money anyway so, in one way, all you are doing is cutting out the middleman. However, the bank lends tiny parts of your money to very many different borrowers (***diversification***) and, in theory at least, is very careful about who it is lending it to. Peer-to-peer lending tends not to be so diversified and, in general, the risk you do not get paid back is much higher. Generally, higher interest rates can be earned by investing this way because the lender (you) wants to be paid for the extra risk you are taking.

Debt

Debt investments take many forms. These sorts of assets tend to be held more for income than to generate capital gains. They tend to be classified according to who the borrower is, how risky the debt is (the chance of getting repaid), how long before the debt is due to be repaid, what security the lender has (for example, does the lender get to seize the borrower's property if the debt is not repaid on time), can the debt be exchanged for another asset (for example, some company's debts can be converted into shares in that company) and what rate of interest is charged on the debt.

Yield

Dividing the interest receivable by the value of the debt gives you the ***yield***.

Higher risk demands higher reward

The rate of income earned on debt investments is directly related to how risky they are perceived to be so, in general, the higher the income, the higher the risk, as the increased interest compensates you for the chance of losing money if the borrower ***defaults*** (can't pay back the full value of the loan or the interest).

Government debt is often seen as low risk

Government debt has different names in different countries – Gilts in the UK, Treasuries in the US, JGBs in Japan, Bunds in Germany, OATs in France. Generally, but not always (think of Argentina or Greece) lending money to governments is lower risk than lending money to companies based in the same country. Therefore lower risk usually means lower return and interest rates on government bonds tend to be lower than on debt issued by companies.

Right now government debt <u>might</u> be very risky

In recent years though, many previously very safe countries, like the UK, US, Japan and many members of the Euro, have been borrowing vast amounts and manipulating their interest rates downwards. Some investors think this situation is not sustainable. Think about the yield definition above, if yields move from 2% to 4%, the value of the debt halves.

You can invest in debt issued by some companies

You can invest in debt issued by companies in a few different ways. Debt traded on a stock exchange is often referred to as corporate bonds but financial companies such as banks issue all sorts of other tradable debt instruments.

Shares

Shares are issued by companies. If you own all a company's shares you own the company.

Private equity

Most companies' shares are not traded on a stock exchange – these are private companies. When institutions invest in them it is called private equity.

An investment in a private / unquoted company can be rewarding but it is much harder to turn your investment into cash than an investment in a public / quoted company and so you should demand a higher return for this type of investment.

To have their shares traded, public / quoted companies have to abide by a number of regulations, keep their investors informed and have their accounts audited. Private companies, especially small ones, aren't subject to as many rules.

Dividends and capital gains

As a shareholder in a quoted company you get rewarded two ways, you get dividends – a share of the profits the company makes – and capital gains when the share price goes up.

Share prices can be hard to predict

Share prices are determined by supply and demand – more buyers than sellers then prices rise and vice versa. People buy shares when they are excited about the prospects for the company. This excitement can be in response to measurable things like historic profits and sales but is also driven by less certain things such as sales growth forecasts. Share prices can be volatile and can react to things outside the company's control.

Don't forget that many companies borrow money and this can make them riskier.

Property

Don't forget you probably already own a lot of property

If you own a house you already have a big exposure to property. Factor this in before considering an investment in this area. Houses (residential property) can perform quite differently to Offices, Retail (shops), Industrial and Logistics (warehouses) however.

Property has some of the same attributes as shares in that it usually throws off an income and there is a chance of a capital gain as rents rise or from building new property or expanding or refurbishing existing property.

Direct investment in property might be impractical

You'd need quite a lot of cash to consider investing in property directly, especially if you are being sensible and making sure you are diversifying your investments. It might be easier to make a smaller investment into a fund or a REIT (real estate investment trust).

Remember though that many property companies and funds borrow money to enhance returns and again this can make them riskier.

Commodities

Some people invest in commodities directly – things like gold, silver, iron, wheat, oil and timber. Commodities do not pay you an income, in fact some of them cost you money to hold, so people invest in them with the hope of making a capital gain. The prices of physical commodities can be quite volatile and unpredictable so this is usually seen as a high risk investment.

Hedge Funds

Hedge funds may invest in any of these assets but they also tend to invest in ***derivatives*** – financial contracts that can take many forms but most simply give you the right to buy or sell an asset at a fixed price in the future. Derivatives can be designed with the aim of reducing risk but can also be used to enhance returns without borrowing money.

The minimum size for making an investment in a hedge fund can be quite large ($250,000 is not uncommon), so including them in a diversified ***portfolio*** (a collection of investments) might be impractical. Funds are available that invest in this area and allow you to invest much smaller quantities.

Alternatives

And then there are a number of assets that do not fall neatly into any of the other categories. Funds have been created to invest in things as diverse as aircraft, reinsurance contracts, life insurance policies, solar & wind power and infrastructure. The risks and rewards offered by these varies quite a bit. As a general rule, and this should apply to everything you invest in, **if you are not sure you understand a fund then it is best avoided – stick to something simpler.**