

Chapter

12

Putting Money to Work - Investing

J.H. Morley said:

"In investing money, the amount of interest you want should depend on whether you want to eat well or sleep well."

Another man with initials in his name, J.P. Morgan, said the following about buying and selling investments:

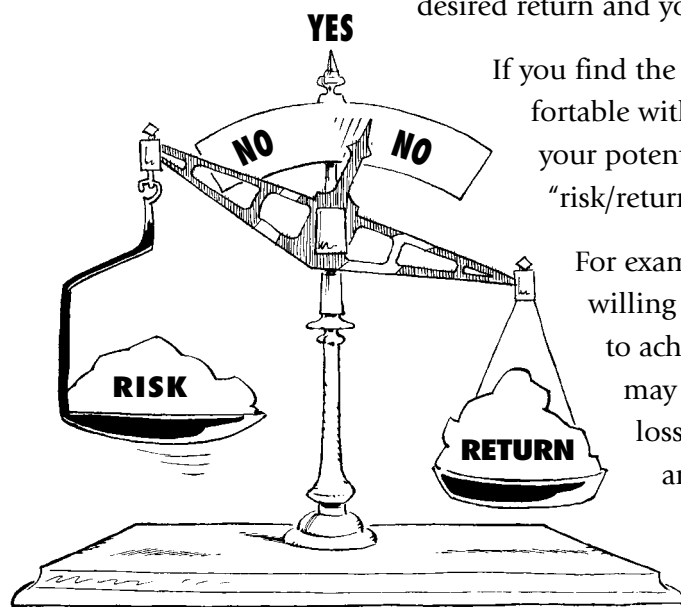
"Sell down to your sleeping point."

These two quotes are meant to show that investing your hard-earned financial resources can bring both benefits and risk, and there is an interesting relationship between the potential "return" of an investment and the "risk" associated with an investment. In fact, there is a "balance" that must be reached. What does that mean?

Suppose you are going to buy and sell stocks as one of your investments, and you are doing this through a broker. Furthermore, suppose you tell your broker that you would like to achieve the following:

- When the stock market rises, you want your investment to do better than the market by 20%. Therefore, if, over the next year the stock market rises 15%, you want your stocks to rise by 18% (20% more than 15%).
- Then, if the market should fall, you want your stocks to fall 20% less. Therefore, if, over the next year, the stock market falls 15%, you want your stocks to fall by 12% (20% less than 15%).

Is this a reasonable wish on your part? The answer, unfortunately, is no. Your potential returns, and your potential risk, have to be in balance. If you want your investment to do 20% better on the “upside,” you have to accept the risk that your investment may fall by 20% on the “downside.” Therefore, your desired return and your accepted risk have to be in balance.



If you find the risk of a 20% loss is more than you are comfortable with, then you will have to lower the target for your potential return. That is, you have to find your “risk/return” balance point.

For example, one person may, for various reasons, be willing to accept the risk of a 25% loss in order to try to achieve a 25% gain. Another person, however, may only be comfortable with a potential 10% loss in return for a possible 10% gain. And another person may not want any risk of loss at all. The trade-off for that person will be that there will also be little or no chance of much gain.

J.P. Morgan, therefore, was advising that you shouldn’t accept more risk than you are comfortable with, a level of risk that lets you sleep at night without concern and anxiety.

So what is your “risk/return” balance point? What risk are you willing to accept in relation to the target return you hope to gain? The answer to this question reveals a lot about the kind of investor you are and the type of investments that are probably most suited to you.

Your risk/return balance point will be affected by many factors, factors such as:

- your age (for example, younger people tend to be better able to accept higher risk than older people)
- how much you have to invest (for example, those with more money to invest are usually in a position to accept more risk)
- your goals and how much you are hoping to earn from your investments in order to realize your goals
- your time horizon, that is, how long before you need the money (if you need the money from your investments in two years for education, you will likely

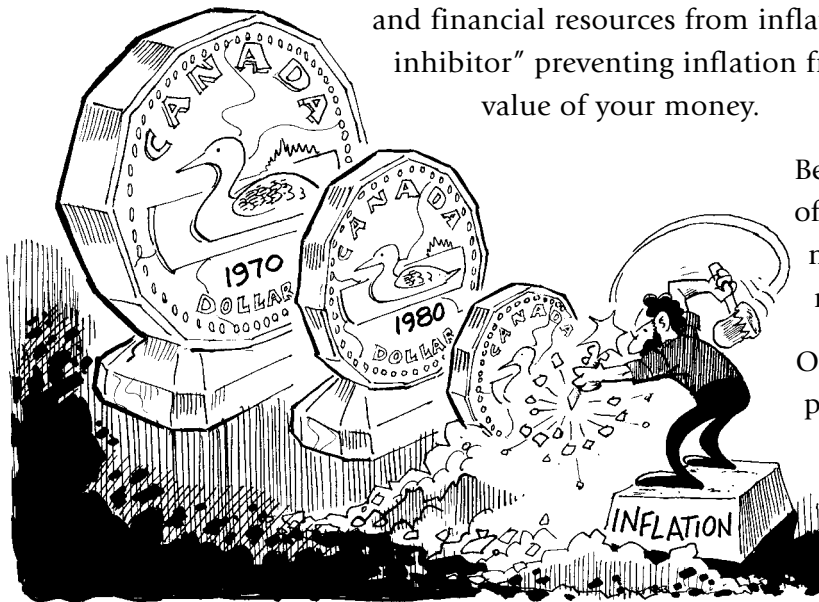
Investment involves putting funds to work to try to increase their value over time and improve your ability to achieve your financial goals.

accept less risk than someone who doesn’t need the money until retirement in 35 years)

The primary purpose of investment is to put to work funds that you don't need today. In doing so, these funds can bring benefits to you in the future. They can help you to realize your goals.

As we noted, one of the biggest threats to the value of funds held as cash is inflation. Inflation erodes the value and purchasing power of money.

Therefore, one goal of investment is to protect the value of your assets and financial resources from inflation. Investment, then, is like a "rust inhibitor" preventing inflation from eating away and eroding the value of your money.



Before we explore the role and process of investment in more detail, let's take a moment to look more broadly at the role of investment in the economy.

Our economy is faced with the task of producing goods and services in response to people's needs and wants. Entrepreneurs and businesses use available resources to produce goods and services that people need and want. We distrib-

ute what is produced via a price system. Every good or service has a price; if you are willing and able to pay that price, then you can acquire it. The standard of living in our society will depend on the wealth that we create in our economy and the degree to which people are able to acquire the wealth that is produced.

As more products and services are produced by our economy, more wealth is generated. This growth or output usually brings with it more jobs, higher incomes, and an improved standard of living.

But where does this opportunity for more products and services and economic growth come from? That's where investment comes into the picture. The funds for investment to fuel business activity and expansion come from people's savings.

By borrowing these savings for investment, new resources are discovered, businesses are expanded, new techniques are devised, new technology is developed, new training programs are provided, and so on. In essence, the money saved by savers in our economy is placed into investments that allow the productive capacity of the economy to grow. In this way, our economy is able to develop and grow over time and increase the level of wealth available in our society.

Understanding this can help you understand why investing your funds can lead to an increase in their value. If funds are put to use in investment — and investment helps to increase the level of wealth that is produced — then those funds, by helping our economy produce more wealth, also become more valuable.

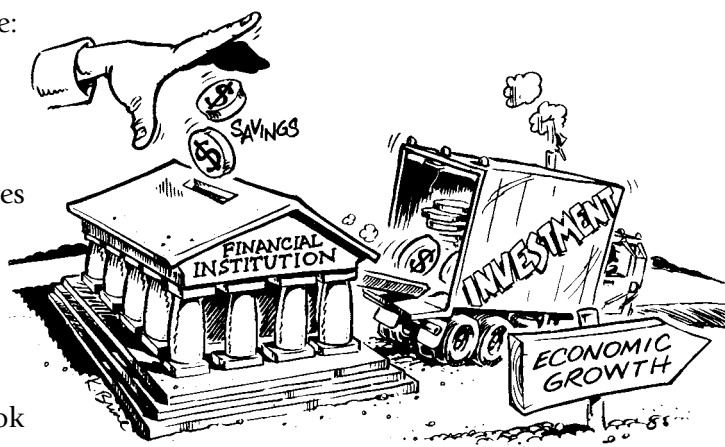
In general, there are two forms of investment. One form is a direct investment into some activity — to actually take a stake in the ownership of the venture. This is called equity investment. Another way is to simply provide a loan and earn interest on the loan. This is referred to as a debt investment. The following are some investments that fall into each of these two categories.

Equity investments include:

- stocks
- real estate
- certain mutual funds*
- collectibles such as paintings, jewellery, cars

Debt investments include:

- savings accounts
- term deposits
- insurance
- bonds and debentures
- mortgages
- certain mutual funds*
- treasury bills



Let's take a minute to look at the criteria that are important to consider when making investments.

INVESTMENT CRITERIA

A little saying that you can keep in mind when considering investments is the following:

"SURE REQUIRE GOOD LUCK TODAY KID"

The first letter in each of these six words stands for one of the criteria important to consider when investing. They are:

- **S**afety/risk
- **L**iquidity
- **R**eturn on the investment
- **T**ime management involved
- **G**rowth potential
- **K**nowledge of the investment opportunity

*A mutual fund is where investors pool their funds together to be managed as a fund by professional investors. Investors buy units of a fund at a certain price. They earn a capital gain if the unit price increases. They experience a capital loss if the price of the unit falls. There is a wide range of mutual funds that differ by the investments made with the money in the fund. For example, some mutual funds invest in Canadian stocks, some invest in U.S. stocks, some invest in government bonds, some invest in a variety of assets in various countries throughout the world.

As we noted, the safety, or the level of risk, involved in the investment is an obvious factor to consider. Don't get involved in risky investments if they make you anxious — or if you can't accept the loss if the investment should lose value, at least in the near term. A key point to note here is the link between the "variability" of an investment and your time horizon.

As we mentioned, by time horizon we are referring to when you will need the money from the investment. Do you need it in three years, five years, ten years, twenty years, twenty-five years, or more? The time horizon will depend on your goals and the use to which the investment funds will be put — this could include education, training, a house, children, travel, retirement, and so on.

The variability of an investment refers to the extent of the potential swings in an investment's value. For example, a set of stocks may range from gains of 35% to losses of 35%. However, as the stock market has shown, an investment portfolio (collection) of some 20 or more stocks will tend to achieve an average annual return of about 14% — at least that is what history has shown since about 1928.

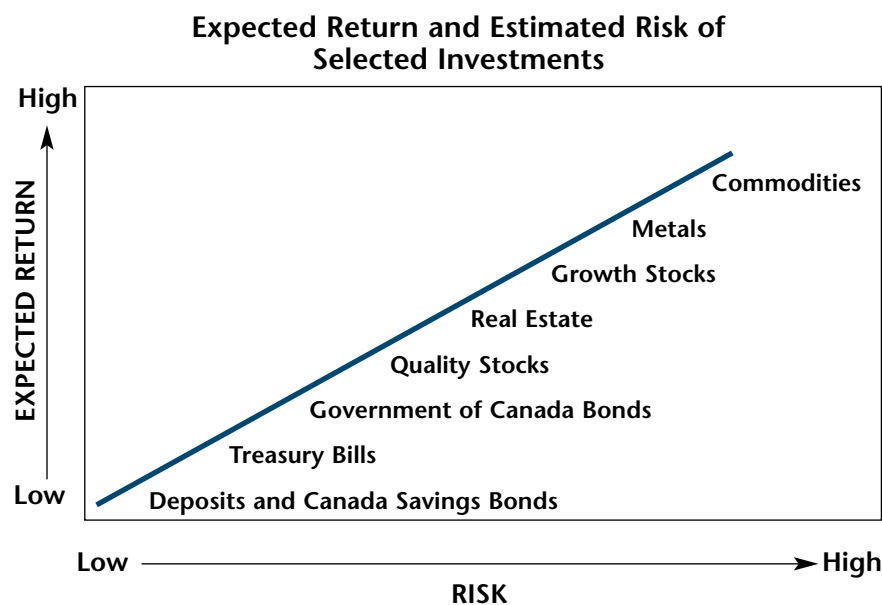
Therefore, if you could buy a portfolio of 20 stocks and hold them for, say, 20 years, history shows you should average a return of 14%. However, if you need those investment funds in five years, the market may have returns of +22%, +5%, -10%, -15%, and -7%. Your average return in this example would be -1% a year ($-5 \div 5$).

Why? Because the market tends to move in cycles. Ideally, you want to be able to leave such an investment in the market for enough time to achieve the long-term average. You don't want to find that you have to take your investments out of the market at a bad time — a time when you'll face a loss.

Be aware that riskier investments will have a higher "variability" with wider swings in value. If you want to make those kind of investments, it's better if you have a longer time before you need the money — then you can wait out any of the "bad times" and cash out your investments in the "good times."

Various investment options will have various levels of risk. The diagram on page 112 shows a variety of investment options along with the level of risk with which they are often associated.

This may be an appropriate point at which to explain the term "portfolio." When a person invests, he/she is said to establish a portfolio. Portfolio refers to the collection of investments a person has.

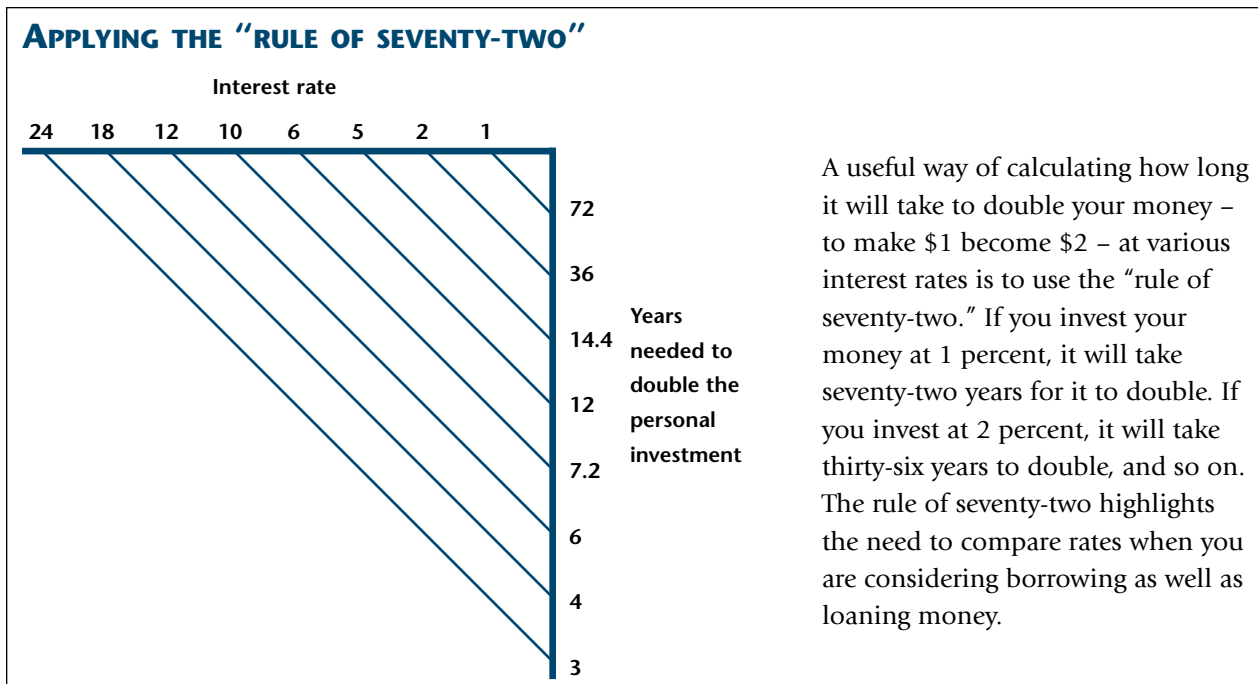


Frequently, investors are advised to “diversify” their portfolios, that is, to include in their portfolio a number of different types of investments. The goal is to achieve, within your portfolio, your personal risk/return balance. For example, you may have some investments that are quite risky (with a potentially high rate of return), others that have moderate risk, and others that are low risk. To diversify a portfolio can also mean to hold investments in different countries. For example, you may hold Canadian investments, U.S. investments, Asian investments, European investments, and so on. Why do this? Well, if the investments in Canada should be in a “downturn,” the Asian investments may be in an “upturn.” Therefore, the investments can help balance each other and reduce your risk of a loss.

Some investments offer a fixed rate of return. That is, they will guarantee to pay a specific amount of interest — a fixed income. A savings account deposit is an example, as is a bond, a term deposit, and so on. These forms of investment will tell you in advance what rate of return you will earn.

Other types of investments, and investments that tend to be more risky, don’t offer a guaranteed fixed rate of return. Instead, your return will depend on the success of the venture into which the investment was made. Purchase of common stock is such an example. Your return through dividends (your share of the profits) will depend on the success of the company. The better the company does, the higher the return. Obviously, the opposite applies as well.

The growth potential of the investment is another important criterion. Will the value of the investment improve over time? An investment that pays a fixed rate of return obviously has little growth potential in its value. An



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investment in a stock or a house, though, may be another matter. The value of this type of investment may rise (provide you with a capital gain) or fall (providing you with a capital loss).

The liquidity of the investment should also be considered. Liquidity refers to how easily/quickly an asset can be converted into cash and how certain its value is. A savings account is an example of a highly liquid asset — it can be turned into useable cash quickly, easily, and with a certain value. A five-year term deposit is not a very liquid asset. Your investment is locked up for five years; should you need the cash, you would have to get it elsewhere.

It is always important that an investment portfolio have some investments that are quite liquid, just in case something unforeseen comes along and you find yourself in need of cash.

The time involved in looking after an investment is also a matter of concern. If you invest in a savings account or a term deposit, little of your time is required to oversee the investment. An investment in a business or in a house, for example, may require a good deal of your time. You need to decide how much time you have available and/or are willing to spend looking after your investments. The potential return on the investment may also affect your willingness to invest more of your time in managing the investment. Alternatively, you may use the services of a financial services company to provide the time and expertise to manage your investment (for a fee).

Lastly, your knowledge of the investment is also important. It is unwise to invest in any investment that you don't understand. Effective investment is linked to knowledge and understanding. Of course, a little luck never hurt either. But, as a rule of thumb, understand what you are investing in, and don't invest in something simply because others have.

At this point, there are a few other things that we should cover related to investment. A key thing to consider is the concept of opportunity cost. Opportunity cost is the next best alternative that is given up when you make a choice. In making investment decisions, you should always keep your opportunity cost in mind. What is the next best thing that you could be doing with that money? What are you giving up? If you think about this, and then still decide to go ahead, then you can be sure that at least you did what you truly wanted to do, even if it doesn't pan out.

A few quick tips on investment:

- Tip number one is to be very cautious about investing on a "tip."
- Check out every investment carefully and fully understand it.
- Don't panic; keep your head and avoid irrational decisions.
- Seek professional advice and assistance.
- Keep inflation in mind when making your investment decisions.
- Invest even small amounts; you will be surprised how they can add up.
- Diversify when you can; don't put all of your investment eggs in one basket.
- Never make investments that you don't understand.
- Keep in mind what J.P. Morgan said: "Sell down to your sleeping point," which basically means, avoid investments that cause you too much anxiety; invest where you feel happy and comfortable. Find your risk/return balance point.

In summary, money that you have available, over and above your current needs, can be put to work and invested — in anything from a savings account to a stock. Indeed, any money you have, but don't need today, should be put to work to help protect, if not increase, its value. Investing is something that should be considered by everyone, not only those with great wealth. Investment is not only good for the financial health of the individual or household; it also fuels the growth and development of our whole economy. So, be prepared to be an investor at whatever scale is possible for you — and at whatever age you are.

Just think about it. Suppose if you had \$100 at age 15, and you were able to invest it for 40 years at an average return of 5% a year. After 40 years, your \$100 would be worth over \$700. Investment can work to your advantage, bringing benefits and helping you to achieve your goals. Invest when you can, and what you can — but do so wisely and make investments that are comfortable for you.

That brings us to the end of this section on investment. It also brings us to two areas in which young people usually have little interest — insurance and retirement. But these are important subjects, and you should understand some of the basics.