MODULE 7 Investment

Learning objectives

By the end of the session you will…

Understand the difference between saving and investing money.

Be aware of the risks of investing money.

Have a better understanding of the various types of investments and what they provide.

Have a better understanding of the jargon & terms used in investment.

Be clearer about what you want from your money.

Activity

7.1 Consider the difference between saving and investing.

7.2 Consider the meaning of risk in terms of investing money.

7.3 The link between risk and return – The risk triangle.

7.4 Consider different investment options for the Case Studies.

7.5 What do you want from your money?

7.6 A jargon buster.

7.1 What is the difference between saving and investing money?

Saving is setting aside part of a regular income for use in the future. These savings need to be 'stored'.

The common way of storing money is in a bank or building society where the money can be regarded as safe. However, because the money is safe, the returns are quite low. If higher returns are sought then money can be invested in other ways which carry a higher degree of risk. This is what is normally called investment.

It is important to realise that investment involves risk and money can be lost. When you sell an investment it may be worth less money than you put into it in the first place, e.g. some shares in companies are worth less today than they were a year ago, others are worth more.

7.2 Consider the meaning of risk in terms of investing your money

Risk is the extent to which an investment is exposed to the chance of loss.

Where are you on the risk spectrum below?

I love risk ⟷ I hate risk

People respond to the risk of investing in different ways. At one end of the spectrum are people who hate risk and could not sleep at night were their investments exposed to any sort of risk. Other people find risk thrilling, and are prepared to accept it in seeking higher returns on their money. Most people are in between the two extremes.

Various factors affect an individual's response to risk, e.g. If money is scarce and needed soon, taking a risk with money would not be a good idea. If the money is needed for essentials then putting it at risk could have serious consequences if some of it is lost. Attitudes to risk may also be influenced by age, e.g. older people have less time to replace the money if it is reduced in a high risk investment. It is important to consider all these factors before making decisions about investment options. For many people, money is hard to come by and all too easy to lose.

The three boxes

In considering your risk profile, don't forget to ask yourself:-

What is the money needed for?
How soon is the money needed?
Would it be a disaster if part of the money is lost?

A useful approach might be to look at money in terms of three boxes. The **first** box will consist of money you need to keep for emergencies and the **second** box consists of money to produce income and not put at risk. The **third** box consists of any remaining money after the first two boxes have been created. More risk can be taken with this box in the hope of obtaining higher returns.

1	2	3
For emergencies	Investment for income and security	Higher risk investments

The size of the boxes depends on personal circumstances, e.g. if there is no money left after boxes 1 and 2 are created, then box 3 will be empty. Remember that your circumstances are likely to change as you get older – you should therefore review the contents of the three boxes regularly.

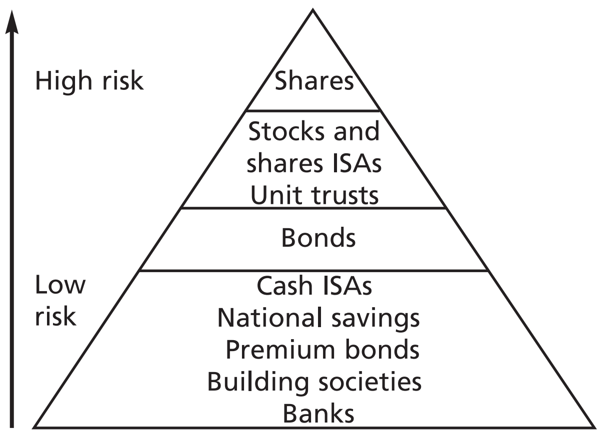
The money in box 1 needs to be accessible; emergencies can come without warning so the money needs to be easily available.

7.3 What is the link between risk and return on an investment?

Low risk is generally associated with low returns and high risk can sometimes generate moderate to high returns. Don't miss the point that the high risk options may have no returns and/or their capital value may fall. That's why they are high risk. If you need to hold on to that money it is very important not to put it in a high risk investment.

The risk triangle shows the higher risk investments at the tip of the triangle. Less risky ways of storing savings are at the base of the triangle.

The Risk Triangle



For more information on these terms, see page **7**/3

Understanding the risk

Because risk is so important, it is essential to have accurate information about investment options.

There are different types of information. Some information is factual and unbiased. Other information is designed to promote a particular financial service or product.

What are the disadvantages of promotional information?

Promotional information may not be unbiased and by focusing on only some aspects may actually be misleading. It can be helpful to have a checklist of questions about the information and also to get information from more than one place so that you can make comparisons.

What can you do to check out financial information?

It is useful to get information from more than one source.

Wherever possible obtain Company reports for shares.

Most daily and weekend papers have money sections (on different days for different papers). Many magazines are published on finance / investment matters.

The Risk Triangle explained in more detail

Banks provide safe-keeping for cash and offer several different types of account. The main ones are:-
Current accounts for ready access to your money, but normally carry a very low rate of interest.
Savings accounts which often limit immediate access to your money, but offer higher rates of interest.

Building societies are similar to banks, but are mutual organisations, i.e. they are owned by their members and have no shareholders. They mostly offer savings accounts, some of which allow immediate access to your money.
NB Banks and Building societies offer other financial services such as mortgages, insurance and advice.

Premium Bonds give you a guaranteed return on your capital at any time, but carry no interest. Instead there is a monthly draw with prizes ranging from £25 to £1 million. These bonds can be obtained from post offices.

National Savings Certificates are issued by the Government, and are therefore as safe an investment as you can get. They offer relatively low interest rates, but the interest is tax-free, and they run for a period of five years. There are two types:-
Fixed rate, where the interest is guaranteed for a five-year period,
and
Index-linked which pay a lower rate of guaranteed interest plus inflation.

Other kinds of National Savings are available. Details and purchases can be obtained from post offices or direct from National Savings & Investments.

Bonds come in two main forms:-
Government Bonds *(or Gilts) are issued by the Government and carry fixed interest or index-linked returns. They can be bought and sold by individuals, with their prices varying according to current interest rates.*
Corporate Bonds *are issued by large companies who wish to borrow money, and carry a fixed rate of interest. As they are less secure than Government Bonds, the interest rate is usually higher.*

Unit Trusts are managed by professional investment managers and consist of a large number of different shares. This allows small investors to spread their investment risk, which they could not do themselves.

ISAs (or Individual Savings Accounts) allow you to hold taxable investments (like shares, Unit Trusts, insurances and cash) without having to pay tax on them. There is a limit on the amount you can pay into an ISA each year. You may have a Stocks and Shares ISA which holds shares and Unit Trusts and are are regarded as having greater risk than Cash ISAs which hold cash savings.

Shares are so-called because they give you a ‘share’ in the ownership of a company. The prices of shares rise and fall according to the company’s prospects of making profits, and other economic factors. Prices can also be affected by the views of other investors as to what might happen to the company in the future. The capital you invest in shares is not protected.

Alternative investments
There are other types of investment, such as property, works of art, etc. This is a specialist area which is not covered here.

7.4 Consider the various investment options available in the tables provided.
What is the link between risk and time?
If the money is required soon, risk needs to be avoided, since losses cannot be regained in the time available.

If the money is not required for some time, say five years or more, it may be appropriate to take some risk to have the chance of higher returns. Historically shares have usually performed better than safer investments over a period of years but, of course, the past is not necessarily a guide to the future.

Investment portfolios

Consider the example investment portfolios and set out the risk profile for the one most appropriate to your own situation. Suggest suitable investment options (up to three).

1) Janet – 57 years old, has a low paid part-time job, pays a small amount into a personal pension. She has very little savings and owns a small house. She hopes to retire at 60.

Amount to invest – £20,000
Aim of investment – Wants income in her retirement.

What are the investment options for Janet?
Give reason for your choice.

2) Tom is 65 and has just retired. He has in addition to his state pension, a small occupational (company) pension.

Amount to invest – £20,000
Aim of investment – to produce extra income in retirement.

What are the investment options for Tom?
Give reason for your choice.

3) Angela is 40, married with 2 small children and doesn't have a paid job. Her husband has a job in a large company with an occupational pension. They have a house with a mortgage of £80,000 still outstanding.

Amount to invest – Angela has inherited **£120,000**
Aim of investment – **to provide some personal security for the future for herself and the children.**

What are the investment options for Angela? Give reason for your choice.

4) Margaret is 73 and lives alone. She has a pension, lives in a house which she owns. She has a son and two grandchildren.

Amount to invest – **£7,000**
Aim of Investment – **a concern about long term care costs.**

What are the investment options for Margaret? Give reason for your choice.

5) Anne is aged 26 and has a job with good prospects. She lives at home with her parents.

Amount to invest – **£2,750**
Aim of Investment – **to prepare for a rainy day or to buy a car in two years' time.**

What are the investment options for Anne? Give reason for your choice.

Investment portfolios answers

1) Janet – 57 years old, has a low paid part-time job, pays a small amount into a personal pension. She has very little savings and owns a small house. She hopes to retire at 60.

Amount to invest – **£20,000**
Aim of investment – **Wants income in her retirement.**

What are the investment options for Janet? Give reason for your choice.

Answer: The risk profile for Janet is as follows
Low income and assets
Time is short

Investment Options
Janet cannot afford to take any risks, which means that her investments must carry minimum risk. So, she should choose things at the bottom of the risk triangle, eg National Savings, Building Society, Savings Account or Cash ISA. Alternatively, since Janet is three years from her planned retirement, she could consider putting her money into Bonds until then.

2) Tom is 65 and has just retired. He has in addition to his state pension, a small occupational (company) pension.

Amount to invest – **£20,000**
Aim of investment – **to produce extra income in retirement.**

What are the investment options for Tom? Give reason for your choice.

Answer: The risk profile for Tom is as follows
His medium-term income is unlikely to increase
He wants income immediately
The income should be without much risk to his capital, so the capital needs to be protected

Investment Options
Tom should opt for low risk options like National Savings, Building Society or Cash ISA. He might consider buying an annuity (see jargon buster on page **7**/9), which would protect his income (but would give away his capital). Alternatively, if he is prepared to take some risk, he could invest in a Stocks and Shares ISA. He may benefit from taking financial advice.

3) Angela is 40, married with 2 small children and doesn't have a paid job. Her husband has a job in a large company with an occupational pension. They have a house with a mortgage of £80,000 still outstanding.

Amount to invest – Angela has inherited **£120,000**
Aim of investment – **to provide some personal security for the future for herself and the children.**

What are the investment options for Angela? Give reason for your choice.

Answer: The risk profile for Angela is as follows
Her time scale is medium- to long-term
She can therefore afford some risk

Investment Options
One option would be to pay off the mortgage, particularly since mortgage interest no longer attracts tax relief. She could usefully consider the Three-Box approach (see page **7**/2).

4) Margaret is 73 and lives alone. She has a pension, lives in a house which she owns. She has a son and two grandchildren.

Amount to invest – **£7,000**
Aim of Investment – **a concern about long term care costs.**

What are the investment options for Margaret?
Give reason for your choice.

Answer: The risk profile for Margaret is as follows
Low income and assets
Time is short

Investment Options
Margaret could invest in in National Savings or use the money to purchase a long-term care insurance policy. Alternatively, she could spend the money now and, if and when necessary, release capital by selling her house and buying a smaller one.

5) Anne is aged 26 and has a job with good prospects. She lives at home with her parents.

Amount to invest – **£2,750**
Aim of Investment – **to prepare for a rainy day or to buy a car in two years' time.**

What are the investment options for Anne?
Give reason for your choice.

Answer: The risk profile for Anne is as follows
She has time on her side
Needs ready access

Investment Options
If she is risk averse she could put the money in a building society, direct telephone or internet notice account or Cash ISA. If she is prepared to accept some risk she could consider things at the top of the risk triangle on Page **7**/2 of this module such as Stocks and shares ISAs or Unit Trusts.

7.5 Consider what you want from your money

Personal preferences will to some degree depend on personal circumstances, e.g. a young single person may well have different needs from a married person approaching retirement. You can only get the best from your money if you are clear what you want it to do.

Knowing what you want from your money will enable you to make appropriate decisions about saving and investment.

Tick the list below and fill in any additional wants.

I want my money to:

- [ ] Create income to live on
- [ ] Provide a cash reserve for emergencies
- [ ] Protect a cash lump sum from inflation
- [ ] Have easy access to some of it
- [ ] Reduce the amount of tax I pay
- [ ] Protect assets for my family's future
- [ ] Have a great holiday
- [ ] Go to university
- [ ] ____________________
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7.6 A jargon buster

Look at the terms used in the jargon buster. Understanding these will help you make sense of the information in daily papers or magazines. If you speak to a financial adviser, you will be more able to make the most of the experience. You will be able to compare one investment with another if you have some knowledge to begin with.

Annuity

An insurance contract that pays you an income for life in exchange for the lump sum you've accumulated in your pension fund. As with all insurance policies, you may get back less than you've paid in – if you die early, for example. Alternatively, you could end up receiving much more income over the years than your fund was originally worth.

The income you get depends not only on the size of your pension fund, but also on the annuity rate you've been offered. Rates differ between providers, and also vary according to your life expectancy, interest rates and the benefits included in the policy. The older you are when you take out the policy, the higher the rate, as insurers don't expect to have to pay out for as long. Women are offered lower annuity rates for the same size of pension fund, as they tend to live longer than men.

Asset

Anything owned of value. Investment assets are mainly cash (deposits), property, bonds and shares.

Bid Price

The price at which an investor sells investments such as shares, unit trusts, investment trusts, investment bonds and other unit-linked investments.

Bonds

These are loans to large organisations, such as governments and companies, which investors can purchase. Interest is normally paid. Bonds are for specific periods of time which can vary from a few months to several years. 'Life assurance bonds' are different.

Capital Growth

The rise in value of any investment.

Capital Protection

This is a guarantee which either a) protects an investment against future losses due to inflation or b) promises no loss on the original sum invested.

Commission

The fee you pay a) to investment companies and stockbrokers for buying and selling your investments or b) to financial advisers for advising on and arranging your investments.

Coupon

The interest rate payable on a bond or gilt.

Dividend

The payment made by companies to shareholders out of profits. Interim dividends are paid part way through the financial year and authorised solely by company directors. Final dividends are proposed by directors each year but need to be approved by shareholders at the Annual General Meeting.

Friendly societies

These are mutually owned organisations which offer tax-exempt savings schemes and insurance plans. All assets are owned wholly by the society's investors. For further information, contact the Association of Friendly Societies.

Gilts

The common name for HM Government gilt-edged securities. These are loans (i.e. bonds) issued and backed by the Government.

Inflation

The change in the average cost of living over time.

ISAs

The abbreviation for Individual Savings Accounts – the Government tax shelter system introduced in April 1999 to encourage more individuals to save and invest for their future needs. Up to annual investment limits, ISAs are currently free of both income tax (except on share dividends) and capital gains tax. ISAs cover most savings and investment products ranging from ordinary deposit accounts to investments on the stock market.

From 6th April 2008, PEPs (see next page) have been reclassified as ISAs.

Liability
The opposite of 'asset'. Liabilities reduce the value of assets.

Liquidity
This is a measure of how reliably and quickly an asset or investment can be exchanged without financial loss. Cash is very liquid but many bonds are not, as redeeming them early, if permitted, can lead to extra charges, loss of value or both.

Market
A place where investments are traded such as the stock market, bond market, or money markets.

Market risk
The risk attached to all investments which can be bought and sold. Investors stand to either gain or lose from an investment depending on whether market price goes up or down.

Maturity
The date at which a contract (bond, insurance policy, etc.) is repaid to the holder.

Offer Price
The price at which an investor buys investments such as shares, unit trusts, investment trusts, investment bonds or other unit-linked investments.

Ordinary Shares
The type of shares usually issued by a company. A company is owned by its ordinary shareholders who have the right to receive a dividend if declared and to vote at company meetings. These shares carry the highest risk and holders are the last to receive their money back in the event of the company going out of business.

Preference Shares
These are less risky than ordinary shares as purchasers receive prior claim on the dividends payable and on proceeds in a liquidation – usually in return for accepting a fixed dividend.

PEP
The abbreviation for Personal Equity Plan, now replaced by the Stocks and Shares ISA. If you have a PEP you cannot put any more money into it, but existing funds will continue to grow tax-free. You can also transfer your PEP from one institutional provider to another so long as you do not sell any funds for cash in doing so.

From 6th April 2008, all PEPs have been reclassified as ISAs.

Real
An important word in investment. A 'real rate of return' on investment is any growth above the rate of inflation. Value rising by inflation only is said to maintain its real value.

Redemption Date
The date on which a bond is due to be repaid to the holder at its full face value. Some give the year of redemption in their name.

Securities
The general name for all types of stocks, shares and other investments which are traded on a market, except for commodities (such as gold or tin) or money.

Socially Directed Investment (SDI)
A type of socially responsible or ethical investment which aims to achieve a positive social or environmental impact, but which does not usually provide a high financial return.

Socially Responsible Investment (SRI)
Covers investment products that seek to address social, environmental and/or ethical concerns as well as meeting financial aims.

Spread
This refers to two key investment aspects. 'Market spread' is the difference between the bid and offer price of a security. The small percentage difference between the two prices represents the fee payable to the market maker (the person who arranges the sale). 'Investment spread' is the number and different types of investment that you hold.

Terms

The restrictions or contractual conditions that apply to an investment such as a minimum and/or maximum sum or notice period for withdrawal.

Yield

The annual return on a security which is measured as a percentage of its current price. For shares, this is usually based on the assumption that the next dividend payable will be the same as the last dividend paid.