The ABC of Investments

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Welcome to the fifth module of the personal finance course, where we will look at the topic of investments.

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We’ll ask specifically why it’s important to invest and we’ll have a look at the main financial instruments. We’ll try to understand the relationship between risk and return for each instrument and how we can reduce risks. We’ll also look at some investment examples and how to build our portfolio, both in theory and in practice.

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What do we do when we invest?
We buy something with our money with the aim of making a profit over time. This profit is called a ‘return’.

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Why should we invest?
Investing can allow us to make a profit and thus achieve our life goals more quickly.
Moreover, investing helps protect our savings from the loss of value caused by inflation, which is the change in the general price level recorded over a specific period.

Let's take a practical example: today at the supermarket, we can buy about 3 packets of pasta for €5, but if prices tripled tomorrow, the same €5 would only buy us one packet of pasta. Our money has lost value, i.e. it has lost ‘purchasing power’ due to inflation.

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In the module dedicated to planning, we talked about how to save, but once we’ve achieved this goal, what do we do with our savings?

Keeping them in a current account is not much different from putting them under the mattress ☺: it certainly makes life harder for thieves but it doesn’t protect us from inflation and it stops us from making potential profits. A current account is useful for managing our income and expenses, i.e. receiving and making payments, but the interest rates offered are very low. If we want our savings to be available for emergencies, we could consider alternatives that offer the same level of security as a current account but yield more, such as savings deposits with a maturity of less than 1 year – guaranteed up to €100,000 per person and per bank, like the current account – and Treasury Bills, which are even more profitable. These are called ‘liquid investments’. However, we should always remember that even for less risky investments, there is always a small chance of loss: there is never zero risk, just like in life!

If we want higher returns, are willing to accept more risk, and have a longer time horizon, we can invest our savings in other financial instruments, such as medium- and long-term government bonds, corporate bonds or stocks (shares).

We can also invest in real assets, such as houses or land, but we'll just talk about financial instruments here.

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For the instruments we've just discussed, it's important to highlight the difference between stocks and bonds.

Bonds are how we lend money to an issuer, which can be the government or a private company. Bonds entitle us to receive a fixed amount upon maturity, called the nominal value, plus a return that can be fixed or variable. The risk mainly depends on the type of bond, its duration and the issuer.

When we buy stocks, we become shareholders of a company, and in this case, we have the right to participate in the company's profits, but if the company makes a loss or decides to reinvest profits, it doesn't have to pay us anything. Additionally, stocks have no maturity date and don't guarantee a fixed payment, but they can be sold at a higher or lower price than the purchase price.

To learn more about these financial instruments, you can follow the in-depth section in this module by clicking on the link below this presentation.

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Before deciding where to invest, we need to know that a higher expected return, i.e. the profit we expect, is always associated with a higher risk of loss. This is the case, for example, with investments in stocks. Conversely, if we want to contain risk, we must settle for a lower return, as in the case of government bonds. It is always wise to be wary of anyone offering very high returns at a low risk!

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What we can do, however, is reduce risk through diversification, i.e. investing our savings in multiple financial assets (for example, in both bonds and stocks) and in financial instruments issued by different entities in various sectors. This helps reduce risk while maintaining the same expected return. For example, if we invested all our money in the stocks or bonds of a single company and it went bankrupt, we would lose everything. However, if we diversified our investment across all companies in the market, the probability that they would all go bankrupt at the same time and thus cause us to lose all our money is negligible. On average, losses due to the bankruptcy of one company will be offset by gains from other companies' instruments.

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Creating a diversified investment portfolio is easier said than done, however, and requires not only a certain amount of money but also effort in terms of research and portfolio management. It's not simple at all.

However, there are financial instruments that diversify for us: they pool the savings of many investors and invest them in numerous financial instruments, making our lives easier. Specifically, we have mutual funds and ETFs, or exchange-traded funds.
By purchasing funds or ETFs, we can, for example, invest at the same time? in almost all listed Italian companies, or in all European companies, or even globally.
ETFs usually have lower costs compared with other funds. Generally, we should bear in mind that even when costs appear modest, they can affect profits significantly in the medium and long term.

Alongside these instruments, we also find some types of insurance policies that allow us to diversify by investing the premiums we pay periodically in many financial instruments. These also include insurance coverage, though often negligible, in case the insured person survives (life case) or in case of death. These policies can be very expensive.

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In addition to costs, we must also consider the taxes applied to different instruments.

The higher the expenses and taxes we must bear, the lower the net return on our investment, i.e. what we actually receive. Among the costs, we should remember the commissions paid to the bank or other intermediaries for purchase or sale, and, if applicable, those relating to the management of the instrument. As for taxes, it's important to note that the taxes paid on any profits are not the same for all financial instruments: as an example, the return on Italian government bonds is taxed at 12.5 per cent, while returns on other bonds, bank deposits and stocks are taxed at 26 per cent.

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An instrument that allows us to compare the costs and features of ETFs, mutual funds and some types of insurance policy easily is the KID, which is a simplified information sheet that each bank or intermediary is required to give us.
The KID is/It's a 2-3 page document written in simple language that, in addition to the costs, provides information on the risk involved with the instrument. It also reports past returns, almost always compared with the deviation from the expected returns, to give an estimate of what the future returns could be.

Thanks to the KID, we can understand whether the instrument is suitable for our needs in terms of costs, expected return and risk.

There are various online tools that facilitate comparisons and make the choice easier, but they should always be used with caution.

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Let's now look at a practical investment example.

Let's say we want to invest €10,000 for 5 years at a relatively low risk. We could subscribe to a BTP (Buono del Tesoro Poliennale), which is a new issuance of government bonds. The BTP promises to repay the invested sum upon maturity plus an annual return, called a coupon, which in our example is 4 per cent, paid every 6 months.

Here's how it would go:

- Today, we invest €10,000;
- After the first six months and until maturity, we will receive coupon payments, equal to 2 per cent of the annual return. Of the €200 euros, we would only receive €175 euros due to the 12.5 per cent tax on government bonds;
- At the end of the 5 years, the €10,000 invested will be repaid.

From this investment, we would earn a total of €1,750. In reality, the figure might be slightly lower because our bank may charge us management fees.

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If we want to take on more risk, we could invest the same amount in stocks via ETFs. However, in this case, we won't know what the return will be after 5 years, but we expect it to be higher than the one offered by the BTP. For example, by investing in ETF 1, our capital would grow from €10,000 to €12,690. We would receive around €1,990 euros of the €2,690 profit due to a 26 per cent tax rate.

A return like the one from ETF 1 shouldn't make us think there are no negative scenarios: investing in ETF 2 would not only give us less than the BTP but would result in a loss of about €112.

In this case as well, the result of our investment will be slightly lower due to possible commission charged by our bank.

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So, to summarize, what should we invest in?

There is no single answer: we must choose among the assets we've just seen those that best suit our return goals, the level of risk we are willing to take and the duration of the investment (time horizon).

If the time horizon is short, it's advisable for the investment to be low-risk, because investing in risky instruments could result in losses without enough time to recover. These types of investment are suitable for safeguarding the part of savings set aside for unexpected events (e.g. car repairs). On the other hand, if the time horizon is longer, we could choose to take on more risk in order to try to achieve higher returns.

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Our portfolio will thus be made up of many different instruments, depending on the risk we want to take.

The more we want to contain/limit risks, the more we'll choose to invest in 'liquid assets'. We will thus invest in low-risk, low-return instruments such as short-term government bonds (BOT, BTP and CCT with a residual maturity of less than 12 months), savings deposits or money market funds.

If we want higher returns, we can take on more risk and invest in medium- and long-term government bonds (CCT and BTP), both indexed and fixed-rate, or increase risk further by investing in corporate bonds or stocks, using mutual funds or ETFs if we want to simplify things, as they allow us to diversify without doing it ourselves.

These riskier investments are more suitable for the medium to long term because we must consider that we might need more time to achieve the expected return. If we decide to sell an instrument before maturity, the amount we receive will depend on interest rate trends and therefore on the market value of the instrument at the time of the transaction.
So we may suffer quite significant losses, especially with stocks.

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Let's now see how we can actually build our portfolio.

The first thing to do is open a securities account with a bank or intermediary and complete a questionnaire, known as the Mifid questionnaire, named after the European regulation that governs the provision of investment services (Market in Financial Instruments Directive).
The questionnaire is a safeguard for us: it is designed to identify our investment preferences and the risks we can bear, helping us choose the instruments best suited to our needs and avoid those that aren't right for us.

So we shouldn't rush to complete it, and we should never let others fill it in on our behalf.

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Before making any investment decision, it's always a good idea to make enquiries.

Not all sources are reliable, so it's important to consult official sources, such as specialized press or the websites of accredited institutions.

Moreover, our bank or trusted intermediary provides financial advisors who, based on the preferences we expressed in the Mifid questionnaire, can help us choose the most suitable instruments for our needs. We don't usually pay separately for advice, as the cost is included in the bank's commissions.

We can also turn to independent financial advisors who do not depend on a specific intermediary and will therefore charge us separately for their advice. Based on our preferences, they can help us choose the right instrument and also the best, most cost-effective bank or intermediary to conduct our operations.

Always check that financial advisors are registered with the OCF, the Supervisory Body for the Register of Financial Advisors.

Consulting a financial advisor can help us keep our anxiety in check and avoid making hasty investment decisions. Price fluctuations are normal, and we might bitterly regret selling our assets when the market is low or rushing to buy when the market is high, following the herd.

It's always better to avoid taking advice from friends and acquaintances unless they work in finance!

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The last step is executing the order: we can make the investment ourselves or get help.
If we choose to do it ourselves, we'll need to look up each instrument that we want to include in our portfolio and then buy it on the market through online banking. For example, if we wanted to buy

an ETF, a BTP or some stock, we'd need to search for them using the ISIN (unique identification code), or the description given by our online banking. We can then place the order in one of two ways:

- Specify a price for issuing the order that may be lower than the market price. In this case, the order will only be executed if the instrument reaches that price;
- Choose the 'best execution' option, which means buying the instrument at the lowest price available in the market at that exact moment.

Doing it ourselves, even in the early stages, can be challenging.

The other option is to turn to a bank or another intermediary, which in some cases charge a commission, and ask them to place the buy and sell orders on our behalf, .

Each transaction has a cost, and not all banks apply the same fees!

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In summary...

1. Keeping our savings in a current account is disadvantageous, especially during periods of high inflation; it's better to invest them.
2. The higher the return we want to achieve from our investment, the higher the risk we must bear.
3. We can reduce risk through diversification.
4. Costs and taxes reduce our return.
5. Our investment choices also depend on how long we want to keep our resources invested (time horizon).
6. Before investing, it's important to gather information and only seek help from experts.

To learn more, you can follow the in-depth content on financial instruments, read the glossary in this module, below this presentation, or consult the 'Invest' section on the economiapertutti.it website.