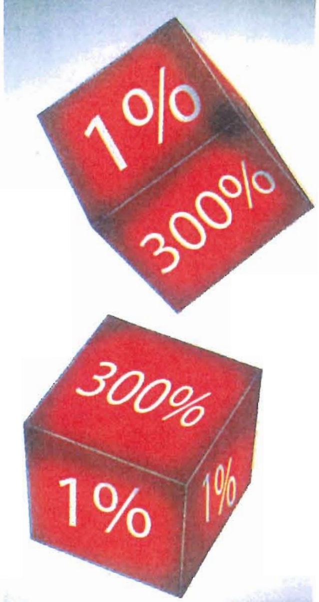
Money Wise

A Return of 1% or 300%? It's Your Choice — and Risk

Colin Bloodworth explains the pros, cons and risks of going after the big return



27.5% is the return on government bonds in Greece but there is a risk that the government will default and you will wind up losing your money.

Why would some people be happy with a 1 percent return on their money while others aim for 300 percent or more?

Keeping in mind that risk increases with expected return what should you realistically be looking for?

Many would be happy with a 10 percent return, provided that the capital was absolutely safe and accessible at all times. Unfortunately there is no investment that can meet all three criteria. Some investments have guarantees but they are only as good as the institution or country providing them. In 2008 the Irish government issued a blanket guarantee on all bank deposits to stem the flight of money from troubled Irish banks but it was quickly followed by a qualifying statement to the effect that the guarantee was subject to the country's ability to honor it.

If you play safe, what should you expect?

Bank deposits are close to "risk free" but if your money is in US dollars, British pounds or euro you will be lucky to earn 1 percent per annum in the current low interest rate environment. If you deposit funds in rupiah you can expect a higher return, currently 5 percent or more, but if you are converting from a major currency you have to watch out for currency movements. As a rule of thumb you should stay with the currency in which you have commitments.

Government bonds: 1.3 to 27.5 percent

Government bonds are among the safest of investments because governments can always print money to meet their obligations. The exception is Europe where the currency is managed by the European Central Bank.

Consequently, we have an absurd situation where, at the time of writing, you could invest in Euro bonds in Germany and earn only 1.3 percent per annum or in Spain where you can earn a handsome 6.9 percent. If you buy the bonds from Greece you will earn a whopping 27.5 percent! The equivalent rate for Indonesian rupiah bonds is currently 5.8 percent.

So why would anyone wish to invest in German bonds for a miserable 1.3 percent? The answer is investors are confident they will get their money back while there is a risk that Greece or Spain will default and their money will be lost.

Investors also feel safe with US, British, Japanese and Swiss bonds, all of which are currently yielding less than 1.5 percent per annum for a 10-year term.

1.5 percent is under the inflation rate

Correct. And that means investors are actually lending their money to governments knowing they will get back less in real terms. But for many this is prudent money management.

If a pension scheme, for example, is investing funds for thousands of employees it has to be sure it can meet its obligations to pay out pensions in full and as they are due. This is where bonds play a major role and why zero real returns are acceptable to many people.

What's available if you accept some risk?

The sky is the limit but let's review what realistic opportunities exist.

- **Corporate bonds:** Companies are prepared to offer higher yields than governments in order to attract capital. Returns of 5 percent to 8 percent per annum would be typical. Bond mutual funds offer easy access but keep in mind that capital values can fluctuate.
- **Equities and commodities:** Potential returns are not easy to quantify as there are many variables, but over the long term, an investment in a wide range of global stocks and commodities should produce returns in the 6 percent to 10 percent (per annum) range, though returns can be erratic. The past 12 years have not been good for the major markets, though very good for gold.
- **Real estate:** An investment in real estate should produce a return comparable to equities. But while stocks are highly liquid, a real estate investment cannot be turned easily into cash and can be a serious burden should you need to sell at the wrong time. Still, a buy-to-let investment should return between 5 percent and 10 percent annually, depending on location, plus hopefully, an eventual capital gain.

What gives routine positive returns?

The last few years have produced sparse returns for investors. This has led many to seek investments that produce consistently positive returns. Ironically, the banking crisis of 2008 has provided opportunities for small investors to step into the role of bankers and invest in funds that lend to industries and groups. Examples are agricultural lending, mortgage lending, student accommodation and litigation funding. Current returns are in the region of 6 percent to 12 percent per annum but they can be higher. The biggest risk here is liquidity.

Where are the really high returns?

This would be the domain of private equity, which entails investing in projects or sometimes companies in distress, a field formerly open to only the ultra-wealthy. In successful cases returns to investors have exceeded the annual equivalent of 300 percent.

Is there a downside? Yes, if the project is not successful you can lose all your money! Much the same risk as if you invest in your own business.

What should an ordinary investor seek?

It depends on many factors but a sensible strategy would consist of a blend of the above asset classes, excluding the last one for most.

If you can consistently achieve an annual return of between 5 percent and 10 percent above the inflation level, you are doing well.

If you are aiming for returns of 300 percent, go ahead, but only do it with surplus money that you are prepared to lose.

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