5 key investment principles

Before you start investing, it pays to learn the basic principles. The more you know, the better off you'll be in the long run.

There are five key principles to think about when investing, which can help reduce your risk and build your wealth. You should also remember that your investment strategy depends on your attitude to risk, your financial situation and life goals.

So what are the five key investment principles?

1. Start early, invest regularly and reinvest distributions
2. Set your investment goals and pay yourself first
3. Diversification- Not putting all your eggs in one basket
4. It's time in the market not market timing
5. Invest for the long term - the trade off between risk and return

Start early, invest regularly and reinvest distributions

The earlier you start investing, the more opportunity your investment has to grow through compounding - which means you generate earnings on earlier earnings.

Investing the same amount at consistent intervals, known as dollar cost averaging, can help take the stress out of investing as you to don't have to worry about trying to time the market. If the market happens to be falling on the day that you buy, you get more units for your money on that day. It is the opposite when the market is rising. This tends to "average" the cost of your investment and can help "smooth out" market fluctuations.

A key benefit of dollar cost averaging is that you don't risk getting in at the wrong time with a large purchase or waiting too long and missing a rebound.

Let's see how this works in practice with Jane and Belinda. For simplicity's sake, we'll assume that both Jane and Belinda earn 6% each year on their investments:

Jane puts away $100 a month, every month, from the day she turns 20 until the day she turns 30, making no withdrawals. By the time she reaches 60, her investment will be worth $962,952.

Belinda also starts at 20 and puts away $100 every month, but she doesn't start until she's 30. Instead of investing for 10 years, Belinda invests for 20 years until she's 50 (twice as long as Jane). By the time she reaches 60, her investment is worth $837,960. Despite the fact that's she's put away twice as much, her investment is worth slightly less.

Why? Compound interest has given Jane a massive head start. By age 60, Jane's investment has been compounding for 40 years, while Belinda's has only been compounding for 30 years. As you can see, that extra 10 years makes a huge difference.

What can we do to get us where we want to be financially?

We can put away more each month. We can save for longer. We can reinvest our earnings.

Set your investment goals

To invest successfully, you need to establish investment goals. Having a clear understanding of your goals will help you select the most appropriate investments to achieve them.

To help you assess your current financial situation, and therefore how much you can afford to invest, you should prepare a current budget. This will help you determine how much you can afford to invest.

Once you have decided on the right type of investment for you, a tried and tested way to stick to your regular investment plan and achieve your goals sooner is to have this investment amount automatically deducted from your pay.

A financial planner can help you through the process of preparing a financial plan, including goals, budget, risk profile and timeframe, as well as recommending a range of investment strategies tailored to your situation.

Diversification

Diversification can be one of the keys to successful investing. Do you want to have all of your eggs in one basket, or do you want a few baskets?

Simply put, diversification is about lowering the level of risk across your investment portfolio by spreading your investment across a number of assets and/or markets. Diversification generally reduces the impact of any single investment or asset type negatively affecting the value of your overall portfolio. In a way, it has a smoothing effect - you won't get the huge gains, but nor should you experience the big losses.

Timing the market versus time in the market

'Timing the market' is where you try to buy when the market is low and sell when it is high. However, anticipating the top and bottom of the market can be extremely difficult. In practice, many who try to time the market end up worse off.

'Time in the market' refers to the length of time your investment stays in the market. History shows that while assets like shares may experience periods of negative return over the short term, over the longer term returns tend to be higher than less risky investments such as cash. Adopting a longer-term investment strategy helps keep you focused on your financial goals.

Invest for the long term - the trade off between risk and return

All investments involve some degree of risk. The potential for higher returns generally means an increased chance of negative returns.

Regardless of the type of investment option you choose, it may not perform according to your expectations. You need to strike a comfortable balance between the level of risk you are prepared to accept and your desired level of return. As a general rule, the longer the timeframe you can invest for, the more risk you can afford to take.

The diagram below shows the trade off between risk and return. You should keep this in mind when thinking about your investor profile and your investor goals. You can find out your investor profile here.

Want to know more?

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