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Season 2. Building personal wealth

Episode 8.

What to expect from different types of investments – Part 2

Hi there. Jason here. And in this Insight we'll complete our look at the sorts of returns and the risks you can expect from the types of investment that most people hold in their pension or investment linked ISA. So, we're talking here about the returns you might expect from collective investment funds which invest in cash deposits, bonds, shares on the stockmarket and commercial property. And as we explored the risks and rewards of cash and bond funds in the last Insight, we'll focus here on fund investing in the stockmarket and commercial property.

But before getting started on that I just want to say why we're not covering residential property as an investment asset in this insight. And there are three reasons for this. First, the market for funds that invest in residential property is, currently, very limited. Second, if you're buying or planning to buy your own home you'll build up a big stake in residential property. And buying more of that asset class inside your pension or ISA might not be high on your agenda. And third, whilst we know that buying property to let can be a rewarding wealth building strategy for some people during some market cycles, that strategy has its own unique set of costs and risks. So, we'll need to come back to buy to let investing another time to cover those issues in detail.

OK, now let's complete our assessment of the main investment asset classes by looking at stockmarket and commercial property-based funds. Stockmarket based funds invest in the ordinary shares (sometimes called 'equities') of companies listed on stock markets. In simple terms, shares give you (or the fund you're investing in) a share in the ownership of a company. And that, in turn gives you a right to your share of any dividend income that's paid out by that company.

Of course, not all companies make profits and not all companies pay out dividends consistently either. So, at any given time, some companies will be growing their sales and profits, whilst others suffer flat or falling revenues and still others fail and go out of business. And it's this uncertainty about the fortunes of companies that causes their share prices to rise and fall each day and sometimes by quite a lot. In the worst case, when a company goes out of business its share price becomes worthless. And this 'total loss' risk is what the experts call specific risk because it only applies to a specific company's share. Now, as we said earlier, you can avoid this risk by investing in broadly based collective funds to spread your risk across many companies. And you'll want to consider the benefits of funds that diversify across many sectors of industry too. Investing in funds that only buy shares in one sector is a very risky approach to investing, as anyone holding banking and financial shares found out during the financial crisis. At that time, the value of most banking group shares all crashed together.

Indeed, a simple way to diversify your investment in shares is to buy funds that hold all the shares in your chosen market, whether it's the UK or the world's stock markets via an index tracking fund. But the right stockmarket fund for you will depend on what you want from your investment. And whether you're concerned about the risk of wider stock market falls. The risks of very big falls in the whole market are obviously less than the specific risk on a single share where you could lose all of your money. If we set aside the risk of a communist revolution, it's inconceivable that every company on the stockmarket could become worthless. However, you do still need to be aware that whole stock markets can produce quite different levels of return over different periods of time. For example, the UK stock market as a whole produced average returns above inflation of around 12% a year during the boom decade up to the end of 1987. Whilst from the beginning of the year 2000 the same market delivered no growth in prices other than what came from reinvested income for nearly 17 years. And the first 17 years of this millennium was a very bumpy ride for investors with two big market crashes along the way.

So, whilst we might dream about returns of 10% or 20% each year from stockmarket investing, it's much more realistic to assume above inflation returns of between 3% and 4% each year on average over time from developed stock markets when making your longer-term plans. The benefit of broader stockmarket investing is this: share prices should rise broadly in line with inflation over time, because as the price of goods and services rise, so do company profits. Then by reinvesting those profits (or your share of the dividend paid out) good stockmarket funds should deliver returns above inflation. Of course we need to remember that stockmarket based funds can suffer some very nasty setbacks from time to time. But it’s worth noting that if you’re investing for growth, using broadly based stockmarket funds, and you have plenty of time in the market, most big falls in fund prices will be offset by the income that’s reinvested inside your funds. And this chart illustrates precisely this point.

Notice how the broader UK stockmarket with income reinvested has delivered more than 3 times as much as the market without that income over this period. Obviously over shorter terms the effect of reinvested income is much less. But it’s worth noting the power of reinvested income to generate most of your total returns over the long term.

OK, so, now to look at the last of our four main asset types. There are three main types of commercial property. There’s retail property, which includes shops and shopping centres and retail parks. Office property, which includes office buildings and business parks. And industrial property, which includes factories, warehouses and industrial estates. And we can say straight away that with a well-diversified and well managed fund of commercial properties, you might reasonably expect total returns approaching those on the stockmarket. Something in the range of 3% to 4% each year above inflation on average over the very long-term. And, in a similar way to investments in shares, there are two elements to your investment return on property. First the price of properties should rise broadly in line with inflation over time because, as the price of goods and services in the economy rise, so do the profits of companies selling them. And so does their ability to pay more for property whether they’re buying or renting it. Then on top of price rises you get an additional return from the rental income after costs, on the properties in the fund. However, as with shares property funds don’t always deliver returns that compare well to the past. And property fund prices, like stock market fund prices, don’t always follow a nice upward sloping path. So, there are timing risks on property fund investing just as there are with the stock market.

Two further points to note about investing in property funds: First, if you look at graphs of fund prices you’ll notice that they look a lot more stable than the stock market most of the time. And that’s because property prices are set more by property valuers than by sale prices which, in turn is because sales of large commercial properties are few and far between. But the key point to note is that in times of financial stress in the economy commercial property prices often fall by similar amounts to the stock market. The second point to watch out for with many property funds is that their terms and conditions allow them to keep your money in the fund for a limited period of time, if lots of investors try to take their money out all at the same time. These terms are actually very sensible, because they give the fund manager time to sell some properties – to raise cash to pay those pay-out requests. Nevertheless, this is a feature that you need to be aware of before you invest in such a fund.

The essential thing to remember with any investment where risks are involved is to invest in line with your personal capacity for risk on each of your financial life goals. And if you're still unclear about risk capacity, take another look at our earlier Insight on 'Choosing the right level of risk for you' which covers this in detail. So, when another big fall in the stockmarket comes along you'll be in a good position to ride it out.

Well, that's about all for this episode into the risk and return profile of the main investment asset types. You can of course, invest in other assets outside of the mainstream funds you'll find in ISA and pension products. And if you decide to invest in things like art or antiques, or vintage cars or wine or gold bullion or stamps and so on. Just be aware that some of these investments can be expensive to store and insure. And few of them produce any income. And, as we've just seen, it's the income from shares and commercial property that will drive the largest part of your returns over the long term. In the next Insight we'll start exploring ways to deal with the risks of falling prices on all types of growth-based investment fund. So see you back here when you're ready for that. All the best for now.

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