Capital Markets Products

When we talk about capital markets, we can think of a financial marketplace.

Stock exchanges are *where* investors buy and sell; capital market products are *what* investors buy and sell. Investors can be businesses or individuals. Investors can buy or sell shares (equity) and debt (bonds) in a company via many different investment vehicles.

Read on and discover more about:

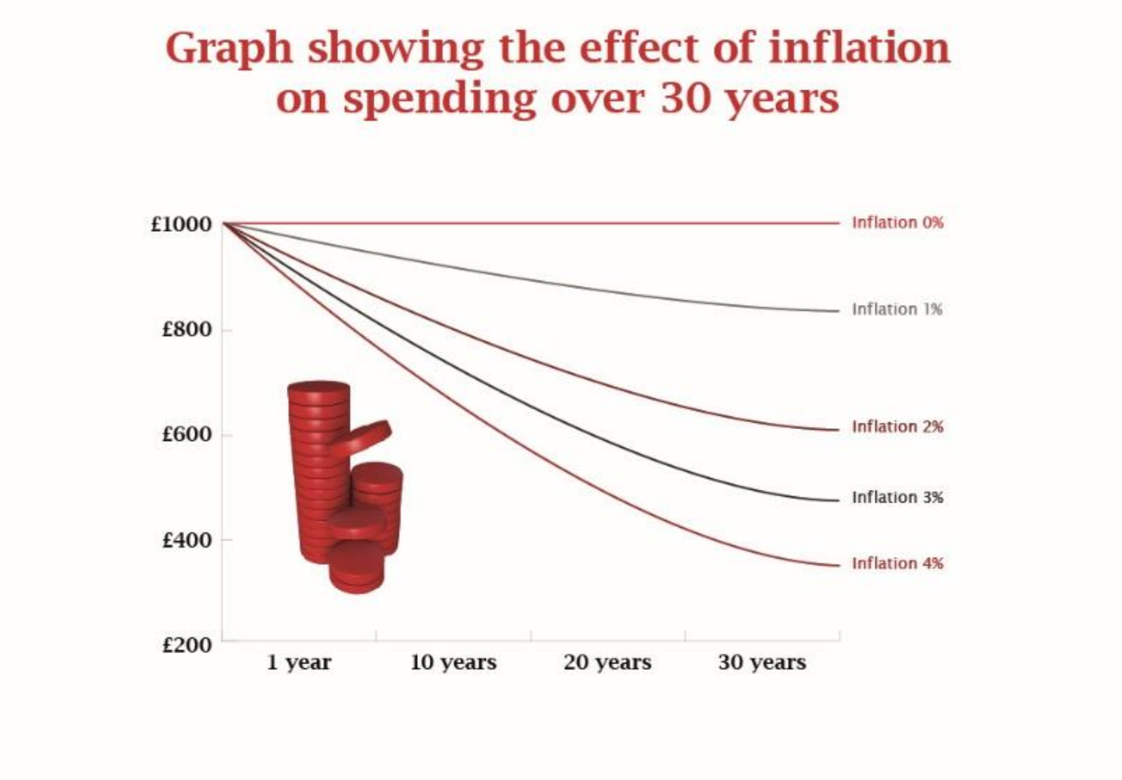
- inflation and why it is important to investors
- the different types of capital market products including cash deposits, bonds, equities, property and alternatives
- some of the risks associated with each type of product
- when and why investors choose different products
- the advantages of combining capital market products to enhance diversification

Firstly, why do investors need to invest?

There are many reasons but at a minimum, investors will likely want to maintain their 'spending power' over the long term.

What is inflation and why is it important to investors?

Find a simple explanation of **inflation** in our Put Simply Capital Markets Glossary.



Inflation is a risk to an investor's future spending power. For example, based on the graph above, a 3% annually average rate of inflation, which has been typical in recent times, will halve spending power over approximately 20 years. An investor will need to achieve a rate of return on their cash or investments that equals or is more than the current rate of inflation, just to maintain their existing purchasing power.

An investor might also look at their own personal rate of inflation as well. A person's lifestyle and spending habits will influence this; for example, school fees, second home costs and future care homes fees. Investors with an overseas property may also want to consider future local price increases and the currency risks involved in meeting any related expenses in future.

Investors can try to at least maintain their spending power or grow their wealth in excess of the rate of inflation, in many different ways. One way is to invest in assets using their capital (wealth in the form of money or assets).

Assets can be categorised into areas of investment, often known as asset classes. The main asset classes are:

- cash deposits
- bonds
- equities
- property
- alternatives

There are many other asset classes which could be considered including hedge funds, commodities and cryptocurrencies. Read on to learn more, including:

- detailed explanations of cash deposits, bonds, equities, property and alternatives as commonly used capital market products
- examples of how these products work
- when and why investors use these products
- other ways to invest

Cash deposits

The most common investment is the cash deposit. Cash deposits gain interest. The level of interest received will vary depending on a number of factors including:

- the cash deposit amount,
- the length of time an investor leaves their cash on deposit,
- the level of competition between deposit takers, such as banks and building societies, and
- the prevailing level of interest rate set by the central bank

Cash deposits are not without risk. The first risk is the risk of inflation. If the rate of inflation is higher than bank deposit interest rates, then your future spending power goes down. If this happens, the investor will eventually have less spending power, because the price of goods and services the investor may want to buy later on is going up quicker than the value of their cash deposit.

This has been the case for cash investors since the global financial crisis in 2008. However, this is a risk worth taking for a proportion of an investor's assets. If an investor is expecting to make any significant purchases or incur costs within the next five years it would be sensible to hold this amount on deposit. Decreasing spending power caused by deposit interest rates being lower than inflation is better than potentially lowering the value of wealth more significantly on the stock market.

If, however, an investor kept lots of cash on deposit for more than five years, this could still lead to a big loss of future spending power.

A short-term relatively immaterial risk can become a more material risk to an investor's wealth and spending power over the long term; although this depends on the prevailing rate of inflation at the time.

The second risk to keeping cash on deposit is default risk; the risk of a bank not being able to repay an investor's deposit on request. You need only look back to the global financial crisis to see that highly regulated high street banks are not immune to bankruptcy.

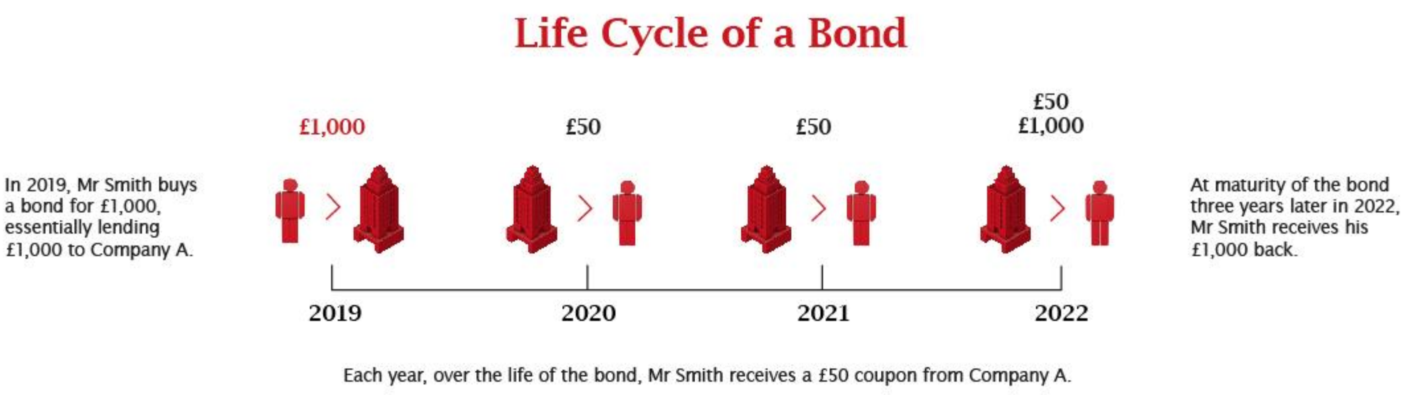
There are some measures in place to protect customers, including investors. The UK has a deposit guarantee scheme called the Financial Services Compensation Scheme (FSCS). The compensation limit is up to £85,000 for deposits at each individually authorised bank which is why it is relatively common for investors with significant deposits to have accounts with more than one bank. Jersey has the Depositors Compensation Scheme which provides individual depositors with protection for up to £50,000 in the event that a Jersey bank should fail.

Bonds

Put simply, these are loans to a government or a company. Companies and governments often need to borrow money to fund their operations. They do this by issuing bonds in the market which are sold to investors.

Bonds are typically for a set period (3 to 30 years is not unusual) where the issuer (borrower) agrees to make regular interest payments (coupons) to the holder of the bond (investor or lender) and to repay the original investment (principal) back at the end of the agreed term (at redemption/maturity).

Bond example: 3-year bond with a 5% return. £1,000 per value bond:

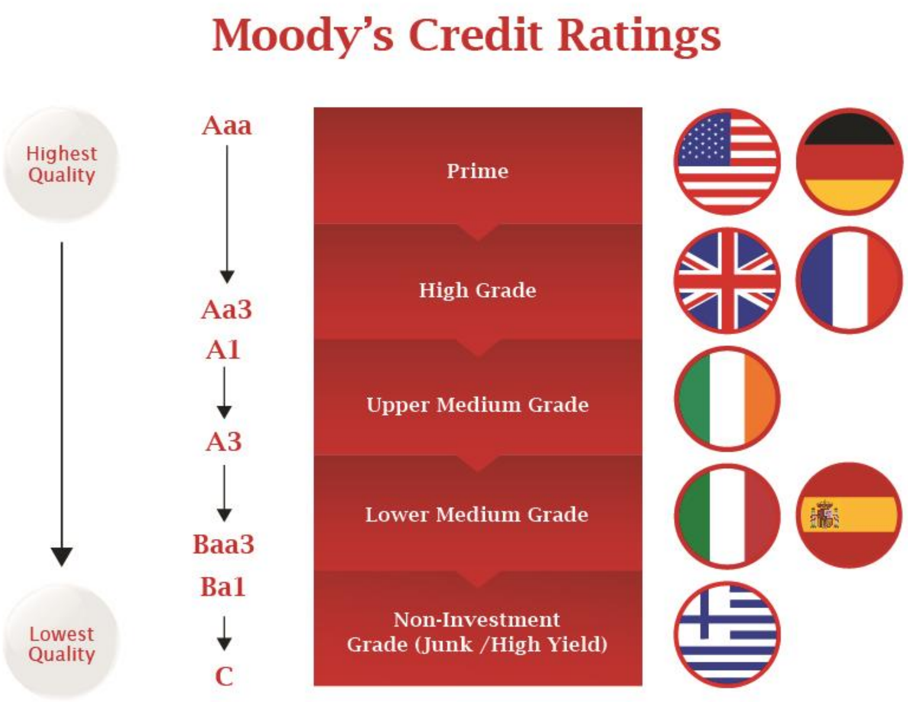


Measuring the risks of bonds

The bond market is diverse, and risks differ between individual bonds – even if the same company (a corporate bond) or country (a sovereign bond) issues more than one type of bond. One way to measure the risk is to look at credit ratings for each bond and its issuer. For a fee, credit rating agencies such as Moody's, Standard & Poor's and Fitch publish credit ratings for bonds. These ratings are based on in depth analysis of all the issues that might impact the quality of an issuer. Find a simple explanation of **default or credit risk** in our Put Simply Capital Markets Glossary

Example credit ratings

Moody's credit ratings give the highest quality issuers a rating of Aaa or 'triple A' and the lowest quality issuers a rating of 'C'. These ratings can apply to both countries and companies. The higher the rating, the cheaper it will be for the issuer to borrow money. Higher quality bonds are known as 'investment grade' (BBB- and above) and lower quality bonds as 'high yield' or 'junk' bonds.



Some bonds are riskier than others (and therefore their pricing is more volatile). For example, bonds issued for a longer time period or bonds issued by companies that are considered 'risky'.

'Risky' companies might include:

- those in cyclical industries such as retail or mining (these industries are affected by what is happening in the economy. Generally, they make more money when the economy is doing well, and less money when the economy is not doing well), or
- companies overly reliant on one good or service, or
- those that are already laden with excessive debt, or
- those with a questionable management strategy.

Bonds with a long maturity date expose the investor to increased inflation risk, because the future returns (coupons and capital redemption) are fixed amounts. If inflation increases while an investor is holding a bond, the fixed payments they receive in the future will be worth less in real terms i.e. they will be able to purchase less goods and services on receipt of the future payments than they had originally anticipated.

A longer maturity date also makes it harder to predict the likely financial strength of the borrower at the final redemption date.

The sooner an investor is due to receive an investment back, the less likely a company is to have entered into financial difficulty, such as operational issues or from entering into a recessionary environment.

As with investing in cash deposits, when investing into bonds an investor needs to consider:

- the risk of rising inflation and
- how the credit worthiness of the borrower will evolve during the life of the loan or investment.

Unlike with cash deposits, bond investors will also need to consider the liquidity of their investments.

It is important to know that bonds do not represent ownership; they are a liability that must be paid by the company or country. If the borrower or issuer goes bankrupt, a bond represents a claim over the company’s assets. This feature means that bonds are generally less risky than equity shares (which represent a share of ownership). In the event of bankruptcy, bond holders must be paid out in full, if there are enough assets remaining, before equity investors have any chance of receiving a payment via the bankruptcy process.

Equities

Equity, also known as stocks and shares, is when an investor has part ownership in a company.

The financial return on equities comes from growth in the value of the shares in a company, plus any income from dividends. Dividends are a portion of a company's profits (if there are any) which are paid to company shareholders, often twice a year. These payments are at the discretion of the company's management.

Before dividends can be paid out to shareholders, a company must first pay the coupons owed to bond holders and interest on bank loans. This makes dividend receipts potentially less reliable, especially in the short term. Any profits not paid out to shareholders in the form of dividends are reinvested into the business. In doing so, this should contribute to the growth in the value of the company over the long term.

Equities are one of the more volatile asset classes, although they can offer good growth potential over the long term. Statistics show that equities have provided 'real returns' (returns above the rate of inflation) over the long term of approximately 5.1% per annum compared to a real return from bonds of around 1% per annum[1]. These are, however, just average returns. There are examples of companies who have performed severely below these levels of growth and others which have impressively outperformed over the long term too. Investing into equities at a low rate over a long period of time can eventually end up reaping high rewards, but this is not without risk.

The potential for higher returns from equities, versus bonds, comes from shareholders being entitled to participate in the growth in the company's profit whereas bond holders are not.

Property

Property includes direct or indirect (via funds) investment into buildings, typically commercial property, but it can be residential, and land. The broad areas of property investment include:

- offices
- industrial property
- retail property, for example warehouses, high street shops and shopping centres

[1] Source: JP Morgan

- other property such as care homes or student accommodation

The size of these property lots can average in the millions, so typically investors will use a collective investment vehicle or fund product to invest into property.

The advantages of investing in property generally include a high and regular level of income from rent. This can often be more secure and higher than the income received by equity investors via dividends. A negative attribute is how long it can take to dispose of such investments; it can take longer to sell investments in times of market distress, such as during a recession. Property is a relatively illiquid investment due to the time it takes to negotiate transactions.

Alternatives

Alternative assets are effectively smaller or less mainstream asset classes that do not fit into the core asset classes of cash, bonds and equities. Alternatives can include:

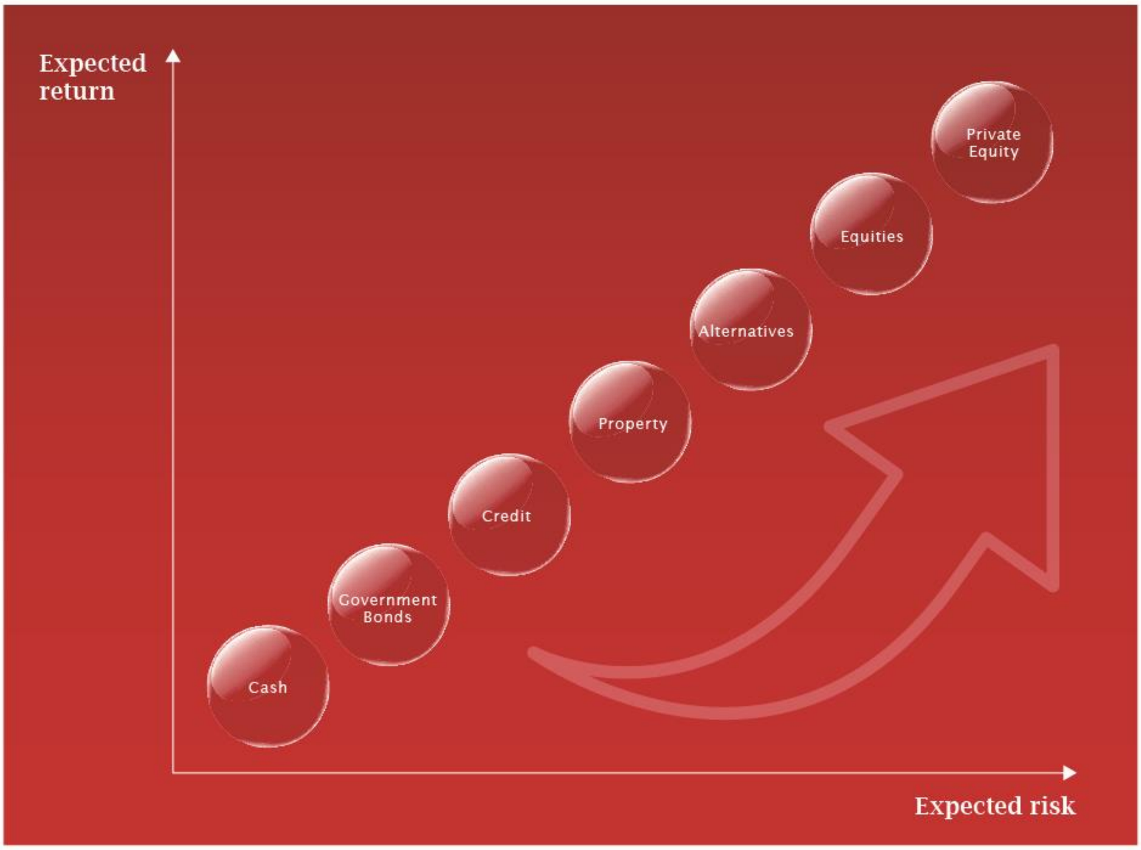
  - infrastructure (e.g. hospitals, toll roads, schools),
  - renewable energy (solar fields and wind farms)
- property (commercial and residential)
- commodities
- cryptocurrencies
- aeroplane leasing
- peer-to-peer lending
- hedge funds
- private equity

They all have their own characteristics, but often those investing into alternatives are seeking return profiles that are different to those from equities and bonds. Many, but not all, alternative investments also tend to pay out an attractive level of income.

When and why investors choose different products

With the advantage of very long-term historical data, investors can get a good guide as to how each asset class might behave over the long term.

Graph showing potential long-term risk and return characteristics by asset class



Looking at this graph, there are two issues which should be remembered at all times.

First, within each asset class investors can be exposed to a broad range of risks. For example, within credit (bonds) an investor could have exposure to a highly indebted company in a cyclical industry, based in the emerging markets, or at the other extreme hold a bond in a global food manufacturing blue chip company. They might both be bond investments, but their risk-reward profiles could be very different.

The risk-reward characteristics of each asset class can overlap, unlike in the academic style graph shown above. For example, a higher risk bond investment could be riskier than a lower risk equity investment. So, it is not safe to assume an investment in bonds is definitely safer than investing into equities, without much more detailed analysis. Broadly speaking, however, the graph shows realistic expectations over the long term, when holding a broad range of investments in each of the above asset classes.

The second consideration is investment time horizon. Over the short term, the potential outcome for each asset class can vary greatly compared to the long term. Equities might provide the highest return over the long term, but over one year, returns could be negative.

For example, in 2008 the UK equity market fell by 30% but then at the other end of the risk spectrum, you could stand to lose all of your cash deposit, above that of the Jersey depositor compensation scheme, if your bank goes bankrupt.

Investing responsibly: United Nations Principles
Investors are increasingly concerned about the impact their investment decisions might have on society as a whole. An example of the work going on in this important area are the Principles for Responsible Investment (www.unpri.org) set out by the United Nations.

These principles were developed by an international group of institutional investors to reflect the increasing relevance of environmental, social and corporate governance issues (sometimes referred to as ESG) to investment practices. By signing up to these principles, companies publicly commit to adopt and implement them – aligning their investment activities with the broader interests of society. In doing so it makes it easier for investors to align their personal convictions in responsible investment.

If the above issues are important to an investor, then it is increasingly possible to seek out an investment manager who incorporates ESG factors into their investment process.

Other ways to invest

Investing in capital markets is complex, this is why investors frequently gain exposure to the markets by purchasing funds rather than investing directly themselves. These collective investment vehicles (or funds) allow investors to pursue a wide array of financial objectives and investment styles while spreading their risk over a greater number of underlying investments. A fund's objectives may restrict the manager to invest in equity in a specific sector, geographical area or niche industry (i.e. biotechnology). Alternatively, multi-asset funds have the breadth of investment across all asset classes (combining bonds, equities and alternatives), or some funds aim to produce a specific annualised return or high natural level of income. There are many different styles of investment, but it should be noted that the level of risk for a fund even within the same asset class can vary widely.

Before investing into funds, investors might consider:

- **Manager credentials**: does the investment management firm have the resources and experience or proven track record to manage the selected strategy?

- **Fees**: If the fund manager is investing via other funds, there will be additional and likely less transparent costs incurred. Will additional costs improve their chances of achieving an enhanced return?

- **Diversification**: (find a definition of 'diversification' in the Put Simply Capital Markets Glossary) Blending equities with other asset classes has the potential to reduce the volatility of an investment.

- **Liquidity** (see the Put Simply Capital Markets Glossary for a definition): Most equity and bond portfolios can be liquidated within a week. Asset classes such as property and private equity can sometimes take months. Despite this liquidity, investors should commit to having the majority of their money invested for at least five years to allow for markets to recover after periods of weakness.