CREATING PROSPERITY BY CONNECTING INVESTMENT OPPORTUNITIES TO INVESTORS

INVESTORS' CORNER

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Investment Return

Part 2

This is the continuation of a two-part series on Investment Returns. Part 1, which outlined the sources of total return for an investment, is available at www.blogs.vertexinv.com or at www.dcsx.cw/education.

We have learned in the previous article, that the total return on any investment has two primary sources – capital appreciation and income. Capital Appreciation is the growth in the value of your investment because of an increase in the price of the securities that you had invested in. Capital Income represents cash flow from your investment, such as dividend income in the case of stocks, interest income in the case of bonds and rental income in the case of real estate. Below we will explore the sources of return for the main categories of investment options:

Bonds – are issued by a company or the government to raise capital to finance and expand their operations and projects. The borrower promises to pay interest until the maturity date at which time he returns the initial investment to the lender.

There are two ways in which you can make money from a bond. The main way is via the interest payment that is promised to you as the investor. This is the income component of the bond's total return. The interest can be paid monthly, quarterly, semi-annually or annually. For the most part, if the borrower hasn't defaulted on its bond, these periodic payments provide a steady stream of income to the investor. For example, if you buy a bond of ANG50,000 with interest payments of 5% paid quarterly, you would receive ANG625 every 90 days, say March 31st, June 30th, September 30th, and December 31st.

The other source of return – capital appreciation - is from the profit you can make if you buy the bond at a low price and sell it at a higher price. For bonds, this way of making money does not represent a significant share of the total return that you could potentially make. This is because bonds do not increase or decrease in price as significantly as other types of investment, like stocks. This is also a good thing because it is very rare that you will lose the money you invested in the bond because of falling bond prices. Accordingly, this is the reason why bonds are considered less risky than stocks. Therefore, the main reason an investor normally buys a bond is to receive a steady stream of income on predetermined dates.

Stocks – gives you part ownership in a company. Unlike bonds, the primary way of making money from stocks is through capital appreciation. The intention of the investor is to buy the stock at a price which they believe will eventually increase to a much higher price in the future. For example, if you had bought a Google share on January 9, 2015, the price would have been $541.80. On August 10th, you would have doubled your money, because the Google share price had increased to $1,252.51. However, there are times that the stock price doesn't increase and there is a strong risk that the price might even decrease instead. This is why stocks are considered risky assets.

The other way of making money from a stock is through dividend payment – the income component of the total return of the stock - which is the payment made to owners of stocks from the profit a company makes. Dividends are most times paid on an annual basis and are based on the number of stocks you own. On average, returns from dividend are not normally the primary way for investors to make money from stock investments.

Real Estate – consist of real physical assets and can include investments in commercial properties or residential locations. Real estate is probably the most common type of investment where an investor can earn significant profits from both sources of return – capital appreciation and rental income. An investor of real estate earns capital appreciation when there is an increase in the market value of the property owned. Capital income is earned from rent received that is normally paid on a monthly basis.

Mutual Funds – like stocks, investors make money through capital appreciation when investing in Mutual Funds such as ETF, Index Funds, etc. A Mutual Fund is an investment fund that pools money from a diverse group of investors to buy many different types of securities like stocks, bonds, real estate and at times other mutual funds. The returns that we mentioned before – capital appreciation and income - are earned by these securities held in the Mutual Fund. The price of the Fund can either increase or decrease depending on whether the securities are generating more/fewer losses compared to gains/income. Typically, capital appreciation is the main means of return for Mutual Fund, unless the mutual fund is a special type of Income fund that pays out income on a periodic basis.

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