

The Principles of Investing

Answer – only one but the light bulb might go down as well as up – Chris Budd looks at some of the basic principles of investing, and clears up some misunderstandings.

It came home to me recently, when discussing the existing portfolio of a long standing client, how easy it is to take for granted some of the basic principles that we apply when managing clients investments.

Take, for example, some of the terminology we use. What, for example, is a ‘bond’? In practice, there are three, perhaps four, different applications of the word bond:

Investment Bond – this is a type of product, offered by insurance companies, and is a mechanism for investing into funds. It is no different, in this regard, to unit trusts, ISAs etc, but has different taxation implications.

Government Bond – these are perhaps more commonly known as Gilts, and are a method by which the government raises money. As such, they are low risk investment, and generally offer a fixed rate of return.

Corporate Bond – very similar to a Gilt, but issued by companies, therefore slightly higher risk.

Premium Bond – certificates issued by the government which offer the chance to win prizes.

We must, as investment advisors, therefore be careful when using such jargon. I often come across the issue that clients perceive, for example, ISAs to be higher risk than other forms of investments. This misnomer is perpetuated by the media, in fact ISAs can invest into low risk funds (such as gilts) equally as they can invest into higher risk funds.

Wrappers

There are many different methods for investing, including ISAs, unit trusts, investments trusts, investment bonds, and pensions. In actual fact, each of these allows you to invest into a range of funds. They just have different taxation implications.

If I may be allowed a rather strained analogy, the different ways of investing can be likened to a football stadium. There will be a large number of entrances to the ground. Further, there will be different sections, including terracing, seating, family enclosure, and corporate boxes. However, everyone is there to watch the same game.

In the same way, the seemingly confusing array of investment products are actually just different routes for investing into the same asset classes.

What is an asset class?

In structuring one's investments, therefore, one should utilise the different types of investments listed above in order of their tax efficiency and appropriate to one's circumstances, and then look to do a versify around the different asset classes.

I have written about asset classes before. In short, this is a phrase used to describe the different types of areas of investment. These include stocks and shares, corporate bonds, gilts, building society, national savings, property etc.

An asset allocation, therefore, refers to the spread of one's investments around these different asset classes. Providing a good spread ensures that risk is reduced, so that if the stock market, for example, were to go down, one's investments would not as a whole go down by the same amount, as part of the portfolio would have been invested in other asset classes such as corporate bonds and property.

The actual split will be different for each individual, and will depend upon factors such as your attitude towards investment risk. For example, someone willing to adopt a high risk strategy would have only a small amount in low risk areas such as gilts and corporate bonds, and a larger amount in stocks and shares, which itself would be broken down to include areas such as Japan and Emerging Markets.

Someone with a lower risk strategy may have only a small amount in stocks and shares, within which they may avoid some of these higher risk areas, but will have large amounts in lower risk funds such as corporate bonds (accepting that all investments carry at least some degree of investment risk – even money under the mattress can be stolen by a burglar).

Conclusion

We can therefore see that every single person has an investment strategy, whether they know it or not. From the most risk averse, who will keep all their money in a building society, to someone with a sophisticated approach to asset allocation and who regularly reviews their portfolio, everyone is adopting an approach to taking risk versus wanting growth.

In doing so, following the process outlined above i.e. choose your vehicles carefully, and decide on your asset allocation, then you will at least have a process that can be followed, hopefully, without being confused by too much by jargon.

This article is for general information only. Remember past performance is not a guide to future performance and investments can go up as well as down. If you have any doubts in respect of your own personal circumstances you should request a full review with an independent financial adviser to get their help.

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