Chapter 3A: Basics of Investing – Main Asset Types

There are 4 main categories of investment or asset types:

1. **Cash**
2. **Fixed-income**
3. **Equities**
4. **Real estate**

Investing is about understanding what these four categories are, their advantages and drawbacks, what determines their prices, and how to combine them into a sound portfolio.

CASH

Definition: coins, notes, checking accounts

Cash includes all coins and notes, as well as current, checking, and money-market accounts that can be accessed anytime at no cost.

Advantage: safe and liquid

Cash is the safest and most liquid form of investment – meaning you can access your money anytime. Bank deposits of up to £85,000 in the UK and $250,000 in the US are guaranteed by deposit insurance.

Drawback: no return

The safety and liquidity of cash come at a price: it offers no or very little return. Hence its value is eroded over time by inflation.

You should keep only a relatively small proportion of your assets in cash, to cover emergencies and unforeseen expenses. A good rule-of-thumb is to keep 6-12 months of living expenses in cash.

Price: constant value

Cash does not change in value, hence there's no risk of loss. But there's no upside either, and it offers no protection against inflation.

FIXED-INCOME

Fixed-income: loans made to various types of borrowers

Fixed-income investments are loans made by an investor to a company, bank, or government. The borrower promises to pay interest at regular intervals and repay the loan amount at maturity. The interest rate can be fixed or floating in line with a benchmark rate.

Common types are Certificates of Deposit, savings accounts, government bonds, corporate bonds, and junk bonds.

Advantages: steady income and low risk

Bonds are a relatively safe form of investment that provides steady income and a higher return than cash.

Investors should keep some proportion of their assets in bonds; older and more risk-averse investors could own relatively more bonds.

Drawbacks: limited returns, some risks, no inflation protection

Over long periods of time, returns have been lower for bonds than stocks, though stocks are more volatile Bonds also carry some risk, including the risk that the borrower may not repay the money due on time and that the money repaid will be worth less after inflation.

In recent years, bond yields have been very low in many countries. If interest rates barely cover inflation or are negative, savers should be careful before committing large amounts to bonds. Cash, property, low-risk equities and gold could be considered as alternatives or complements to bonds in such circumstances.

Price: bond prices vary inversely with market interest rates; the interest rate for any particular bond depends on its characteristics

Prices of bonds vary inversely with interest rates: when market interest rates rise, bond prices decline, since investors could earn a higher return by selling existing bonds and buying newly issued ones.

The general level of interest rates depends on factors like growth, inflation, and monetary policy. When growth or inflation are strong, interest rates tend to rise.

The interest rate paid by a specific bond depends on its characteristics: bonds with higher risk, longer maturity, and less liquidity tend to carry a higher interest rate.

EQUITY

Equity: part ownership of a business

Equity or stocks represent partial ownership of a business. They can generate big gains, but are risky since the company can make losses or go bankrupt.

You can buy individual stocks or stock mutual funds. Mutual funds pool money from multiple investors to invest in a range of stocks. They offer the advantages of diversification and professional management, and can be used to target specific countries or sectors.

Actively managed mutual funds try to use insights and skills to beat the market. Index or passive funds track a general market index and charge lower fees. Exchange Traded Funds (ETFs) are a popular type of index fund combining liquidity with low costs; they can be a good addition to a diversified mix of funds.

Advantages: good long-term returns, outperforming other investment classes

Stocks offer virtually unlimited growth potential. Stockholders can benefit from dividend payouts (the part of profits that companies distribute to their stockholders), stock buybacks (the purchase of its own stock by a company), and increases in the share price (which can be due to many factors, from positive developments in its business to a general rise in the stock market).

In the long run, stocks tend to outperform other types of investment. Stocks also offer some degree of inflation protection: if prices rise, the revenues and profits of most businesses increase as well.

Drawbacks: risky – prices are volatile and can go through long periods of decline

Stock prices are volatile. Stocks of individual companies can fall sharply on account of negative corporate or business news. The stock market as a whole can go through long periods of decline.

Price: prices depend on profits, dividends and growth prospects

The value of a stock depends primarily on the profits earned by the company, the dividends it pays to its shareholders, and the growth prospects for both.

Markets are driven by sentiment as well as fundamentals; they can be subject to speculative bubbles or irrational fear. In the long run, however, prices tend to track fundamental value.

REAL ESTATE

Real estate: your home or related types of investment; the most important investment most people make in their lifetime!

The most common form of real estate investment is your house or flat. Real estate also includes vacation homes, buy-to-let properties, raw land, Real Estate Investment Trusts, etc.

Buying a home is the largest investment most people make during their lifetime; it is essential to research and plan it carefully.

Advantages: comfort and security; prices stay ahead of inflation in the long run

A home can provide residential comfort and financial security. You can make any changes you like to your home and – unlike rent – part of the mortgage goes towards building your home ownership.

A home may increase in value over time, as population grows and incomes rise. Historically, the price of real estate has exceeded inflation, making it a valuable inflation “hedge” or shield.

Drawbacks: lumpy and expensive; prices can decline both locally and nationwide

The real estate market can be prone to speculative bubbles, where prices move out of line with fundamentals like wages and rents. Mortgages can make homes more affordable and offer tax advantages – but be careful of debt exceeding 80% of home value or requiring more than 35% of income to service.

Real estate investment tends to be lumpy and illiquid: it takes lots of money to buy even a small flat. Houses are not easy to sell on short notice, though they are generally saleable within a reasonable time frame if the price is right.

Price: general economic and demographic trends + specific characteristics of home

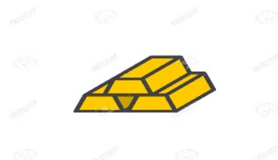
General economic and demographic trends exercise a key influence on the real estate market. Rising population and incomes boost demand for housing, while zoning laws limit supply. Interest rates and tax laws can make mortgages more or less affordable.

In the long run, real estate prices must be related to average incomes and rents, as these determine what tenants or buyers will be willing and able to pay.

Regardless of general market conditions, check out carefully the specific condition of any home you plan to buy and the attractiveness of its location.

OTHER ASSET CATEGORIES

Other assets: gold, commodities, art, collectibles, etc. – for knowledgeable investors!



A small amount of gold and commodities could be included in a more sophisticated portfolio, and investors with relevant know-how could buy art, tangibles, or collectibles. But these are not essential for a reasonably balanced portfolio, and students should try to absorb – and master – the principles relating to the four major asset categories before venturing too far beyond them.