Introduction to Investing

3. Investment Asset Classes

Introduction

Let's explore the concept of asset classes (also known as investment classes), which are the foundation of any investment. By breaking down the primary asset classes, you will have a better understanding of these essential building blocks for investment.

What is an Asset Class?

An asset class is a group of investments that share similar characteristics and behave similarly in the marketplace. They are essentially categories of investments, each with its own risk and return profile. Think of them as different ingredients in your financial recipe. Like ingredients, each asset class has its own unique characteristics (flavours), risks (textures) and benefits (nutrients).

The main asset classes include stocks, bonds, cash and real assets. Let's explore each of these in more detail:

Asset Class	What is it?	Why invest?	Risks?	Example:
Stocks (also known as equities or shares)	• Stocks represent ownership in a company. • When you buy a stock, you're buying a small piece of that company, known as a share. • If the company performs well, the value of your shares may increase. • Some stocks also pay dividends, which are a portion of a company's profits paid out to shareholders.	• Stocks have the potential for high returns, especially over the long term. • Dividend payments (i.e. profit sharing) from certain stocks can provide a regular income.	• Stock prices can be very volatile, meaning they can rise and fall quickly. • If the company performs poorly, you could lose some or all of your investment.	Imagine buying a share of a publicly traded company you like, such as Microsoft: • If Microsoft does well, the price of your small piece (or share) could increase. • Additionally, Microsoft might pay you a portion of its profits regularly (dividends). So, not only can your investment grow in value, but you could also receive extra cash periodically just for holding onto your shares

Asset Class	What is it?	Why invest?	Risks?	Example:
Bonds (also known as fixed income, fixed income securities, debt securities)	• Bonds are essentially loans that you (as the buyer of the bond) give to an issuer (the entity issuing the bond and borrowing from you), such as a government or corporation. • In return, the issuer promises to pay you back the principal amount (the amount you lent) on a specified date and to pay you interest (called a coupon) periodically.	• Bonds are generally considered safer than stocks and can provide stable returns.	• They have lower potential returns compared to stocks. • While bonds are generally less risky than stocks, they are not risk-free. There is a risk that the issuer could default (fail to pay back the loan), especially with corporate bonds. • When interest rates increase, new bonds offer higher rates, which makes existing bonds with lower rates less attractive and causes their prices to fall.	• Imagine you buy a bond issued by a company for $1,000, which is essentially a loan you give to that company. • Suppose it's a 10-year bond with a 3% interest rate paid annually. • Each year you'll receive $30 in interest payments (3% of $1,000). • At the end of the 10 years, the company will return your initial investment of $1,000
Cash and Cash Equivalents (i.e. assets that can be converted into cash immediately, also referred to as money market assets)	• Cash can include physical currency in the form of coins or banknotes, as well as money held in a normal bank account which can be readily accessed as needed for transactions. • Cash equivalents are short-term, highly liquid investments which means that they can be quickly converted into cash with minimal risk. • These include savings accounts and short-term Treasury bills. • Treasury bills are short-term loans issued by the U.S. government that have a maturity period of less than one year.	• Ideal for preserving capital as they are very low risk. • Holding cash or cash equivalents can be useful if you have a low willingness or ability to take risk. • Can serve as an emergency fund to cover unforeseen expenses or financial emergencies. • Cash equivalents are highly liquid meaning they are easy and quick to convert into cash, allowing you to meet short-term obligations and unexpected expenses without having to sell other assets.	• While low risk, there is no explicit guarantee that this asset will not fall in value. Charges and possible falls in interest payments, means you could get back less than what you invested. • During a low interest rate environment, returns may be negative. • There is also the risk that this type of asset will not keep pace with inflation, which would mean prices in shops rise quicker than your investment increases in value, so its spending power is reduced.	• Keeping money in an easy-access savings account at your bank that pays a modest interest rate. • The money in your account will grow slowly but it remains easily accessible and is not exposed to market fluctuations.

Asset Class	What is it?	Why invest?	Risks?	Example:
Real Assets	Real assets are based on tangible things, such as a building or a barrel of oil. These assets derive their worth from their physical properties and/or the income they generate. The most common types of real assets are **real estate** and **commodities.**			
▪ **Real Estate**	▪ Real estate involves investing in physical properties like houses, apartments, commercial buildings or land. ▪ Buying a rental property (i.e. a property that you will rent out) is a common way to invest in real estate. ▪ You can earn rental income and potentially benefit from the property value increasing over time.	▪ Potential to benefit from property value appreciation and steady income from rentals. ▪ Provides diversification benefits, as real estate often behaves differently from stocks/bonds	▪ Real estate requires significant capital upfront and can be illiquid (hard to sell quickly). ▪ Property values can fluctuate and managing a property can be time-consuming and costly.	▪ Suppose you purchase a single-family house for $300,000. ▪ You decide to rent it out for $2,000 per month, generating $24,000 in rental income each year. ▪ Over time, property values in the area increase as more schools and public amenities open, and your house's market value rises to $350,000.

(please refer to the next page for detail on Commodities)

Asset Class	What is it?	Why invest?	Risks?	Example:
Real Assets (continued)	Real assets are based on tangible things, such as a building or a barrel of oil. These assets derive their worth from their physical properties and/or the income they generate. The most common types of real assets are **real estate** and **commodities.**			
▪ **Commodities**	▪ Commodities are physical goods such as precious metals (e.g. gold), energy resources (oil and natural gas), and agricultural products (e.g. wheat)	▪ They can act as a hedge (protection) against inflation which means that their prices often rise when inflation is high (although this relationship is imperfect). ▪ They can provide diversification benefits.	▪ Commodity prices can be highly volatile, influenced by many factors like geopolitical events and supply and demand. ▪ Investing directly in physical commodities also involves storage and insurance costs.	▪ Suppose you invest in gold by purchasing physical gold bars at a price of $2,000 per ounce. ▪ If inflation rises significantly over the year, causing the cost of goods and services to increase, the value of money declines. ▪ However, suppose the price of gold also went up during the year to $2,500 per ounce. ▪ While the real value of cash declined because of inflation (meaning the same amount of cash buys less), your investment in gold appreciated, effectively countering the negative effects of inflation.

Sharia-compliant investments

Sharia-compliant investors can invest in a subset of the asset classes mentioned above, adhering to specific guidelines outlined by Islamic principles. Sharia refers to a set of religious principles that are an important part of Islamic tradition for many Muslim investors. Sharia-compliant investments allows an investor to invest in line with their Islamic religious beliefs and can be considered a form of socially responsible investing as they typically exclude investments which derive most of their income from the sale of certain products such as alcohol, pork products, gambling, military equipment or weapons.

Diversification

One of the golden rules of investing is **diversification**, which means spreading your investment across different asset classes to reduce risk. By not putting all your eggs in one basket, you can protect yourself against significant losses if one particular asset class performs poorly. For example, if the stock market is down, bonds or real estate might still hold steady, balancing out your overall portfolio performance.

It is important to remember that different assets have higher or lower risks attached to them and could potentially give you higher or lower returns on your initial investment. While the general long term relative performance of the asset classes can be estimated and quantified, it's important to note that the way an asset class has performed in the past isn't necessarily how it'll perform in the future. Please remember that whichever asset class or asset classes you are investing in, the value of your investment can go down as well as up, and could fall below the amount(s) paid in. This also applies to 'cash' and 'near- cash' investments, which do not necessarily guarantee positive returns, nor do they provide complete protection for your investment.

The right mix of asset classes will depend on various factors, including your financial goals, risk tolerance, investment horizon, and current financial situation.

Conclusion

Understanding the different asset classes is a fundamental step in becoming a confident and informed investor. Each asset class has its own unique characteristics, potential returns, and risks. By considering your personal financial situation and goals and then diversifying your investments across different asset classes, you can create a balanced and resilient investment portfolio.

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