



Understanding the Fundamentals of Saving and Investing

WHY SAVE AND INVEST?

When we speak of savings we are referring to that portion of our income which we do not spend. This is usually a conscious decision to accumulate funds over time which often starts with the opening of a savings account. Investments are often taken to mean the purchase of shares or equities in a company, but also include other instruments such as bonds, treasury bills and mutual funds. There is often a thin line of differentiation between the terms **savings** and **investments**, as such in this article we shall use them interchangeable.

Most, if not all of us, would have heard the saying 'save for a rainy day'. This is one of those 'true true' sayings that has been passed down from generation to generation; and now that the 'showers' are well and truly here those of us who heeded this advise would most likely be faring better than those who did not. Apart from the 'rainy day' motive, we save for the acquisition of assets e.g. car and home, our children's education (and perhaps our own as well), building that retirement 'nest egg' to supplement our pension and thus preserve our standard of living in our 'golden years'. Last but by no means least, leisure e.g. the occasional vacation.

DEVELOPING A HEALTHY SAVINGS HABIT

In developing a savings habit a good place to start is with the preparation of a budget. A budget usually helps in prioritizing expenditure, identifying and cutting out unnecessary spending and distinguishing needs from wants. In today's difficult economic circumstances the mantra should be less discretionary spending, reducing your food bill, eating out less, cutting back on travel/leisure and starting or building your savings/ investment fund. A disciplined approach is required to stick to your budget and to maintain a proper savings habit. A good practice is to establish a standing order with your bank to transfer funds from your main account on pay day to a specially designated savings account.

All banks offer a suite of savings accounts to meet the varying needs of customers. These include the regular/standard savings account, higher yielding/premium savings accounts, savings accounts specifically designed for special interest groups e.g. minors and seniors, and certificate of deposits. These accounts work on the principle that the higher the balance maintained, the higher the interest rate offered on the account.

Certificates of deposit offer flexible terms (usually 3 months to 24 months) at the highest interest rates which are fixed for the duration of the deposit. This product is therefore suitable for those serious savers who have sums that can be set aside for these specific periods.

As the balance in your savings account grows, you would likely seek alternative investment opportunities for some of these funds at higher rates of return. This is the beginning of the construction of an investment portfolio. It's important to be mindful that in order to preserve the

value of one's savings and investments, an investor should seek a return that is at minimum equal to the annual inflation rate. A return that is higher than the annual inflation rate results in positive real returns and conversely a return that is lower than the annual inflation rate results in negative real returns. Negative real returns represent an erosion of wealth and over time negatively impact the purchasing power of your savings.

LIFE CYCLE PLANNING

The construction of an investment portfolio does not occur overnight. It is a gradual process accomplished over a period of time as the value of our savings and investments grow. To begin the process, we must first establish an investment plan to include the following:

- Investment goals or objectives
- Investment horizons
- An investment strategy to meet the stated objectives and horizons

Underpinning this strategy will be our appetite for risk which in turn is likely to depend on the stage at which we are in our life cycle. This life cycle concept is very important in financial planning and is premised on the assumption that the younger we are the less risk averse we are likely to be, and hence more willing to take greater financial risk. However as we move through the cycle of life we become more risk averse and therefore less willing to take on financial risk.

The following table provides a good guide on investment-based life cycle planning:

Age	Investment goal	Strategy
20 - 45	<ul style="list-style-type: none"> - Wealth Accumulation - High tolerance for risk 	80% - Equity Investments/ Company Shares (Capital Appreciation & Dividends) 20% - Fixed Income Instruments e.g. Traditional Bank Deposits
46 - 60	<ul style="list-style-type: none"> - Wealth Consolidation - Preparation for Retirement - Medium tolerance for risk 	50% - Equity Investments 50% - Fixed Income Instruments
Over 60	<ul style="list-style-type: none"> - Wealth Preservation - Retirement - Low tolerance for risk/ risk averse 	80% - Fixed Income Instruments 20% - Equity Investments

Let's look at a couple of hypothetical examples to help bring home these fundamental points. To do this, we need to make some base assumptions on our investment objective and horizon to allow us to plan our strategy. In the first example, let us assume that we are 25 years of age and our investment objective is to accumulate a 10% down payment of \$30,000, to allow us to approach a financial institution for a mortgage loan to acquire a house costing \$300,000. Let us further assume that we plan to purchase the house in 5 years. This 5 year timeframe is therefore our investment horizon. Finally let us assume that we are able to save \$400 a month from our salary.

At a savings of \$400 a month at the minimum bank rate of 3% we would accumulate \$26,000 over the 5 year period. However, this is short of our investment objective of \$30,000 to meet the 10% down payment required by the financial institution. For us to achieve our investment objective of \$30,000 at the end of the 5 year investment horizon from our monthly contributions of \$400 we will need to invest these funds at a rate of 9% compounded annually. This rate is more than is available on traditional bank deposits and would therefore require that we take some risk if we are to attain our objective. Given our early stage in the life cycle our appetite for risk is likely to be reasonably healthy and hence we can adopt a fairly aggressive investment strategy weighted heavily, as much as 80%, in higher yielding (higher risk) investments e.g. equities (see table above).

In our second example, let us assume that we are 55 years of age and that through our thrifty savings and wise investment habits we have managed to accumulate savings of \$250,000.00. These funds represent our retirement 'nest egg' to be used to supplement our pension and provide for the continuation of our standard of living. At this stage in the life cycle we are less tolerant to high levels of investment risk, preferring to focus on the preservation rather than the creation of wealth. Our investment strategy will therefore be heavily tilted in favour of lower yielding (lower risk) instruments such as traditional bank deposits and government backed bonds, which offer fixed/ steady rates of return, with a smaller portion say 20-30% in higher yielding (higher risk) investments such as equities (see table above).

RISK VERSUS RETURN – THE TRADEOFF

The Life Cycle Concept brings into focus the very important investment principle of Risk versus Return. This principle basically says that the higher the return we earn on an investment then the higher the risk associated with that investment. Conversely, the lower the return the safer the investment. It is essentially a tradeoff between the two. It is therefore essential for a wise investor to hold this guiding principle 'top of mind' when considering investment options. Unfortunately, history, including recent history in the OECS region, is littered with examples of investors who drifted away from this fundamental investment principle and paid the ultimate price – loss of their hard earned savings. The old adage 'if it looks too good to be true it probably is too good to be true' is relevant here.

DIVERSIFICATION IS KEY – THE PORTFOLIO EFFECT

Another guiding principle of investing is the importance of diversification. Diversification is simply spreading the risk of the portfolio by investing in several different instruments rather than just a few. This limits the exposure to, or concentration in, any one investment instrument. Diversification is akin to not putting all our eggs in one basket for fear that the basket may burst and all our eggs get broken. A properly diversified investment portfolio would involve not only a varied mix of investment instruments, in accordance with our risk appetite, but also a mix within the investment classes. For example, a diversified portfolio could include a mix of equities, government or corporate bonds and traditional bank deposits. But further, within these asset classes, there should also be diversification so that, for example, the equities are spread among several companies rather than concentrated in just one or two companies. For larger portfolios, further diversification in equities could be achieved by investing in various industries example

Banking and Finance, Manufacturing, Other Services. Diversification in terms of currencies is also useful with some investments in EC and some in US dollars.

A well diversified portfolio of investments could include:

- A mix of equities – shares in several companies/ industries
- A mix of Fixed Income Instruments e.g. Government Bonds, Corporate Bonds and traditional Bank Deposits
- Mutual Funds
- Real Estate

EQUITIES AS AN INVESTMENT

Given the current economic realities, it would be quite understandable for investors to be wary of investing in equities at this time as the outlook for equity markets is at best uncertain and further downside may be expected. However, while the value of equities can vary widely, even over a short time period, history has shown that equities provide a better all in return (capital appreciation plus dividend) over the medium to long term than money market instruments. Therefore investing in equities must be viewed as a medium to long term strategy rather than a means to short term financial gains.

Investing in the shares of a company requires that we obtain an understanding of the company and its financial position. This can be a fairly complex matter and therefore the best way to achieve this is to seek the advice of a financial advisor or stock broker. To facilitate an informed meeting with these professionals, the prospective investor should read through (or at least

peruse) the last audited financial statements of the company highlighting any areas that require explanation and jotting down any questions that come to mind. Remember the financial jargon in these statements can be complex so do not feel apprehensive about asking what you may consider ‘silly’ questions.

Remember too that the financial statements are historical in nature, that is, they report on the company’s most recent past performance. While this is an important guide to the future, we live in uncertain times and a prospective investor is more interested in the future of the company and its ability to pay dividends and provide capital appreciation going forward. So be sure to raise questions on the company’s future plans and projected performance.

It is also a good idea to go ‘beyond the numbers’ by questioning not only the financial or quantitative aspects of the company’s performance but also the non financial or qualitative aspects. Some general areas to consider:

- the nature of the industry/ market in which the company operates,
- how well positioned is the company relative to its competitors; and
- the experience, competencies and track record of the Board of Directors and the management body

Within Grenada and the wider Caribbean, investors seeking to construct a well diversified equity portfolio should consider investing in the Eastern Caribbean Securities Exchange (ECSE), the Trinidad & Tobago Stock Exchange (TTSE), the Jamaican Stock Exchange (JSE) and the

Barbados Stock Exchange (BSE). There are several stock brokerage firms in these territories from which information on investing in these markets can be readily obtained. For the really serious investor there is an even vaster world of investments further afield in the international capital markets. However, on a note of caution, always bear in mind that investing in foreign markets leads to the creation of exchange risk. This is a factor to be very carefully considered but is beyond the confines of this article.

REAL ESTATE AS AN INVESTMENT

For the larger investment portfolios, diversification should also include real estate. Like equities, property values may fluctuate based on economic circumstances but tend to appreciate over the medium to long term. Some areas to consider when investing in real estate include:

- Obtaining a professional valuation of the property and reading through the valuation report carefully looking for any negative comments. Consider the marketability of the property and its suitability to your investment objectives and horizon.
- Do not rely entirely on the valuation report but visit the property to gain a firsthand appreciation of the value and other specifics of the property.
- Despite the saying 'land does not rot', it is generally preferable to invest in rental/ income generating properties than in idle land which does not generate income.
- Always consider the outgoings/ maintenance costs associated with the property. A general yardstick would be to cater for 10% to 15% of the rental income in outgoings/ maintenance costs.

Quality real estate can be a worthwhile investment and add balance and diversification to any investment portfolio.

CONCLUSION

A healthy savings and investment habit are important ingredients in ensuring a secure financial future. There is no better time to start than the present. Establishing an investment plan by setting investment goals and horizons and designing a strategy to meet these are key elements in the process. Be guided by your risk tolerance. Make wise decisions based on your stage in the life cycle and diversify your portfolio to avoid the risk of concentration in a small number of investments. Be sure to seek the advice of a financial advisor before investing in products that you are not familiar.

Save and Invest Today – Your future depends on it!!

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