Investing In the Stock Market

Risk & Return

This might seem obvious, but you'll be surprised how many peoples' investing goes off the rails because they aren't clear on what they want to achieve. It's like planning a long car trip: You have to know your final destination and the roads you'll take to get there.

Step1. Define your financial goals

Smart investors set clear goals for their investments. They write them down and refer to them like a roadmap from time to time.

There are any number of goals that you might have. A comfortable retirement, money for your children's education …a new house! Your goals can be for a month from now or for 30 years down the road.

Whatever the case, most people's goals can be boiled down into four basic investment objectives. What you've got to do is decide which of them applies to each of your goals. Once you understand which of the four investment objectives applies, you'll be in a better position to find matching investments.

So, with your goal in mind, which of the following objectives are priorities for you?

- **Safety of principal**: The principal is your initial investment. To some investors their most important objective is to put their money into something fairly safe where they won't lose their initial investment. This is an important consideration if you know you'll need your money soon. If you're saving for a mortgage down-payment in a year from now, don't risk your principal.
- **Income:** This is the regular payment of money earned from your initial investment. It may be in the form of interest if the investment is a bond or dividends if the investment is a stock. If you're retired, your primary concern is earning income on your investments to pay your living expenses.
- **Growth:** Investors often want their investment to grow in value over time. This increase is referred to as a capital gain. If you're saving for retirement many years away, then you're likely most interested in getting growth from your investments.
- **Liquidity:** This refers to how quickly you can turn your investments into cash. If you think you might need to get at your money quickly, then liquidity is an important issue. You can usually turn most investments into cash within a few days, expect for investments that attract few buyers, like artworks.

Step 2.Pick investment to match your goals

Every investment has it's own "personality". Your strategy should be to find investments whose personalities best fit your objectives. This is easier to do when you can analyze different investments according to four personality traits or characteristic.

The two most important characteristic are your investment's risk and return profiles. Risk and return go hand-in-hand. As a general rule, the higher the potential return the riskier the investment. Let's take a closer look at the four characteristic of an investment.

Risk: Every investment poses some risk. Even putting cash in the bank involves risk – the risk that inflation will eat away at its future buying power. There are other types of risk, too, including the risk the company you invest in will go bankrupt. Of course, some investments are riskier than others. Investing in commodities like gold is probably the riskiest investment you can make. Stocks of smaller companies that aren't well established, called small-cap stocks are riskier than blue-chip stocks, which are shares of large established firms. Government T-bills is one of the safest investments you can make, but they don't pay high returns in a low interest rate environment. Your job as an investor is to know the risks of an investment and decide if you feel comfortable taking them. It's also important not to take risks when you don't have to, or especially if you cannot afford to. If you only need a small return to reach your goal, then stick with the safer investments that offer lower returns.

Return: There are two ways an investment can earn a return for you –an income return and a capital gain return. The income return is the regular dividend or interest that you receive. A capital gain return is when you sell an investment for more than you paid for it. The total return of an investment combines both of these returns. There can also be a capital loss instead of a gain when you sell an investment for less than what you paid for it. This would decrease your total return.

Liquidity: This is not only how quickly you can turn your investment into cash but also the chance that you'll get a fair price for it. An illiquid investment may be difficult to sell because no one wants to buy it from you, which means you may have to accept a very low price. A liquid investment is one that other investors are always willing to buy.

Term: An investment's term is the length of time it is valid for. If you're investing for the long term, you probably don't want to put your money into a short term T-bill.

Step 3. Spread out the risk

By now you probably realize that risk is an integral part of investing. You simply can't avoid it, so it makes sense to find away to deal with it. A core technique of savvy investors is to reduce risk by never putting all their eggs in one basket. In investment jargon this is called diversification.
Diversification means putting your money into a variety of investment to reduce risk. You choose investments that behave differently, so if one does poorly, the others might do better. There are several ways you can diversify your investments:

Between types of investment: You can put your money into several kinds of investments, like stocks, bonds and T-bills. A technical term for this kind of diversification is asset allocation.

By degree of risk : You can have a portfolio of stocks with different degrees of risk such as blue chip company stock paying consistent dividends and small-cap stocks where there's potential for greater earnings and also of bigger losses. You might hold a variety of bands less risky government bonds along with corporate bonds.

By industry: You can pick stocks from various sectors of the economy. You could buy a bank stock and one from each of Manufacturing, Telecommunication, Beverages food & Tobacco, Diversified, Hotels & Travels and Construction & Engineering sectors.

By geography: You can diversify across the country, holding say a Hotel from Down South, a Plantation company in the Central Province, and a Manufacturing company in the Western Province.

Types of Risk

There are many factors that can affect an investment's risk level. Here's a few key types of risk to consider.

- **Default or business risk:** the risk of losing your investment if the company runs into financial trouble.
- **Liquidity risk:** the risk of not being able to cash in your investment when you want and at a reasonable price.
- **Interest rate risk:** the risk that changes in interest rates will affect the value of your investments.
- **Inflation risk:** the risk that the return on your investment will be less than inflation.
- **Reinvestment risk:** the risk tied to the uncertainty of not knowing at what rates of return your money can be reinvested in the future.