INVESTING BASICS

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Many people today are in a quandary about their personal savings and investments. With the drop in bank interest rates, many are looking for alternatives to get a better return on their capital. Will the interest rates stay low for a long time? Is it safe to take savings from the bank and invest in the stock market? Is it a good time to buy stocks? Will the stock market come down? How risky is the stock market? Should I get out of the stock market now? These are some of the questions often posed by would be investors.

It is natural to be concerned about investing, because stock market can be volatile. However, history has repeatedly shown that investors who stick to a sound strategy for the long term come out ahead. Despite many short-term crises, stock markets have historically recovered – driven by long-term consistent company earnings growth.

FACT SHEET FOR INVESTING

- Learn as much as possible about investments
- Establish an investment strategy
- Pay yourself first by regularly allocating a portion of your earnings for investing
- Remember it is small amounts invested regularly that become large amounts over time
- Know the rule of 72 - Divide 72 by the return and the result is the number of years it will take to double your investment. If you earn 6% return on your money, it will take 12 years (72/6) for your original investment to double in value
- But it is how much real returns (returns over and above inflation) you get what matters
- All investments carry risk, RULE: the higher the return, the higher the potential risk
- Know your risk tolerance: the amount of psychological pain you're willing to suffer for your investments
- Be fearful when other are greedy, Be greedy when other are fearful – Markets sways back and forth
- Do not fall into the trap of "selling low and buying high"
- Compound interest is your greatest friend, in investing that means starting as early as possible and letting investing returns build upon itself
- Invest till you retire but reduce risk of your portfolio as you get nearer to retirement
- Seek **Professional** investment advice

Have a strategy for your financial future

The only way to attain financial security is to save and invest over a long period. The lesson for investors is straightforward: a well-planned strategy can make all the difference. There can be number of misguided reasons to act impulsively, or even panic sell following a steep decline in the stock market. One needs to resist the temptation to make investment decisions without a clear strategy.

The best way to build your investments is to establish and follow a disciplined investment plan. A tool many investors use is the investment policy statement (IPS), a document that spells out your investment objectives and risk tolerance. The IPS will vary depending on the needs and circumstances of each individual investor, i.e. age, investment horizon, liquidity needs and tax considerations. An IPS is developed in collaboration with an investment advisor and addresses the responsibilities of all parties in managing the investments. Based on your investment goals and risk tolerances the IPS will recommend a suitable asset allocation that the investment advisor will manage for you.

Diversify your investments to reduce risks

Different asset classes have different levels of risk, return characteristics, and behave differently under same market conditions and over time. Diversification is a risk management technique that takes advantage of the correlations between different asset classes. For example, when asset classes are negatively correlated, positive performance of one asset class can offset the negative performance of another asset class. This allows the investor to get higher returns without taking on more risk at different times. Diversification across five asset classes and within each asset category, i.e. stocks, bonds/debentures, currency, real estate, commodities is important to ride out volatility. Further, asset allocation needs to change to suit changing market conditions. Diversification within each asset class gives a second layer of diversification for better risk reduction. For example, buying different equities by capitalization, country, and sector, and bonds with various credit ratings and maturities from different bond issuers, helps to achieve a well-balanced diversification. Regular review and rebalancing of asset allocations are required to keep your portfolio in good shape.

Investing in real assets, such as property is an option, but comes with several downsides mainly in the form of illiquidity and holding cost. A more serious challenge in investing in real assets is that the investor is subject to risk emanating from information asymmetry and adverse selection. This is especially true in property. Buying a second home as an investment in the wrong location and at the wrong price can cripple any average investor's financial future. For the average investor it is always prudent to invest in more liquid financial assets.

Understand Risk

For investors, risk is the possibility of losing money. A more technical definition of risk is the deviation from an expected outcome. Whatever the investment choice there is no escaping risk. Many people fear losing the principal value and leave their savings in places they presume to be safe. Keeping your long-term savings in low yielding bank accounts does not protect you from inflation. Point-to-point inflation, as measured by Colombo Consumer Price Index rose to 7 percent in November 2010. Unless you generate a return over the inflation rate, the erosion of the purchasing power of your long-term money caused by inflation can be devastating.

By understanding how risk affects your investments, you can make it work for you. Most of us take risks in everything we do in life, but not when it comes to financial planning. As risk involves the possibility that an investor could lose money, therefore a premium is paid to compensate the investor for taking risk. Understand the risk and return of your investments before you invest. Your objective should be to maximize return and minimize risk, in other words obtain the best possible return for the risk you are taking. Where there is risk, there is opportunity. The dividing difference between financial success and failure is your effort to pick suitable investment opportunities that provide optimal return for the risk you wish to bear.

Rupee cost averaging - investing a fixed amount of Rupees on a regular basis regardless of market prices (meaning you buy less stocks when prices are high and more when prices are low) and by having a well diversified portfolio with proper asset allocation, you can reduce long term risk. The best way to reduce risk is to invest in instruments you are familiar. Therefore, acquiring a good knowledge of your investments will always help to make informed investment decisions and avoid costly mistakes.

Use a Professional Investment Adviser

If you are person who is busy with your job or other responsibilities and do not have the time to manage your own investments or feel you don't know enough about investing on your own, than you may need professional investment advice. Competent investment advisers are knowledgeable about financial markets and the investment landscape. The demands and complexities of effective investment management can prove challenging even for the most diligent investor. Similar to medical sciences, finance has advanced and one needs considerable expertise and market knowledge to manage investments to maximize return and minimize risk. Just as you will not attempt to treat yourself when you are unwell, trying to manage your long-term investments yourself without seeking professional investment advice may not be a wise decision.

Your investment advisor should understand your investment goals, whether you are saving to buy a house, pay for your children's education or for a comfortable retirement. Further, more importantly, your tolerance to risk, how much money you can afford to lose if the value of your investments decline. An investment professional has a duty to recommend only investments that are suitable for you.

While you should monitor performance of your investments regularly, you should also compare how your investments are doing against an index of similar investments over the same period to see if you are getting the adequate returns net of fees and commissions for the risk you are taking.