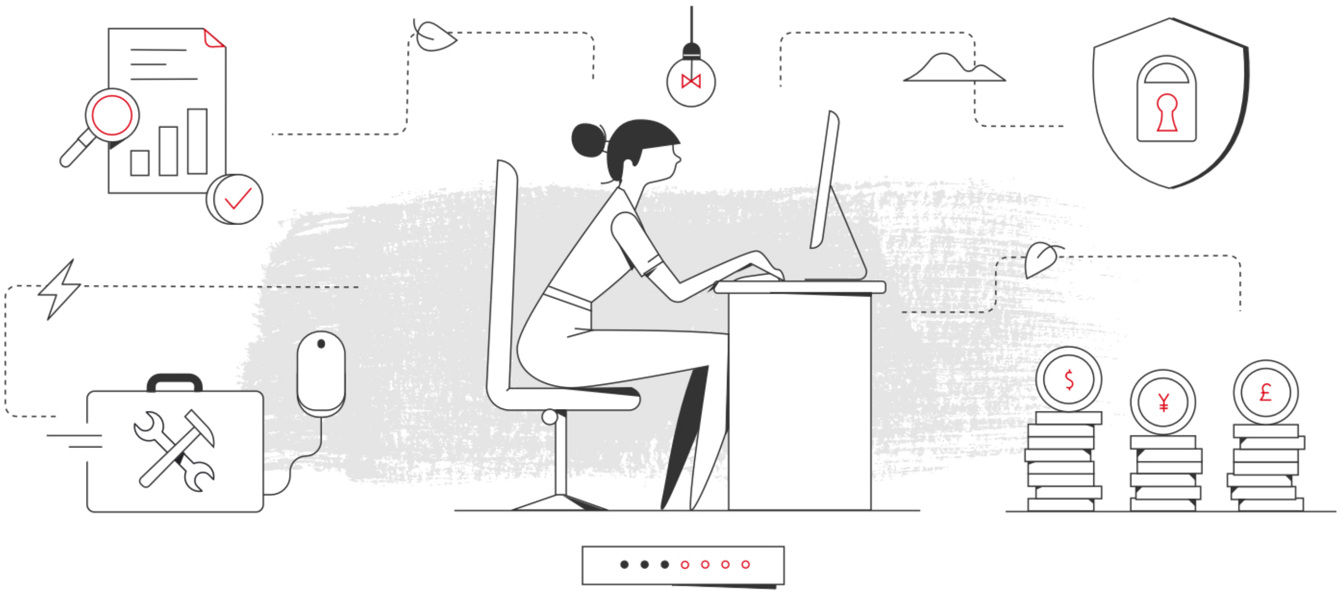

Day 3: Four common ways to invest

Time to read: 8 minutes

Today we're going to introduce you to 4 kinds of investments. Each of these "asset classes" (a fancy way of saying "type of investment product") offers different risks and rewards, but they can all play an important role in your overall investing strategy.

So let's take a look at these investment products, and remember, this is an introductory course, so while there's lots to know about them, we're only covering the basics.

Equities

Most people have heard of equities – also known as stocks or shares. When many people think about investing, this is what they're thinking about.

Generally, when you buy shares in a company, you become a part owner of that company. If the value of the company goes up, then the share price goes up and your share is worth more than you paid for it. Similarly, if it goes down then it is worth less than you paid for it. If you decide to sell those shares on the stock market when the price has gone up, you make a profit, but if you sell them when the price has gone down, you make a loss.

Sounds simple, right? Just pick the stocks that are going to go up and you'll make money! It's not that easy. There are thousands of companies listed on the stock exchange operating across many different countries. Not only that, these companies cover a huge range of industries, including retail, technology, agriculture and more.

Unless researching companies is your full-time job or you have a deep understanding of a particular industry or sector, picking which companies to invest in can be very difficult. Fortunately there are a couple of options that make it easier:

Blue-chip stocks

One way to potentially limit your risk is to invest in what are known as blue-chip stocks. These are typically very large companies that have first-rate reputations and a proven ability to withstand impacts when the economy goes bad. In Hong Kong, the stocks that make up the Hang Seng Index are generally regarded as blue-chip.

Another benefit with blue-chip stocks is that they often pay dividends to their investors. Dividends are when the company takes some of the profit it has generated and gives it back to shareholders either as a cash payment or in the form of more shares of the company. The choice is often up to the shareholder to decide how they would like to receive the dividend. However, not all companies can or do pay dividends.

One potential downside to blue-chip stocks is that because the companies are successful, their shares can be quite expensive, which can make it a costly investment.

If you want to invest in equities, learning more about blue-chip stocks might be a good way to get started. If it seems too intimidating right now, don't worry. There are other ways to invest that involve less intensive research and maintenance.

Index Trackers

Instead of trying to beat the market by picking the individual winners (which is very hard to do over a long period of time), some people just buy the whole market by investing in an index tracker.

An index tracker is a fund that invests in the top companies in a given market. For example, the Hang Seng Index is made up of 50+ stocks that broadly represent the overall performance of the whole Hong Kong market. Rather than trying to buy each of those stocks in the right proportions, the index tracker does the work for you. Buying the index fund will give you an investment that closely mirrors the overall market.

There are index trackers for most stock markets and other types of funds as well, and you can research these further on your own. While it's certainly desirable to try and beat the market, as a disciplined investor you're seeking to generate an adequate return and matching the market's performance could be considered a good result.

We should also point out that index funds can be made up of just about any asset class, not just equities, but we've used equities in this example for simplicity.

Fixed Income

Ever heard of a bond? This is where investors lend money to companies or governments to fund the activities that they need to grow or operate. This is known as a "debt instrument loan" AKA a bond. In exchange for your loan, this investment will regularly pay you a fixed amount of interest until a specified date (called the “maturity date”). Similar to the stock market, you can buy (and sell) bonds on the bond market.

The majority of fixed income products are considered conservative investments as they are relatively low risk compared to equities. For this reason, they often offer lower returns than equities, but they can form an important part of a diversified portfolio. (We’ll talk more about this on day 5.)

It’s important to point out that "low risk" does not mean risk free or guaranteed returns.

What is the risk for a bond yield?

If you buy a bond when it's being issued by a company, and hold until it is repaid in full, you generally don’t need to worry about the yield. So a HKD10,000 bond with a 5% yearly return, will earn you fixed income of HKD500 each year.

But that yield would change if you didn't buy the bond when it was issued, and instead bought it from the bond market. In this case, you'd need to pay the price the seller is requesting, which could be more or less than the HKD10,000 initial buy-in. The demand for bonds follows the appetite of investors for this asset class, so prices can go up and down.

Regardless, the company or government that issued the bond will still pay 5% of HKD10,000 each year. But someone who paid HKD12,000 for the bond will have a lower "real yield" of only 4.16%, as their fixed income of HKD500 is a lower percentage of the purchase price of HKD12,000.

There are other factors that impact bond prices, but generally when you hear that a yield have gone down, it means the bond price has gone up, and vice-versa.

Default Risk

In general, government bonds are considered the safest, lowest risk.

If a company (or even a government) goes bankrupt before your bond matures, they might not be able to pay back your principal. Corporate bonds are given ratings to help you understand how likely it is for a company to be able to pay what they owe you. These ratings often have letters like AAA or BBB to tell you how risky they are.

In general, bonds are split into “investment grade” and “non-investment grade”, higher risk bonds also known as junk bonds. Different ratings agencies like Moody’s or Standard and Poor’s (S&P) use slightly different combinations of letters to classify bonds as non-investment grade. For example, Moody’s will rate them from “Baa1" to "C" and S&P rate them from "BB+" to "D".

Even though the returns might look attractive, as a disciplined investor, you’ll want to consider carefully whether junk bonds belong in your portfolio. With their high risk, they're usually more suitable for speculators.

There are lots of different types of bonds and going into all of them is more advanced than we’re covering in this 101 course, but at least now you now the basics.

Unit trusts or mutual funds

Technically speaking, a unit trust or a mutual fund could be considered a type of equity. But it's different enough that we've given this asset class its own category.

When you buy a unit trust, whatever amount you invest is pooled with money collected from investors worldwide. A fund manager uses this pool of money to buy different assets, building a diversified portfolio of equities, bonds, or a mix of the two (or even other things).

Despite a fund being made up of many different tiny investments, you can be pretty specific in what what you want to invest in, whether it's a particular geographic region or a certain industry. For example, if you believe that Asia Pacific as a whole is a good region to invest in long-term, you could find a unit trust that is made up of investments that try and represent the region, rather than you having to build a portfolio yourself.

Likewise, if you are optimistic about a particular industry (such as technology or medicine) or only want to invest in companies that are eco-friendly, you can find funds that are specific to that.

The other plus is that the fund is actively managed by the fund manager, so if it's not performing as expected, they'll change up the investment, removing some companies and adding new ones. But even though your investment will be managed by a professional, it's still important for you to look at the fund fact sheet to understand what investments are being made in your unit trust and develop some understanding of what kind of risk you are exposing yourself to.

It's also important to note that because there's a fund manager, there's usually a management fee. You should be sure to take that fee into consideration when you're figuring out your bottom line.

Cash equivalents

The last asset class we're going to look at is cash equivalents. These are generally used for short-term investing. We know we said investors don't invest for the short term as short-term often means high risk, but with cash equivalents the risk and the return are usually both low.

One of the most popular cash equivalents is the time deposit. This is when you lend your money to the bank for a fixed period of time, say 3, 6 or 12 months and in return the bank offers you a higher, guaranteed interest rate. The longer you leave it there the higher the rate.

This effectively makes a time deposit a "risk-free" investment as the bank is guaranteeing your money back plus the interest they promised you.

As with all things, there are positives and negatives. If you suddenly need your cash back, you'll pay a penalty for early withdrawal; and if you're locking up your money for long periods of time you may miss out on other opportunities if interest rates rise. But overall, time deposits are a good way to use cash that you don't need in the short term to help lessen the effects of inflation.

What's next?

Today you learned about 4 common asset classes you can invest in, as well as the risks and rewards associated with each of them.

In tomorrow’s lesson you’re going to start learning how to build you portfolio.

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