an introduction to investment

Welcome to 'principles of investment'. These factsheets aim to provide an understanding of particular investment topics.

We start with an introduction to investment, including a look at risk profiling – vital in formulating an investment objective.

how much risk can you handle?

There are many different reasons for investing and any two people will not have exactly the same objectives. For some it might be a way to pay off a mortgage, for others a way to build a retirement fund or safeguard their long-term savings.

The level of risk that an investor may be willing to accept is an important consideration that needs to be established before an investment is made. Typically, risk is assessed using the following broad categories:

1. Low risk

Tend to prefer investments with low or no risks. Low-risk investors may be more interested in preserving the capital value of their investment than increasing its value.

2. Medium risk

A reasonable emphasis is placed on growth investments together with an acceptance that these could go down in value as well as up. Medium-risk investors can tolerate some fluctuations and volatility, but tend to stay away from investments that may dramatically or frequently change in value (either increase or decrease).

3. High risk

Accept a greater risk of a decline in value in return for potentially higher returns. High-risk investors are prepared for the possibility of losing a large proportion or all of the money invested.

Investing is not about gambling or speculation. It is about taking reasonable financial risks to achieve specific goals.

different investments carry different levels of risk

cash

Cash or deposit accounts are often regarded as low risk, but they are by no means risk-free. Inflation, for example, reduces the purchasing power of cash if it exceeds the rate of interest earned, as it increases the value of goods and services over time. This means that the real value of investments into cash-like products could decrease over time. There is also an 'opportunity risk' of not being invested into other types of investments that could potentially deliver better returns.

bonds

Many low-risk investors choose to invest in bonds or fixed-interest securities. When investing in a bond an investor is essentially loaning money to either a Government or a company for a fixed term. In return for the loan, these entities pay a fixed rate of interest, usually at regular periods, and buy back the bond when it matures.
The benefit of this type of investment is that the investor receives a fixed income. The risk is that the company may default and fail to return part or all of the original investment or the redemption value may be less than the purchase price.

shares

Historically, the best returns for a long-term investor have been from investment in shares (also referred to as equities). However, past performance is not a guide to future performance and investing in individual shares does mean taking on greater risk.

The price of companies trading on a stock market is a reflection of their value as interpreted by supply and demand for the shares by investors. When investing in a company the investor is essentially buying a part of that company and its future profits. On the other hand, they also own the potential losses. The risk can be high, especially if shares are owned in only a handful of companies. If one company is not performing well, this can have a significant effect on the value of the total investment.

The potential exposure to risk can be reduced for an entire investment portfolio if an investor spreads the risk amongst several company shares in different sectors. This can be taken a step further by investing across a wide range of different asset classes, such as shares, bonds and cash. In this way, an investor is achieving diversification across their portfolio, lessening its overall vulnerability.

achieving diversification

Take a portfolio holding shares in an ice cream company. If another ice cream company is added to that portfolio it reduces the reliance on the performance of that one company. However, the portfolio is still dependent upon one factor: the demand for ice cream. If this demand drops, the portfolio will suffer.

By adding a share in another sector, for example a sun lotion company, an investor will have a more diverse portfolio and reduce the risk of being in one market sector. However, this means exposure to the risk of a rainy summer. To solve this problem an umbrella manufacturer could be added to the portfolio – an asset that will appreciate during a rainy summer and potentially, or go some way towards offsetting the poor performance of the ice cream and sun lotion companies.

Investing in the stock market may be more suited to someone willing to accept medium- or high-risk investments – an adviser will be able to determine how suitable they are for each investor.

investment funds

A way of investing in all these asset classes could be to invest in an investment fund. An investment fund offers a potentially less risky solution than holding a small number of shares directly. Under the supervision of a fund manager, an investment fund pools together money from many investors. This combined pool of money is spread across a number of assets with the aim of reducing the risk of the overall portfolio. The concept is to enable investors to have a diversified portfolio with a stake in a wide range of assets.

Each fund has an objective which describes what it aims to accomplish for its investors and how it plans to achieve it. Some fund managers will aim to achieve high returns by investing in riskier stocks, which offer potentially higher returns but could also result in higher losses. Others are more defensive, seeking reasonable gains without the threat of big losses. However, no matter where they invest, the value of investment funds may go down as well as up.

The choice of funds today is enormous, with funds that invest in different countries, regions and industries – as well as a mixture of bonds, shares or other financial investments. A financial adviser will provide an investor with the necessary guidance when selecting funds for investment.

Whatever the type of investment being considered, it is important that it is tailored to each investor's preferred level of risk.

This is why Skandia considers it essential that investors use the expertise of a financial adviser, who will be able to help you assess risk profiles and recommend suitable investments for you.

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