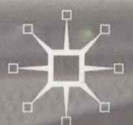


# Personal Investment

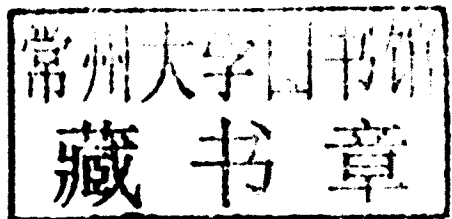
*financial planning in an uncertain world*

Mariana Mazzucato, Jonquil Lowe, Alan Shipman and Andrew Trigg



# Personal Investment: financial planning in an uncertain world

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# Preface

It is hard to escape the need for personal investment and financial planning. In many advanced economies, the affordability of state support during periods of unemployment, infirmity or old age is being questioned, driven in large part by the need to adapt to the demographic challenge of ageing populations. At the same time, decades of economic growth have raised societies' expectations about living standards throughout life. As a result, individuals and households are finding that increasingly they must organise their own financial security, and personal investment has become the main route.

The first objective of this book is to raise your understanding and confidence in making personal investment decisions. These will be affected by some factors outside your control (for example, inflation and the setting of interest rates) and others within your control (such as choices about the mix of assets that you hold). All financial planning requires an understanding of how the local context – your own particular situation – is part of a wider context, including the role of the economy and governments. In helping you to better understand both the local and wider context of investment planning, the book will help you to become more knowledgeable and thoughtful about your own investment decisions.

Some of you reading this book will be doing so as part of a university or college course covering personal investment and financial planning, for which this is a core text. You may be following, or preparing for, a career in financial services, an industry in which selling and giving advice about personal investment products plays a key role, and is going to increasingly require higher level study. In the UK, Level 4 of the Qualifications and Credit Framework in England, Wales and Northern Ireland or Level 7 of the Scottish Credit and Qualifications Framework has already been set as the new minimum qualification level for investment advisers from 2012 onwards, with a requirement for ongoing continual professional development. So a second objective of this book is to make a major contribution to that professional development for people working in the financial services industry.

The book explores the landscape of the financial services sector: how financial innovation creates new products and may change the nature of existing ones; how savers interact with providers and other players, such as banks, life companies, fund managers and advisers; the different incentives

and conflicts involved; and the role of financial regulation. It will be useful for anyone who wants to know more about ways of planning for the financial future, and what happens to money once it leaves the hands of savers and investors.

*Personal investment: financial planning in an uncertain world* crosses traditional disciplinary boundaries to bring together economics, finance, statistics, history, business and sociology. It also draws on a wealth of relevant and topical examples from the everyday world around you, including bank runs, asset bubbles and changing pension provision. We hope that this book will not only empower you with a new understanding about how to plan your personal investments, but also give you a passion for understanding the fascinating subject of personal finance.

## Acknowledgements

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The Editors would also like to acknowledge the substantial contributions to this project from: Leslie Budd, Ian Fribbance, Susan Himmelweit and Martin Upton at The Open University; our External Assessor, Professor Peter Howells of the Centre for Global Finance at Bristol Business School; and John Bloxham, financial services practitioner and Associate Lecturer with The Open University.

The book's production would have been impossible without extensive and generous assistance from the following people: Karen Barboteau, Brenda Barnett, Margrit Bass, Helen Birkbeck, Kathleen Calder, Heather Clarke, Lene Connolly, Jeff Edwards, Richard Golden, Paul Hillery, Shereen Karmali, Joanna Mack, Margaret McManus, Nic Morris, Luke Nolt, Sally O'Brien, Nina Randall, Liz Vidler and Andrew Whitehead, all at The Open University; and Martin Drewe at Palgrave Macmillan.

## Disclaimer

This book does not claim to give specific individual financial advice and nothing contained within it should be interpreted as doing so. If you think that you need specific individual financial advice, you should see an authorised financial adviser.

# Contents

<i>Contributors</i>	<i>ix</i>
<i>Preface</i>	<i>xi</i>
Introduction	1
1 Themes in personal investment	6
2 Structure of the book	17
References	19
 PART ONE: PRODUCTS AND PLAYERS	 21
Chapter 1 From saving to investment	25
1 Introduction	27
2 High-street banks: the first place to save?	31
3 Risk and return in banking	38
4 Banks and financial markets	55
5 Conclusion	62
References	64
Chapter 2 Investment choices	67
1 Introduction	69
2 Investment choices	71
3 Understanding risk	81
4 Evaluating risk and return	91
5 Non-financial investments	106
6 Conclusion	109
References	110
 PART TWO: STRATEGIES AND MARKETS	 113
Chapter 3 Risk–return strategies	117
1 Introduction	119
2 Taxation and transaction costs	121

3	Building a portfolio	126
4	Balancing risk and return	138
5	Measuring investment performance	148
6	Investment in practice	157
7	Conclusion	162
	References	163
	Chapter 4 Markets and players	165
1	Introduction	167
2	What financial markets are intended to provide	169
3	Derivative markets	176
4	Financial market efficiency	188
5	Active investment management in the light of the EMH	195
6	'Infomediaries' and the problem of unbiased information	199
7	Conclusion	204
	References	205
	PART THREE: BUBBLES AND THE ECONOMY	209
	Chapter 5 Economic fluctuations	213
1	Introduction	215
2	Economic fluctuations	217
3	Are economies self-correcting?	222
4	Economic indicators	235
5	Fiscal and monetary policy	242
6	The open economy	250
7	Conclusion	254
	References	255
	Chapter 6 Bubbles and investment behaviour	259
1	Introduction	261
2	Bubbles in historical perspective	265



3	Categorising asset bubbles	273
4	Overvalued compared to what?	277
5	Volatility and animal spirits	280
6	Efficiency or madness of crowds?	283
7	Behavioural finance	285
8	Implications for personal investment strategies	296
9	Conclusion	300
	References	301

## PART FOUR: REGULATION AND THE LONG TERM 305

Chapter 7	Regulating the financial system	309
1	Introduction	311
2	Financial markets and financial regulation	313
3	Financial liberalisation in the UK	322
4	UK financial regulation	325
5	Regulatory challenges	334
6	International financial regulation	346
7	Conclusion	353
	References	355
Chapter 8	Conclusion: investing for the long term	359
1	Introduction	361
2	Retirement planning for the individual investor	364
3	Retirement as a social challenge: the case of pensions	372
4	Conclusion	385
	References	386
	Glossary	389
	Acknowledgements	429
	Index	431

# Introduction

Mariana Mazzucato, Jonquil Lowe, Alan Shipman and  
Andrew Trigg



# Introduction

At some point in our lives most of us will save: for retirement, for a deposit on a home, or just for a rainy day. By not spending our money in the present, saving allows us to put aside resources for the future. Countries around the world differ greatly in the extent to which their citizens save. In Italy, for example, people have higher saving rates than in other large European countries, which means that they are less vulnerable to unexpected changes in personal and economic conditions. By contrast, US and British citizens are better known for their indebtedness than their savings, with the average American having 50 per cent more debt than income (Bucks et al., 2009). Those of us who are reluctant or unable to save are often encouraged by government to do so, usually through tax incentives or other subsidies.

Ensuring that savings will be available in future to meet an individual's or household's goals requires strategic planning and decision making. Investing strategically requires knowledge and understanding about the options available, the significance of the context in which choices are made and the implications of those choices. Consider the issue of inflation. Rising price levels damage the real value (buying power) of most investments. Therefore it is essential that investors understand where inflation comes from, how governments may react and the impact on different investments. For example, back in 1948, £60 would have purchased a new motorbike; 60 years later it could barely buy a pair of wing mirrors – a vivid demonstration of the destructive power of inflation. In comparison, £60 invested in the UK stock market in 1948, with income reinvested (ignoring tax), would have been worth over £50,000 by 2009 (based on data from Barclays Capital, 2009) – enough to buy ten motorbikes. Inflation compels investors to make choices to try to protect the future value of their money and to engage with stock markets. Even when savers put money into bank accounts, they usually expect a return that will beat inflation and this is possible only if banks invest the savings in some way.

This book provides an introduction to the main choices available to personal investors. Four types of assets will be considered as possible vehicles for investment: cash (meaning deposits, such as savings accounts), bonds, shares and property. These assets can be chosen directly, for example, by purchasing the shares of a particular company, or indirectly by investing in financial products, such as investment funds. Personal investment, as we broadly define it, looks at the

investment of savings in such assets and their related financial products. (This can be distinguished from real investment, which refers to investment by companies in physical goods such as plant or machinery.)

To make personal investment choices, there are various techniques and tools available to investors. This book explains how these work and, in so doing, introduces you to the academic discipline of finance, a field to which many eminent economists have contributed. Key to this field of study is the lack of certainty about how returns from investment can be predicted. The share price of a particular company, for example, may be based on a calculation of future profits, which depend on a number of unknown factors. These might include the success of its future sales, how well it controls costs, the hiring of a new management team, or the trajectory of economic conditions. You will be introduced to the power of investment tools in turning unknown factors such as these into precise calculations, but also to the limitations of the tools in the face of uncertainty. That is not to say that such tools should be discarded, but their suitability must always be understood in the context in which they will be applied, just as, say, a hand lens would be a poor tool for scanning the horizon.

Table 1 A guide to common personal investment terms\*

Term	What it means
Bonds	Investments that are loans to a government, company or other body. Typically, a bond has a set repayment date and, in the meantime, pays interest and can be bought and sold on the stock market.
Saving	The flow of money not used for current consumption and that contributes towards an individual's or household's savings.
Savings	The total value of all financial assets, including investments, that an individual or household has at a particular point in time.
Shares	Also called equities, securities or stocks. These are investments where each holder becomes part-owner of a company. The return may comprise regular dividends (a share of the company's profits) that are not guaranteed and/or a capital gain or loss when the shares are sold. Shares are often, but not always, traded on the stock market.

Investing	Saving is sometimes called 'investing', especially when the money is set aside for long-term goals. 'Investing' is often used to mean the purchase of financial or physical assets that involve some risk of capital loss. However, there is no set definition and the terms 'saving' and 'investing' are often used interchangeably.
Investment fund	A financial product that invests in a broad range of different bonds, shares and/or other assets.
Investments	This tends to mean assets that are traded on a stock market or products that invest in such assets. However, there is no set definition and across the financial services sector you will find the term used to mean different things.
Real value	The value or price of something after stripping out any change due to inflation. For example, if £100 is invested and grows to £110 but the general level of prices goes up 10 per cent, the real value of the investment is still only £100.

\* These terms generally have different meanings when used by economists and business specialists. This book makes clear when a more specialist meaning is intended.

# 1 Themes in personal investment

Our intention, in writing this book, is to encourage you to think critically about personal investment. You will be encouraged to make informed decisions, to look at the implications in the small print when considering financial products, to understand how the operation of financial markets impacts on your planning, and to search behind the marketing messages and advice of providers and advisers. The book develops three main themes:

- *Risk and return.* To make a financial return from investments, individuals must take risks. Stocks and shares, for example, are more risky, but over long periods of time typically offer higher returns than bonds and cash. As you will explore in Chapter 1, even savings accounts are not risk free. This theme looks at the relationship between risk and return, and the extent to which investors can increase returns without necessarily incurring extra risk. It also highlights how our understanding of the risk–return relationship rests on some deeply embedded assumptions that we might want to question.
- *Uncertainty and change.* This theme explores the importance to personal investment of unforeseen forces and events. Some events occur suddenly, throwing investment plans into disarray. Other forces, such as population ageing, are more gradual, but generate great uncertainty for personal investment decisions.
- *Regulation and ethics.* Investors need to be assured that financial institutions are sound and that financial product providers and advisers are behaving in an ethical way. This may be achieved through formal regulation and the financial services sector's own ethical codes and practices. Both are forged within the context of government policies that aim to regulate the national and international economy in pursuit of stability and other goals. Ethics may also embrace a concern that the aims and actions of organisations issuing investments are compatible with social, religious, humanitarian and environmental objectives.

The following is a brief introduction to each theme, and why it is important to personal investment. Some key concepts will be introduced as part of this introduction.

## 1.1 Risk and return

Savers have a diverse choice when looking at ways to set aside resources for future consumption, and the options differ greatly in terms of risk. The least risky for personal investors is generally taken to be savings accounts, since they can easily be cashed in with no loss of the original capital invested (ignoring any erosion due to inflation). In other words, savings accounts have low **liquidity risk** and low **capital risk**.

Risk is related to return because the vast majority of investors must be persuaded to take on extra risk and the persuasion comes in the form of a higher potential return – a **risk premium** (only ‘potential’ otherwise there would be no risk). Of course, gamblers enjoy and seek out risk – they may be playing the financial markets for their own sake and require no extra reward, but most investors do not fall into this category.

The key choice that investors face over the degree of risk and return associated with their investments is illustrated in Figure 1. Risk is plotted along the horizontal axis of the chart and potential return on the vertical axis; the space created by these axes can be thought of as the **risk–return spectrum**. We have placed a number of investments in this space, choosing the position of each one according to the balance of risk and return that we think it offers. For example, we have put savings accounts in the bottom left-hand corner, corresponding to low risk but a potentially low return. Moving upwards and to the right, the investments become progressively more risky – generally because liquidity risk or capital risk or both increase – but the reward for the extra risk is a higher potential return; in other words the *risk premium* increases. Shares are very risky, which is why most people do not buy them individually but instead invest in a broad spread of different shares through an investment fund. On the whole, where we have placed each investment should be fairly uncontroversial. But the investments shown are broad types, and within each type there will be examples of some that are higher risk and some lower risk than the position on the chart suggests. For example, a fund investing in the shares of small, high-growth companies may be more risky than buying shares in a single well-established high-street name.

Don’t worry if some of the investments in Figure 1 are unfamiliar to you at present. Chapters 1 to 4 will introduce you to them, explaining how they work and the nature of the risks involved.

### Liquidity risk

The risk of being unable to cash in an investment rapidly or at an acceptable price.

### Capital risk

The possibility that investors may lose some or all of their original capital and returns made to date.

### Risk premium

The extra return that an investor expects as a reward for choosing a risky investment rather than a risk-free one.

### Risk–return spectrum

The relationship between the risk of, and return from, investments: usually, lower-risk investments offer lower returns, while investments offering the chance of higher returns involve additional risk.



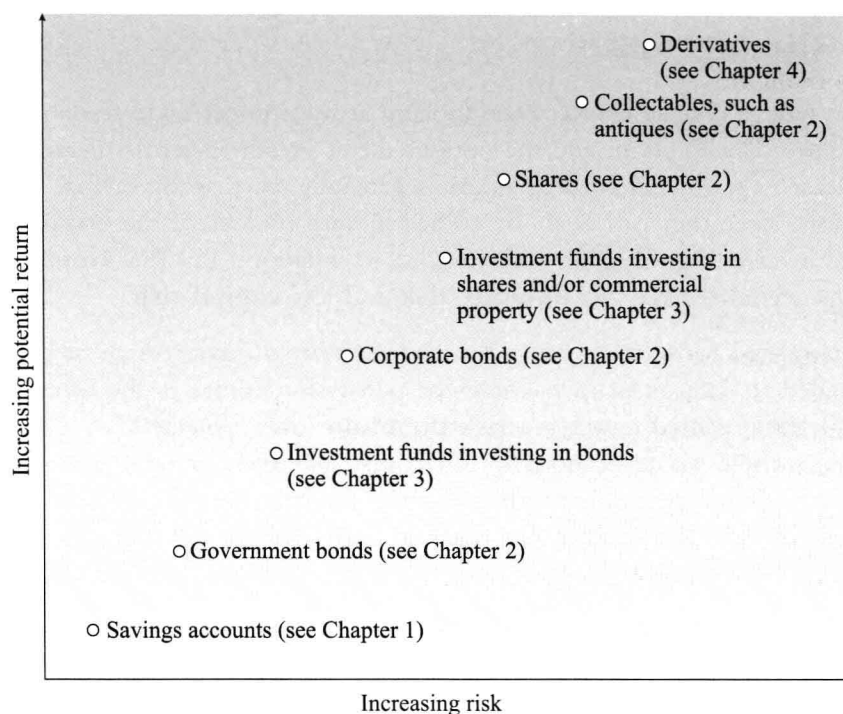


Figure 1 The risk–return spectrum

### Activity 1

Many personal investors look on their home – or perhaps a buy-to-let property – as their most important investment and you may have noticed that neither of these is included in Figure 1. Where on the chart would you place them?

Whether or not a home should be viewed as an investment is debatable. Although the property may increase in value, there is the problem of selling it to realise the gain, since the owner will still need somewhere to live. It might be possible to sell and buy somewhere cheaper, but this is not certain. Setting that issue aside, investing in a single asset is always more risky than investing in many. In this case, the single property chosen could be affected by, for example, subsidence, a declining neighbourhood, plans to build a new road, and so on. By contrast, the fate of one property will have only a limited impact on a fund invested in a spread of many properties. However, the biggest impact on risk is the way in which homes and buy-to-let properties are usually bought: with a mortgage. You will explore in Chapter 1 how borrowing to invest (leverage) increases both the risk and potential return considerably. So