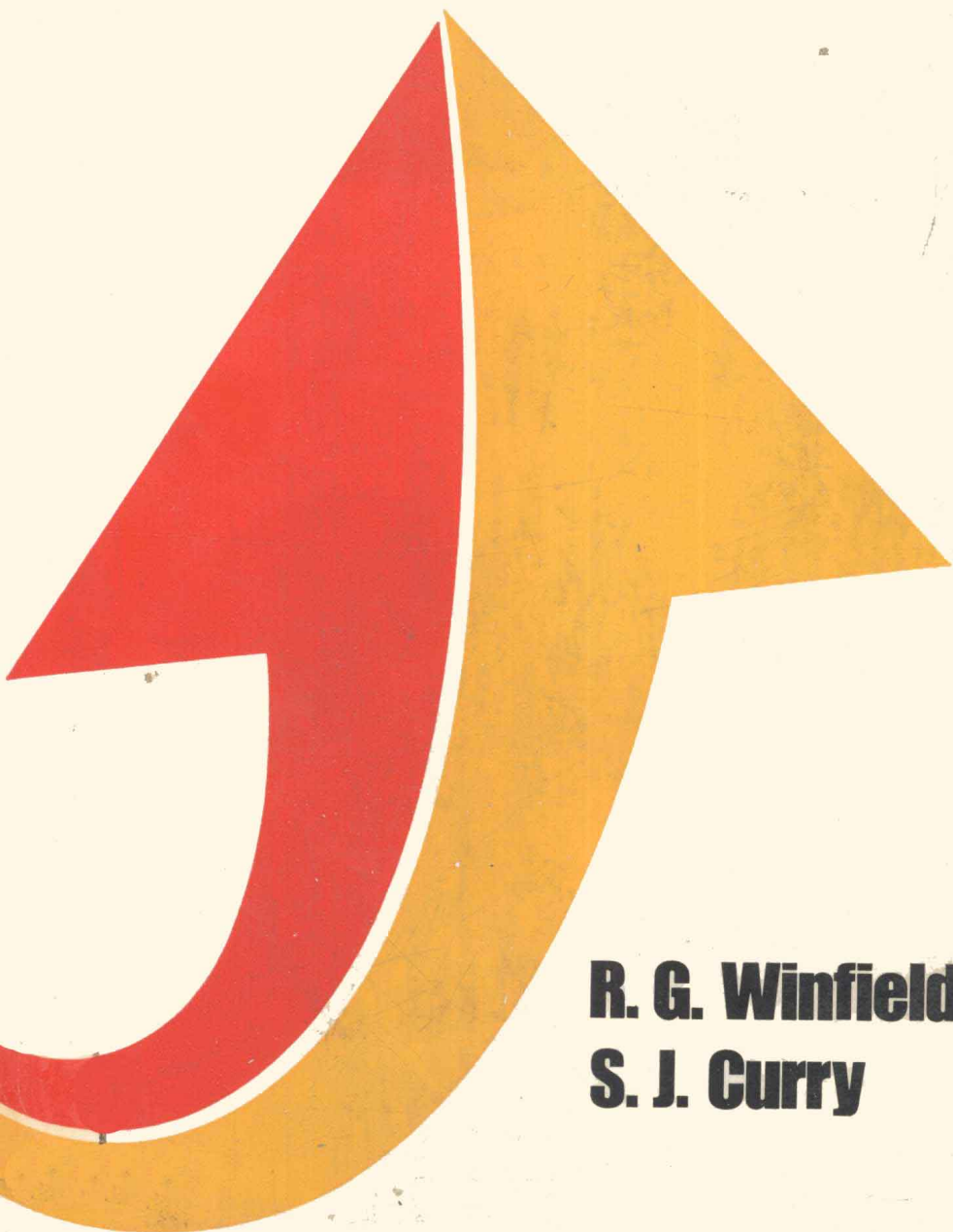


SUCCESS IN **Investment**

Recommended by
The Institute of Bankers



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Success in

INVESTMENT

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Foreword

Books on investment usually fall into two categories. The first are the 'light-weights' – chattily readable but limited in scope; the second are the 'heavies' – theoretical, full of mathematical formulae and mainly for the specialist. In *Success in Investment* we have tried to strike a midpoint between the two, combining readability with instruction in a book designed to be of maximum practical help to its readers.

Investment is a wide subject touching many areas of business activity. We have therefore had to be selective and to concentrate on main topics that are relevant. We visualize three types of reader: first, the person who has money to invest and wants information on the investment scene today and the different kinds of investment that are available; second, the professional person, not an investment expert, who needs to be informed enough to give sound general advice to clients; third, the student working for professional qualifications.

In this book we aim to provide a comprehensive treatment of investment, integrating theory and practice, bearing in mind the changes of recent years. In the 1950s and 60s there was an important shift in the preference of investors from fixed-interest securities to equities, and new forms of investment, particularly those based on insurance, became popular. In the 1970s investors increasingly became aware of the problems of inflation and sought other forms of investment: index linking and floating interest rates were introduced and competition for investment funds was intensified. Alternative forms of investment in real assets, such as stamps, furniture and wine, also flourished. The 1980s began with a period of recession although a new stock market 'high' was reached in April 1981, and it is possible that further, higher peaks will be scaled before the end of the decade.

Although the day-to-day workings of the financial world fluctuate continually, basic structures and principles do not. In this book we keep these structures and principles in full focus, but it is frequently necessary to quote specific examples and readers must be on their guard about changes in interest rates, taxation, government policy and legislation. It is essential for students of investment to keep up to date by reading the financial columns of the press as well as specialist periodicals such as the *Investors Chronicle* and *Money Management*.

Success in investment depends on being aware of the opportunities available at a given time, and making decisions which prove to be good. There is no royal

road to getting rich quickly but anyone who understands the main principles and knows the pitfalls and risks is well on the way to making the most of whatever resources are available.

This book replaces the original *Success in Investment* by Peter Roots; in that book the author gave wise and excellent advice, especially in his final summing up. We feel we cannot better this and have quoted from it liberally in our Unit 22 'The Successful Investor'.

Students on business or professional courses will find the text covers syllabus requirements of the following: the Institute of Bankers, London Chamber of Commerce, Business Education Council, Institute of Chartered Accountants, Association of Certified Accountants, Institute of Cost and Management Accountants. It also covers investment and finance aspects of examinations of the Stock Exchange, Chartered Insurance Institute, Institute of Chartered Secretaries, Society of Investment Analysts, and the relevant aspects of degree courses in Business Studies, Accounting and Banking.

R.G.W. and S.J.C.

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J.M. Keynes's *General Theory of Employment, Interest and Money*.

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R.G.W. and S.J.C.

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Unit One

Investors and Investment

1.1 What is Investment?

The Multinational Motor company puts money into developing a new small car. Gushing Oil Incorporated spends millions of pounds in North Sea oil exploration. The Government decides it must step up its nuclear energy programme. At the same time Smith is buying Perfect Paints International ordinary shares, Jones is subscribing for Government gilt-edged securities while Sykes opts for additional life assurance as the means of saving some of his increased salary.

What all these actions have in common is that they are all forms of investment. Each involves the sacrifice of something now for the prospect of something later. This means that either individually, as a company or as a country, we forgo the consumption of goods today in order to achieve greater consumption in the future. The essence of investment is *time*, and also *risk*. The sacrifice takes place first and is unavoidable; the returns come later, if at all, and their magnitude is uncertain. (There is the apocryphal story of the two German brothers during the latter days of the Weimar Republic. One was honest and sober, the other wayward and drunken. The former put his savings into bonds which were wiped out by inflation; the latter made a million on the 'empties'.)

With some types of investment, such as Government securities, the time aspect predominates because future returns are absolutely certain in money terms (or as certain as anything can be). With others, such as options or warrants – which are sometimes not much more than a gamble on the price of the shares going up or down – the element of risk is dominant. Often both time and risk are important, as with ordinary shares, for instance.

1.2 Real and Financial Investment

It is useful to distinguish between investment in 'real' things, such as buildings, plant and machinery, houses or hospitals, and various types of 'paper' investment. This distinction is not made in any pejorative sense; it does not imply that 'paper' investment is any less valuable to the community.

In a highly industrialized economy, such as that of the United Kingdom, most industrial investment is undertaken by large-scale public and private business enterprises, but a significant proportion of the savings necessary

2 Success in Investment

to finance such investment comes from private persons. For example, if a company wished to undertake an expansion programme it could use its own savings (retained earnings and depreciation allowances) to finance the programme, but it might also raise funds from the general public by offering securities, like shares or debentures. Anyone buying this kind of offering would be acquiring a *financial asset*. In effect, the financial asset would be a claim on the future income from the underlying *real assets* financed by these savings. New financial investment is frequently a prerequisite for 'real' investment in the economy.

More often than not nowadays, a *financial intermediary* intervenes between the ultimate saver and ultimate borrower. For example, by buying a life assurance policy Sykes acquired a financial asset. He will pay the premiums to the life assurance company, which in turn might invest the proceeds in financial assets issued by companies and the Government. There may even be another link in the chain if the life assurance company invests in a unit trust or investment trust.

Risk cannot be eliminated from business ventures, but financial claims can be packaged to cater for the different time and risk preferences of investors. For this reason companies and governments rarely issue only one type of security. For example, those investors who desire low risk might choose a company's fixed-interest stock or preference shares, while those who are ready to accept a stronger element of risk might go for the ordinary shares. Thus different classes of financial asset appeal to different types of investor, even though they are all ultimately claims on the same real assets. Moreover, once 'real' investment is undertaken it is difficult or impossible to 'undo' by withdrawing resources. But financial assets, if negotiable, provide a means by which the original investor can recover the use of his capital, while the original funds remain 'locked' in the project.

Most, but not all, personal investment is of the 'financial' type, the most obvious exception being the owner-occupied house. This is the biggest investment for most people, and in recent years probably the most profitable. But even here 'financial' investment plays a part. The outlay involved in house purchase is greater than most people can supply from past or current savings, so a large part of the required funds is usually provided by a building society mortgage. The building society provides one of the best examples of a financial intermediary at work. It creates short-term financial liabilities, by borrowing usually at one month's notice of withdrawal, and acquires long-term financial assets by lending for periods of up to twenty-five years, or occasionally more. The short-term financial assets of one set of households (the lenders) is matched by the long-term financial liabilities of another set (the borrowers). Short-term lending finances long-term 'real' investment. The building society is willing to finance the borrower on terms that would not be acceptable to the original lender. It can only do this because of its ability to vary its borrowing and lending rates and because it holds sufficient *liquid assets* (assets which are in cash form, or which can be quickly turned into cash) to meet sudden withdrawals.