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Investments

Understanding the basics

Investing fundamentals series

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Types of investments | Essential terms | Risk tolerance | Investment costs

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The world of investments may seem complicated to new investors. Understanding some key terms can go a long way to cut through the industry jargon. With this knowledge you can better understand what kind of investor you are, and which investments you might be most comfortable owning.

Types of investments

Guaranteed investment certificate (GIC)

A GIC is an investment that protects your invested capital over a pre-determined period of time. They can have either a fixed or a variable interest rate and are available in various maturities.

Fixed income (bonds, debentures)

Fixed income generally refers to debt borrowed by a company or government. Bond buyers, in effect, lending money to the issuer, which agrees to pay a pre-set interest rate, as well as return the amount invested on the maturity date.

Equity (stock, shares)

Equity represents a fractional ownership stake in a company, denominated in "shares" and traded on a stock exchange. If the company is successful, shareholders tend to benefit; if the company fails, shareholders may lose their investment as assets are distributed to bondholders.

Alternative investments

There are two broad "alternative" categories. The first invests in non-traditional assets with returns that tend not to be correlated to stocks or bonds. These include commodities (oil, gold, etc.), infrastructure (ports, highways, etc.), and real estate. The second type of alternative uses non-traditional strategies, like short-selling and leverage.

Mutual funds

A mutual fund represents a pool of money from many investors. This money is professionally managed and may be invested in stocks, bonds, options, cash equivalents and/or other securities.

Exchange traded funds (ETFs)

An ETF is a pooled portfolio that typically holds assets such as stocks, commodities or bonds. As their name suggests, ETFs trade on stock exchanges and their values fluctuate throughout the trading session more or less in line with the total value of their holdings.

Managed solutions

These provide investors with a diversified portfolio of mutual funds and/or ETFs, overseen by a professional portfolio management team. They typically are tailored to suit one a broadly defined investor profile.

Segregated funds

Similar to a mutual fund, a segregated fund is issued by an insurance company. Its primary distinction is that upon maturity, regardless of investment returns, the investor is guaranteed to receive at least a pre-set minimum percentage of their payments into the fund.

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Essential terms

Return

Your return is the profit or loss you earn on your investment. It can vary widely and may be unpredictable. It can be classified in one of two ways:

- Income, which is derived from interest or dividends
- Capital gain/loss, which is the difference between the price you paid when you bought it, and the price you receive when you sell it.

Generally, your return will have a relationship with risk, and the terms are often seen together.

Risk

Risk is often considered the potential of losing your money when investing; it can also refer to the level of volatility of an investment. Generally speaking, the higher the risk, the higher the return potential.

Almost every type of investment involves some risk, even if there is no risk of loss. For example, you cannot lose money with a GIC, but because your money is locked in, you may miss other, potentially better investment opportunities (opportunity risk).

Diversification

One approach to managing risk is to invest in a variety of different assets that may reasonably be expected to perform differently from each other. This is called diversification, and there are two main approaches:

Portfolio diversification: Holding one or two oil stocks, for example, may leave you exposed to the risk of a downturn in energy prices. A more prudent investment approach would be to spread your investment dollars across multiple companies in different economic sectors.

Asset allocation: Holding strictly stocks or strictly bonds may leave your portfolio susceptible to downturns within that asset class. A more prudent approach would be to include a combination of stocks, bonds, cash and other assets within your portfolio. There is less risk that all assets will lose value at the same time.

Liquidity

Liquidity refers to how easily you can access the full value of your investment if needed. This can be important if the proceeds from your investments are needed in the near term.

Highly liquid assets include savings accounts and shares in many companies. Most exchange traded funds (ETFs) and many mutual funds are also highly liquid.

Shares in smaller companies may be harder to sell in a timely fashion and you may need to accept a discounted price. Cashing out of a GIC before its maturity date may incur a penalty.

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Risk tolerance

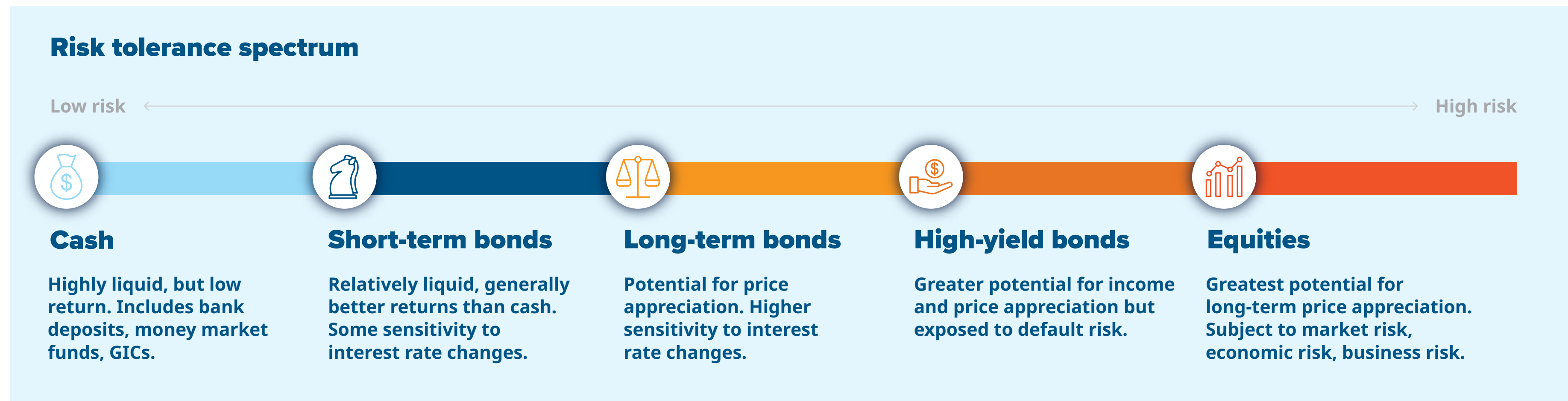
Risk tolerance is your comfort level with the possibility of losing some or all of your investment. If you prefer little or no risk, your risk tolerance is low.

If you accept the risk of losing some or all of your investment because you want the potential for higher returns, your risk tolerance is high.

Several factors are at play in your risk tolerance, including:

- when you will need your money
- can you tolerate unpredictable returns
- how you would you react if your investments declined in value
- your employment stability
- whether you have an emergency fund
- whether you can cover your debts without this money

Every investment involves some risk, even if there is no risk of loss. Generally, the higher the risk, the higher the return potential.



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Investment costs

There are costs associated with virtually all investments. Sometimes these are not obvious and may be embedded within the product. For example, a GIC has no stated fee, but there are costs embedded in their low returns.

Other investments are more transparent with the costs.

A mutual fund must clearly state its **management expense ratio (MER)**, which reflects the manager's fee, any advisor compensation and HST. Investment returns are reported after fees, so they reflect actual gains (or losses) that an investor would experience over a given time period. Active management provides the potential to outperform the broad market, as the manager seeks to buy investments that are undervalued and sell those that have risen in value.

An ETF must also state its MER, but this tends to be much lower on index-tracking portfolios, as there is no human manager to be paid. There is no advisor compensation charged through the ETF, but there are usually fees to buy and sell.

Segregated funds tend to cost more than the underlying mutual fund, because they include the insurance-based guarantee.

Stocks and bonds generally have trading commissions, but otherwise have no recurring costs.

It is important to remember that every investor is unique, and not every mutual fund is suitable for everyone.

Talk to a financial advisor to learn more about which investments suit your financial goals.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.
Unlike mutual funds, the returns and principal of GICs are guaranteed.
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