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Season 2. Building personal wealth

Episode 7.

What to expect from different types of investments: Part 1 – Cash and Bond Funds

Hi there. Jason here. In this Insight we'll start to look at the level of returns and the risks you can expect from popular types of investment. We're talking here about the types of asset that most people hold inside their investment linked ISA or their Pension. And to keep things simple, we'll assume that you invest into these assets through collective investment funds inside your pension or ISA plan. Collective funds are simply a way to pool your money with lots of other investors to give you a spread of investments and avoid the risk of having all your eggs in one (or just a few) baskets.

Of course, you could invest your money into the shares of one company if you really wanted to, provided that you have the right kind of self-investing pension or ISA plan to do it. And you might make a lot of money that way if you're lucky enough to invest in the right company at the right time. But you could equally make much lower returns than from the wider market or even lose everything if the company you chose went bust. Which is why most people avoid this approach and why we'll focus here on the returns you might reasonably expect from a spread of investments in each of the main asset classes.

Now the four types of asset that most people hold inside their investment plans are: cash deposits, bonds, shares and commercial property. And in this first of two Insights on the risks and rewards in these asset types, we'll focus on cash deposits and bonds. We'll cover shares and commercial property in the next episode.

Now you already know that you can hold your cash in a bank or building society account. And, as we said in an earlier episode, your bank savings up to the compensation limit will be safe and secure in the bank. So, cash (as an asset class) is perfect for your emergency fund and your other shorter-term goals. But what you might not realise is that it's often possible to access a cash deposit type of fund, also known as a money market fund, inside your investment ISA or pension plan. And these funds can be very useful if you want to park some of your monies in a safe place inside your investment plan for a period of time. Or when you're getting ready to take some money out of your plan. You just need to be aware that these cash (or money market) funds inside your investment plan, like ordinary bank deposits, are unlikely to help you beat inflation or make good returns over the longer term. And until interest rates return to a more normal range, any money you hold in cash type funds will likely fall in value in real, inflation adjusted terms, over the longer term.

Normally, we'd expect the Bank of England to set their rate of interest - the green line on this chart - a little bit above the rate of inflation - the red line - to encourage savings. The returns on instant access savings accounts, which to keep things simple, we've not shown on this chart, would typically track a little below the Bank of England rate. So, bank savings would very broadly - offset inflation – over time as we've said before. Unfortunately, at the current time the money markets are turned upside down with interest rates at emergency low levels and cash funds earning less than inflation.

And whilst it's impossible to know how long this situation will continue, it's clear that if, after charges in a cash fund, your money earns less than inflation you'll lose some purchasing power on that over that time. So, be sure to use cash and money market funds for your shorter-term needs and not for your longer-term investing.

Now, Bond funds are generally considered to be the next step up from cash deposits on the risk reward scale. And, at a very basic level, bonds are easy to understand. They're simply loan contracts (or IOUs) issued by companies or governments when they want to borrow some often very large sums of money in the financial markets. Government bonds are called 'gilts' in the UK and company bonds are called corporate bonds. So, that's simple enough. But for a manager of a bond fund choosing bonds is not simple for various reasons. First there are different types of bonds. A general bond fund might hold a mix of government and corporate bonds and within each of those categories it could also hold different shapes of bond including: Fixed income bonds which pay investors a fixed regular income for a fixed amount of time and then, if all is well, pay back the original amount borrowed. Zero Coupon bonds which pay no income, so the total return depends entirely on the maturity value. And linkers – which deliver income and a return of capital that's linked to inflation. Then, the fund manager needs to decide on the length of term (the duration) of each type of bond they buy, bearing in mind that longer term bonds tend to be riskier, whilst shorter term bonds tend to perform more like cash deposits. And, in the case of government bonds, they could buy some undated bonds which never mature to pay back the capital borrowed but instead simply pay an unending stream of income. So, that's a lot of choice for the fund manager. And it's important to understand that bond funds don't generally buy bonds when they're 'issued' and hold them purely to maturity to get their capital back. They buy bonds in the markets after they've been issued and/or sell them before they mature, in an attempt to make profits for you. And that means there's some risk in these funds.

Now, the amount of risk in a bond fund and the potential return you can get from it really depends on: the type of bonds held in the fund; the time left to maturity on each of them; the financial strength of the bond issuer; and on the outlook for inflation and interest rates. So, for example, all other things being equal, a loan to the UK government will be viewed as safer than a loan to a company through a corporate bond and will therefore be priced by markets to offer a lower but safer return. The returns from a portfolio of long dated, UK government bonds for example, has produced average returns of 3% a year above inflation over the past 50 years. So, that's a bit more than safe bank deposits which, produced just 1% a year real return. But less than stockmarket returns, which produced 5.5% a year over the same period.

However, whilst past performance on investments can be interesting. It's important to note that bonds have had a very good run over the past 50 years or so. Inflation has come down a lot in that time and interest rates at the bank are significantly lower than they've been ever at time in history. Indeed, for most of the past 10 years, interest rates have been close to zero. And most experts agree that some bond funds could suffer quite large falls if or when interest rates return to more normal levels. So, you should not assume that the wonderful returns on bond funds over past decades will be repeated. And there are clearly risks of low or even negative returns from many bond funds from this point in time. Of course, your personal outcome will depend on the type of bond fund you invest in, and on the quality of your fund manager if your fund is actively managed. And hopefully this overview has shown that bond funds are one area where good quality advice could be valuable.

In the next Insight we'll look at the long-term growth potential of share and commercial property-based investments. See you back here when you're ready for that. All the best for now.

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