© IFWF 2024

Lesson 5
Introduction to Investing, Risk and Return
("Investing 101: Growing Your Money")

Objectives: Students will acquire foundational knowledge about investing, empowering them to make informed financial decisions. They will understand the essential concepts of risk and return, diversification, and asset classes, which will enhance their awareness of financial market movements and their ability to develop effective investment strategies.

In this session, students will learn:

- Understand the fundamental concepts of investing
- How to identify different types of investments and their characteristics
- The critical relationship between risk and return
- How diversification can mitigate risks and enhance returns

Vocabulary: Asset, Investment, Portfolio, Stocks, Bonds, Mutual Funds, ETF (Exchange- Traded Fund), Risk, Return, Volatility

Concepts: Introduction to investing, the relationship between risk and return, importance of diversification, understanding different asset classes, market dynamics

1. Understanding Different Types of Investments

Investing involves committing money or capital to an endeavor with the expectation of obtaining additional income or profit. Unlike consuming, investing earmarks money for the future, hoping that it will grow over time. It's a powerful tool for wealth creation, enabling you to potentially outpace inflation and increase your financial security. However, it's important to grasp that all investments come with risks—understanding these risks and how to manage them is key to your success.

Different asset classes play distinct roles in an investment portfolio, each contributing uniquely to the overall balance of risk and return. A **portfolio** is a collection of different investments held by an individual or institution. To effectively manage and grow your investments, it is crucial to understand these roles and how they complement each other within a diversified portfolio.

Stocks, or **equities**, represent ownership shares in a company. When you buy stocks, you become a partial owner of that company, entitling you to a share of its profits. Stocks are known for their high potential returns, primarily through capital gains as the stock's value increases and dividends distributed from company earnings. However, this potential for high returns comes with significant volatility. **Volatility** refers to the degree of variation in the price of a financial instrument over time. High volatility means that the price of the asset can change dramatically in a short period, while low volatility indicates more stable price movements.

The value of stocks can fluctuate widely based on the company's performance, market conditions, and broader economic factors. For instance, technological advancements might drive up the value of tech stocks, while regulatory changes could cause fluctuations in healthcare stocks. Therefore, investing in stocks requires a higher risk tolerance and a longer investment horizon to weather market

ups and downs.

Bonds are essentially loans made by investors to corporations or governments. In return for the capital invested, the bond issuer pays interest at regular intervals and returns the principal amount upon maturity. Bonds are generally considered safer investments than stocks because they provide more predictable returns through fixed interest payments. However, the trade-off for this lower risk is typically lower returns compared to stocks. Bonds can be an essential component of a diversified portfolio, offering stability and regular income, which can help offset the volatility of stocks.

Mutual funds are pooled investment vehicles managed by professional money managers who invest in a diversified portfolio of stocks, bonds, and other securities. Investors buy shares in the mutual fund, which represents a portion of the holdings of the entire fund. This diversification reduces the risk compared to investing in individual stocks or bonds, as the performance of the fund is not dependent on a single security. Mutual funds are suitable for investors who prefer to rely on the expertise of professional managers to make investment decisions and achieve diversification.

Exchange-Traded Funds (ETFs) are similar to mutual funds in that they consist of a diversified collection of stocks, bonds, or other assets. However, unlike mutual funds, ETFs trade on stock exchanges like individual stocks, allowing investors to buy and sell them throughout the trading day. This provides the flexibility and liquidity of stocks combined with the diversification benefits of mutual funds. ETFs often have lower expense ratios than mutual funds, making them a cost-effective option for investors looking to diversify their portfolios without incurring high management fees.

Investing in real estate involves purchasing property—whether

residential, commercial, or land. **Real estate investments** can provide income through rental earnings and potential appreciation in property value. While real estate can offer a hedge against inflation and add tangible assets to your portfolio, it is often more capital-intensive and involves higher maintenance compared to other asset classes. The real estate market is also influenced by various factors such as interest rates, economic conditions, and location-specific dynamics.

Commodities include physical resources like gold, oil, and agricultural products. Investing in commodities can be volatile due to factors like market demand, geopolitical tensions, and economic shifts. Despite this volatility, commodities can be an excellent diversification tool as their performance often moves inversely to stocks and bonds, providing a buffer during market downturns.

Certificates of Deposit (CDs) and **Money Market Funds** are lower-risk investments offered by banks and financial institutions. CDs provide fixed interest rates in exchange for locking in your money for a predetermined period, while money market funds invest in short-term, low-risk securities. Both options offer stability and liquidity but come with lower returns compared to other asset classes.

2. The Relationship Between Risk and Return

The core concept in investing is the relationship between risk and return. Typically, the higher the potential return of an investment, the higher the risk of losing money. Understanding this trade-off is crucial as it will guide you in making choices that best fit your financial goals and risk tolerance. For instance, investing in stocks might offer high returns, but it also involves higher uncertainty

compared to bonds, which generally provide lower but more stable returns.

Figure 1: Risk vs Return of Different Asset Classes

Here's a chart illustrating the risk and return levels of different investment types. As shown, investments like CDs and Money Market Funds have the lowest risk and return, making them the safest but least lucrative option. On the other hand, stocks exhibit higher risk and potential returns, aligning with the principle that higher rewards often come with increased risks. Commodities and real estate are notable for their moderate to high risk and return profiles, influenced by market volatility and economic factors.

3. Diversification: Balancing Risk and Return in Your Investment Portfolio

Diversification is another key strategy that helps manage investment risks. It involves spreading your investments across various asset classes to reduce the risk of losing money. For instance, consider a scenario where you have invested all your money in the technology sector. If the technology market experiences a downturn due to unforeseen factors, your entire investment could suffer significant losses. However, if you diversify your portfolio by including assets from different sectors, such as healthcare, real estate, and bonds, the impact of the downturn in the technology sector can be mitigated by the stability or growth in other sectors.

Diversification works on the principle that different assets often perform differently under the same economic conditions. When one asset class underperforms, another might outperform, thereby balancing the overall returns of your portfolio. For example, during a recession, stock prices might fall while bond prices might rise due to increased demand for safer investments. By holding both stocks and bonds, the negative performance of stocks can be cushioned by the positive performance of bonds.

Moreover, diversification can be achieved not only across different sectors but also across different geographical regions. Investing in international markets can provide exposure to growth opportunities in emerging markets, which might be independent of the performance of domestic markets. This geographical diversification can further reduce the risk associated with economic downturns confined to a particular region.

In addition, diversification can be extended to different investment instruments within the same asset class. For example, within the stock market, you can diversify by investing in various industries

such as technology, healthcare, finance, and consumer goods. Similarly, within bonds, you can diversify by investing in government bonds, corporate bonds, and municipal bonds, each with different risk profiles and returns.

The ultimate goal of diversification is to build a balanced portfolio that maximizes returns while minimizing risks. By carefully selecting a mix of asset classes that complement each other, investors can achieve more stable and predictable investment outcomes. This strategy is fundamental for long-term financial planning and is particularly beneficial for young investors who have a longer time horizon to recover from potential short-term losses.