Financial SAFEGUARD

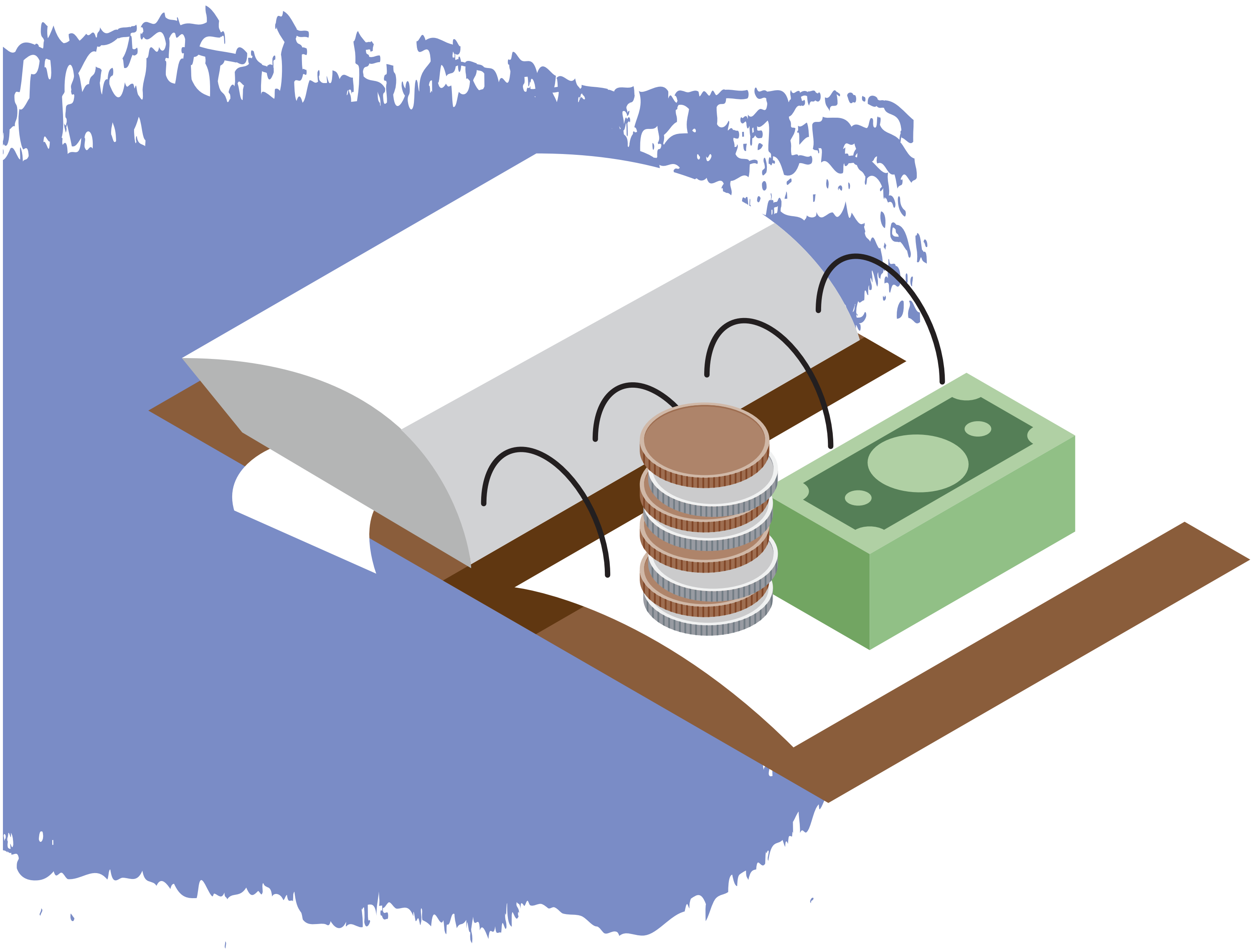
More about

Investments:
Understanding investments

Introduction

There are a number of reasons to invest, such as, to earn a return on idle resources; to generate a specified sum of money; for a specific future purpose and to provide for future uncertainties.

Depending on what you invest in, and how you choose to invest, you may make a profit if you sell your investment for more than you paid for it. You may also be able to earn income whilst you own your investment.



1. Understanding investments

What you earn, is known as "Return on Investment".

Naturally, we all want to achieve the highest return possible. However, it is very important to consider that different investments carry different types of "risks", and that returns are often not a "black-and-white" scenario. It is therefore important to balance the risk with the amount of return that you want to achieve.

It is vitally important to have an "investment goal" in mind and to consider exactly how "long you may have to invest". You need to have an investment plan / strategy. This will help you to decide how much money you want to invest and how you want to invest it. For example, do you want to grow your capital, save to beat inflation or preserve the money that you are putting away for retirement?

Note: Investing can be described as using your money to buy something that you believe will earn you more money in the future.

There are two categories of investments namely:

- Variable income investments. A variable-income investment pays interest at a rate that changes based on variety of factors, such as the growth of the company being invested in or its economic situation or the behaviour of the financial markets. An example of a variable income investment is buying shares in a company.
- Fixed interest investments. An investment that pays interest at a rate known in advance by the investor for example government bonds.

1.1 Return on investments

When you invest, your invested money is called your Capital and the things you invest in like shares, bonds and unit trusts are referred to as Assets.

If the price of your asset increases over the period that you own it, your capital grows. Some assets may also earn income for you whilst you hold them, like dividends payments (dividends are sums of money paid regularly, normally once a year, by a company to its shareholders out of the profits the company has made) from companies that pay out profits. The capital growth and interest earned is referred to as the return on investment (ROI).

The return on investment is expressed as a percentage.

When formulating your investment plan, you need to decide what percentage of return you will need in order to achieve your goal.

Of course, you have to be very mindful of the fact that investment returns on high-return investments are not guaranteed.

Often, the past performance of an investment cannot be used as a fool-proof indicator of the future returns that may be earned from that investment.

Note

- Capital is the money you invest.
- Assets are the instruments you invest in.
- Return is the difference between what you invested and what you get out at the end.
- Positive return = profit
- Negative return = loss

1.2 Risks and investment

Returns are very closely associated with risk, both type and level, which differ, depending on what you invest in. The most obvious and significant doomsday risk is the likelihood that you will lose all your money on a permanent basis. However, risk can also be associated with the concept of volatility or simply not achieving the initial financial goal. It is for this reason that it is imperative that you understand what you are buying and when and how it will earn you a return.

The value of an investment can also move up and down unpredictably as the asset prices change. Think about shares and bonds as their prices are affected by supply and demand. If there is a high demand for a particular share, then the price will increase, however, if there is a sudden large amount of shares being sold then the price will decrease.

This is known as investment volatility. Volatility can result in a permanent loss of money if you sell your asset for less than you bought it for. This can be perceived as a risk. However, if your investment goals are to be achieved over a long term, you may be able to recover from volatility based losses over time.

Note: Risk can be described as the possibility of loss, injury or other adverse or unwelcome circumstances. – Oxford Dictionary

Note: Stock market volatility is when the stock market goes up one day, and then goes down for the next five, then up again, and then down again.

1.3 Importance of investment

Over time, the risk of the value of your investment decreasing as a result of inflation rather than market volatility is real.

The value of your money will decrease as a result of inflation; this is a fact that nobody can escape. You will find that 10 years ago you could buy a whole lot more with R100 than you can today. Inflation decreases the value of money.

For this reason, it is very important that you are mindful of inflationary erosion when choosing an investment option that suits your goals.

As previously stated, the longer you invest your money, the more opportunity you have to regain losses incurred as a result of market volatility. Also, bear in mind that the longer your investment runs, the more opportunity you have to realise compounded interest.

1.4 Golden rules of investment

The golden rules of investment are:

- Invest early
- Invest regularly
- Invest for the long-term
- Vary your investment options to prevent "placing all your eggs on one basket."

2. What is not an investment?

We have discussed what is an investment and the considerations when making an investment.

The following are not investments

- Funeral cover
- Short-term insurance such as car and household insurance
- Timeshare

Why must I invest?

- It is an opportunity to grow wealth
- To generate a specified rate of return
- Opportunity for capital growth
- To become financially independent
- To provide for future uncertainties

3. Investment considerations

There are four things to evaluate before you should consider investing your money:

- What is your debt situation? You should not be investing money if your debt exceeds 35% of your household income.
- What is your savings situation? Have you made provision for emergency fund savings, retirement funding and medium-terms savings?
- Are you insured for eventualities? Do you have short and long-term insurance cover?
- How well are you preparing yourself for your retirement?

3.1 Your budget

It is vitally important that you sort out your debt situation before looking to invest money. Remember that the interest payable on loans far exceeds the interest generated on investments.

Also, should you consider investing in a high-risk investment and you end up losing some money, you may find yourself unable to service your debts?

- Draw up your “GET-OUT-OF-DEBT” plan
- Spend with cash only
- Cut off your credit facilities
- Negotiate with your credit providers to re-spread your debt to a manageable level
- Work your plan with the intention of using the money you currently spend on debt on your future investment portfolio

Note: Rule of thumb - have at least 3 months’ worth of salary in savings before thinking about investing in other products.

3.2 Financial needs

Financial journalist and author, Maya Fisher French, advises that when considering how to “grow” your wealth, certain stages of your life need to be taken into consideration.

The 20s – the Acquisition Stage
During this stage, you are literally “acquiring”. In your 20s you are probably completing your further and/or higher education, getting a job, a car and considering purchasing a home. From a financial security perspective, you would be considering medical cover, disability cover, and retirement planning. Yes – you should be considering retirement planning in your 20s already.

The 30s – the Game Changing Stage
In your 30s you may be in a stable employment situation, and you may be earning more as a result of the increased work and perhaps educational experience. You may already have acquired a car and a home, be it a humble abode or a mansion. At this stage, you may be considering starting a family and as such your additional income should be considered for use in your financial planning system rather than buying further luxury goods, a smarter car or a bigger house.

The 40s – the Sandwich Stage
In your 40s you should technically be “settled” with relatively stable employment and plenty of work experience. During this phase of your life, you will, however, feel mounting pressure from the life that you have carved out for yourself. You will feel the pressure of having to pay school fees, aftercare, car financing, home loans and the infrastructure required to keep your home ticking over. Your financial planning may well be focused on educational savings and life cover. At this point in your life, you HAVE to start planning for your retirement if you have not already done so.

The 50s – the High-Risk Stage
Career wise, your risks increase as you proceed closer to retirement age. Many companies consider the “close to retirement” candidates first when downsizing. At this stage of your life, you should be considering to maximise your retirement contributions and perhaps some medium-terms savings that will assist you with a “self-employment” strategy until you are ready to retire.

The 60s – the Sweet or Sour Stage
This is absolutely your last chance to maximise your retirement funding. Your dependants may have moved on, and your mortgage should be paid up, so you could use the surplus cash flow to increase your retirement contributions. This is the stage of your life when you should be starting to wind down and enjoy the fruits of your hard labour. This is also the period you may experience immense regret for not having

taken care of your financial matters earlier.

Irrespective of which stage of your life you find yourself in, you should be focusing on 5 key savings priorities:

- Emergency funds (crisis cash)
- Paying off short-term debt
- Retirement funding
- Medium-term savings
- Protection