A guide to...
Investing.

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Five tips to getting started...

Set yourself a time frame and financial goals before you invest.

Through investment, you have a much greater potential for growth than by leaving your money in a savings account.

In the current economic climate, with interest rates so low and inflation rising, you could be losing out by keeping your money in a savings account because inflation is beating the return on interest rates and, therefore, the real spending power of your money is less.

Investment can enable you to match or even beat inflation and help you reach your long term financial goals, but it's important to understand that, in order to do this, you are introducing the risk of loss to your money.

When you invest, you encounter what is known as a risk/return pay off. Traditionally, the greater the risk you take with your money, the greater the potential for growth.

But, with this, comes an increased chance of losing your money. Before even considering investing your money, you need to be fully comfortable with introducing the potential for loss.

No investment is risk free and if you simply can't reconcile that there are no guarantees with investment and that you could, potentially, lose some of your money, you are not ready to become an investor.

When making financial decisions, it's important to consider the five steps below before you do anything with your money.

1. What are your financial goals?

Set a clear goal of what you want to achieve by investing. Are you just looking to grow your money? Are you looking to provide an income? Is there a set amount that you want your money to grow by or a minimum income that you need to be provided by your investments?

Having an idea of these will help you to decide how much risk you need to take to reach your goals. You may not have a particular reason to invest or it might be open ended, but try to ascertain exactly what you want your money to do.

2. What's your time frame?

Once you know what your goals are, work out how long you need to achieve them. This will give you a clear idea of the kind of rates of return that you'll need from your investments and whether or not your goals are realistic.

Factors like your age and health are important to consider. If you have short-term goals (less than five years) you should stick to cash savings. A Best Rate cash ISA is perfect for this but don't invest – if your investment falls you might not have time to recover your losses before you need the money. Check out how to find the best cash ISA, Medium (five to 10 years) and long-term goals (10 years or more) are appropriate for investment, but some investments become less appropriate the older you get. You have less time for your money to recover if it falls in value and, if you're retired, your capacity to earn is diminished.

3. Understand your attitude to risk

Understanding the risks you'll encounter through investment and how much risk you think you're willing to take could have an impact on the length of time you want to invest and, indeed, your financial goals.

If you want your money to grow significantly over a shorter time period, you may have to invest in riskier assets to achieve that growth – but if the potential downsides are too much, you may have to realign your goals. Read our guide to understanding investment risk to learn more about your attitude to risk.

4. How much can you afford to invest?

Be realistic about how much you can afford to invest. Assess all of your liabilities, like debts, insurance premiums, pension contributions, savings and living costs, to see how much spare cash you have to invest.
Remember that investment is long term and you should avoid having to access the money you're investing, as it may not reach its full potential if you do.

5. Seek financial advice

Only those who have knowledge of the markets and strong financial sense should really be managing their investments on their own.

By seeking financial advice, you'll be able to talk through all the points raised above and ensure that your investments are tailored exactly to your needs. Read our guide to choosing a financial adviser for the best ways to get investment advice.

Lump sum or regular savings?

Regular investments could prove more beneficial than a lump sum.

So, you've figured out what you want your money to do, how long you want to invest for and how much you can afford to invest, but how you actually pay money into your investments could have a significant impact on the returns you receive.

The two main ways of investing your money is either as a lump sum (all of your savings are invested immediately) or through regular investment (typically through monthly contributions).

How you invest might depend on your circumstances and the affordability of investment, but also your attitude to risk.

If, for example, you're comfortable with risk and have conviction in your choices of investment, you may want to invest a lump sum.

However, if you don't have enough put aside (most investment funds, for example, have a minimum lump sum investment of£1,000) or are cautious about piling everything in, you might prefer to drip feed your money on a regular basis.

Lump sum or regular - which is best?

Say you have £10,000 to invest. If you invest all of it straight into the stock market, your full amount of capital has the greatest potential for growth, as it's immediately fully exposed to the market. The assets within which you invest, be it shares, bonds or units (in a unit trust), are bought at the same price and you can benefit from any price increases straight away.

If you drip feed your £10,000 investment on a regular basis, only some of your money will be earning investment returns in the early months and you won't get the access to the total growth you would if you were fully invested.

The potential downside of this is that you're exposed to potential downward fluctuations in the market. So, if you invested all of your money in the FTSE 100 (the stock market index that tracks share performance of the top 100 companies in the UK), for example, and it dropped by 20%, your investment would follow suit.

Staying invested in the stock market over a long period gives you the opportunity for your money to recover – but this could take a long time and requires a lot of nerve and patience on your part as an investor.

You also have to think about market timing – are you investing at a peak or at a low? This can be hard for even professional investors to judge.

A way to steer around the fluctuations in price of markets or assets is to invest on a regular basis. This is technically known as 'pound cost averaging.'

Pound cost averaging explained...

This is the process of regularly investing the same amount, usually on a monthly basis, to smooth out the highs and lows of the market within which you're invested. It's also extremely useful as a means of tipping your toe in the water and monitoring your investments on a monthly basis if you're a beginner or simply don't have an up front lump sum to invest.

The effect of pound cost averaging is that you're buying assets at different prices on a regular basis, rather than buying at just one price, and while riding out the movements of the market, you could also end up better off than if you invested with a lump sum. Let's look at this in practice. If you invested a £10,000 lump sum and bought shares valued at £10 each, you'd have 1,000 shares. Now, if you bought £500 worth of shares per month over 18 months (amounting to £10,000 overall all), you would buy 50 shares in the first month.

But if the share price went down to £9.50 in the second month, you'd be able to buy 52 shares, as the shares are at a lower price. Therefore, rather than your full £10,000 investment being affected by the drop in share price, only a small proportion of your money drops in value. After 18 months of movement in the share price, it might end back on £10.

If you invested with a lump sum, you'd still have the same amount of money and the same number of shares, but, by regularly investing, you may end up with more shares and, consequently, some growth of your capital, despite the share price ending up the same as when you invested and investing the same amount.

However, it's important to remember that you may not necessarily benefit this way using pound cost averaging. One potential downside of this is that if your investments continuously grow, you'll be missing out on some of that growth as not all of your money has been invested over the whole period.

In fact, data from the Association of Investment Companies (AIC) shows that over the very long term (20 years), a lump sum investment of £12,000 has returned £86,000, while a £50 a month investment over the same period has returned £31,000. but if you're nervous about the markets, or in a particularly volatile market, regular investment can help smooth out the market risk.

Combining the two...

If you're confident in investing a lump sum in a particular asset or market, you could split some of your money between a full investment and regular contributions. If you decide to do this, make sure that the money you are holding back for regular investments is working as hard as possible for you in the mean time by keeping it a high-interest savings account that allows you to make regular withdrawals.

Five-step guide to diversification...

Diversification can help you spread risk around your investment portfolio.

One of the principle tenets of spreading risk in your portfolio is to diversify your investments. Diversification is the process of investing in areas that have little or no relation to each other. This is called a low correlation. You can also invest in assets that have a negative correlation. This means that the assets will move in opposite directions to each other.

Diversifying your assets helps spread risk because you're lessening the potential for losses. If you had all of your money invested in one asset, sector, or region and it began to drop in value, your investments would suffer.

By investing in assets that aren't related to each other, while one part of your investment portfolio is falling in value, the others aren't going the same way. Some assets will actually go up in value when others decrease.

You can diversify through investing in different markets, countries, companies and asset type.

Diversification is an essential part of building your investment portfolio. It can give you peace of mind that your investments will sustain in adverse market conditions and cushion losses. It will not lessen all types of risk.

Diversification helps lessen what's known as unsystematic risk, like drops in the value of certain investment sectors, regions or asset types in general, but there are some events and risks that diversification cannot help with, or systemic risks. These include interest rates, inflation, wars and recession. This is important to remember when building your portfolio.

1. Assets

Having a mix of different asset types will spread risk because their movements are either unrelated or inversely related to each other. It's the old adage of not putting all your eggs in one basket.

Probably the best example of this is shares, or equities, and bonds. Equities are riskier than bonds, and can provide growth in your portfolio, but, traditionally, when the value of shares begins to fall bonds begin to rise, and vice versa.

Therefore, if you mix your portfolio between equities and bonds, you're spreading the risk as when one drops the other will rise to cushion your losses. Other asset types, like property and commodities, move independently of each other and investment in these areas can spread further.

2. Sector

Say you held shares in a UK bank in 2006. This investment may have been very rewarding, so you decide to buy more shares in other banks. When the credit crunch hit the following year sparking the banking crisis, the value of your shares in this sector (financials) would have tumbled.

Once you've decided on the assets you want in your portfolio, you can diversify further by investing in different sectors, preferably those that aren't related to each other.

If the healthcare sector takes a downturn, this will not necessarily have an impact on the precious metals sector. This helps to make sure your portfolio is protected from dips in certain industries.

3. Geography

Investing in different regions and countries can reduce the impact of stock market movements. This means you're not just affected by the economic conditions of one country and one government's fiscal policies.

Many markets are not correlated with each other - if the Asian Pacific stock markets perform poorly, it doesn't necessarily mean that the UK's market will be negatively affected. By investing in different regions and areas, you're spreading the risk that comes from the markets.

However, you need to be aware that diversifying in different geographical regions can add extra risk to your investment.

Developed markets like the UK and US are not as volatile as some of those in the Far East, Middle East or Africa. Investing abroad can help you diversify, but you need to be comfortable with the levels of risk that come with them.

4. Company

Don't just invest in one company. It might hit bad times or even go bust. Spread your investments across a range of different companies.

The same can be said for bonds and property. One of the best ways to do this is via a collective investment scheme. They will invest in a basket of different shares, bonds, properties or currencies to spread risk around.

With a bond fund, you might be invested in 200 different bonds. This will be much more cost effective than recreating it on your own and help diversify your portfolio.

5. Beware of over diversification

Holding too many assets might be more detrimental to your portfolio than good. If you over diversify, you might not end up losing much money, but you may be holding back your capacity for growth as you'll have such small proportions of your money in different investments to see much in the way of positive results.

It's usually recommended that you hold up to 15-20 investments (be it shares, bonds or funds) as a maximum.

Your rights as an investor...

You have investor protection through the FOS and FSCS.

When you invest your money with a firm and they are authorised by the Financial Conduct Authority (FCA), you get significant protection if you're not happy with the service you've received.

Authorised firms must have formal complaints procedures and belong to the Financial Ombudsman Service (FOS), which resolves disputes between a firm and its customers.

As a last resort, if an authorised firm goes bust, owing money to its customers, there is a compensation scheme in the UK that may step in and pay compensation.

Making a complaint through the FOS...

If you have a problem with a financial product, service or advice from an authorised firm, first, complain to the firm involved. It is obliged to acknowledge your complaint within four weeks (30 days) and must resolve your complaint within eight weeks.

If you have not had a response within this time or the complaint has not been upheld, you can take your case to the FOS. The ombudsman can order a firm to put matters right, including awards up to £100,000.

If you're unhappy with the ombudsman's verdict, you can bring a court case against the firm. However, this can be a time consuming and a costly experience, whereas going to the FOS is free and requires no legal representation.

Claiming compensation through the FSCS...

If you've lost money because of an authorised firm's dishonesty or negligence, normally, you'd seek compensation through the firm (using FOS if your complaint is not originally upheld). But your chances of getting money from the firm evaporate if the firm goes out of business.

In that situation, you can make a claim through the Financial Services Compensation Scheme (FSCS), which might refund some or all of the money.

The FSCS pays compensation of up to £50,000 per person per firm.

Remember, investment isn't covered...

In general, the law and the FCA rules do not protect you from investment risk. It's in the nature of many investments that you might lose money and that is a risk you accept in return for the potential of a higher return.

So, if your investments have lost money, you cannot raise a complaint about the performance (unless you have evidence of mismanagement or negligence).

However, if you take advice on your investments and the adviser failed to make sure you understood the risks you were taking, you might have a valid complaint if you lose money as a result.

This highlights another important reason to take independent financial advice when deciding to invest; not only will you lessen the risk of making inappropriate investments by seeing an adviser than you would on your own, you also receive an extra layer of protection if the recommendations you get are not right for you.