Introduction

Basic Concepts of Finance

Before beginning to plan our finances and invest it is vital that we understand some basic concepts of finance. These include the importance of planning, the responsible use of consumer finance, the relationship of risk and reward, the importance of a long term approach, the concept of compounding, the need for discipline, diversification, the theory of efficient markets, asset allocation, and the need for monitoring and expert advice.

1. The Value of Personal Financial Planning

Every investor is different; therefore each should have their own personal financial plan. Planning needs can include a monthly budget, a personal balance sheet, retirement planning, education planning for your children, planning for a major purchase, or planning to enhance one's monthly income.

Before beginning any investment program it is important to develop a picture of your financial situation. The two documents you need to create are a balance sheet of your assets and liabilities, and an income statement of your monthly income and expenses. The balance sheet will show your assets, or what you own, as well as your liabilities, or what you owe to others. These documents will provide a clear picture of where you stand, and will form the basis for financial planning.

Traditional financial planning is all about math and money. You look at how much you earn, figure out how much you will need in the future to maintain your desired lifestyle and try to come up with an investment plan that will help you reach the magic number that will allow you to retire, pay for education, make a major purchase, etc. The process is generally about as exciting as balancing a checkbook and can be emotionally draining. Unfortunately, many people choose not to deal with it all, preferring to put off worrying about the future until it arrives. Others go about the process with a sort of resignation born of the fact that, aside from death and taxes, bills are just another part of life - they need to be dealt with because you don't have much choice. However, there's a quiet minority of investors that are taking a different approach. It goes by a variety of names, but "life planning" is one of the more frequently heard terms.

A well thought out plan is important for sound personal financial planning and investing. This is covered in more detail in Lesson 2.

2. The Responsible Use of Consumer Credit

The typical uses of consumer finance includes secured loans such as mortgages for a home or automobile loans, and revolving debt such as credit cards. We'll discuss these in general now and then provide added information later in the guidebook.

A mortgage is a debt instrument that is secured by the collateral of specified real estate property and that the borrower is obliged to pay back with a predetermined set of payments. Mortgages are used by individuals to make large purchases of real estate without paying the entire value of the purchase at the time of purchase. Normally mortgage loans are long term, from 15 to 30 years.

An automobile loan is a secured loan in which the borrower's car is used as security. These loans are usually for 3 to 5 years. Interest charged on an auto loan is higher than a mortgage but lower than credit cards.

Credit cards are issued by a financial company giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short-term financing. Interest usually begins one month after a purchase is made and borrowing limits are pre-set according to the individual's credit rating. Interest rates charged on credit cards is very high and every effort should be to repay any amount charged each month. Credit cards are different than debit cards. With a debit card the amount of a purchased is debited or deducted from one's account at the time of purchase.

The use of mortgages, automobile loans, and credit cards by consumers is similar to the use of electricity. If used safely and wisely they provide useful means of managing one's personal finances. If used carelessly, they can be deadly.

Lesson 9 explains the tenets of responsible use of credit.

3. The Relationship of Risk Taken to Reward Received

It is important to understand Risk and Reward so let's define these terms.

Reward is the return received on an investment. This can be in the form of income received (a dividend received or interest paid), or an increase in the value of the investment that was made (a capital gain).

In finance risk is the chance or probability of receiving a return different than was expected. Statistically standard deviation is used to measure risk. Risk can be systematic, or risk inherent in the market or economy or unsystematic or risk related to an individual investment.
It's important to understand that the greater the risk of any investment, the greater the reward or return potential should be, and the lower the risk, the lower the return.

4. The Importance of Long Term Investing

A long-term approach to investing offers the best strategy for taking advantage of the higher return potential that is available on stocks. It's best not to try to "time the market", or move in and out of investments in an effort to buy before prices increase, or sell before they decline. The best alternative is to develop a long term strategy.

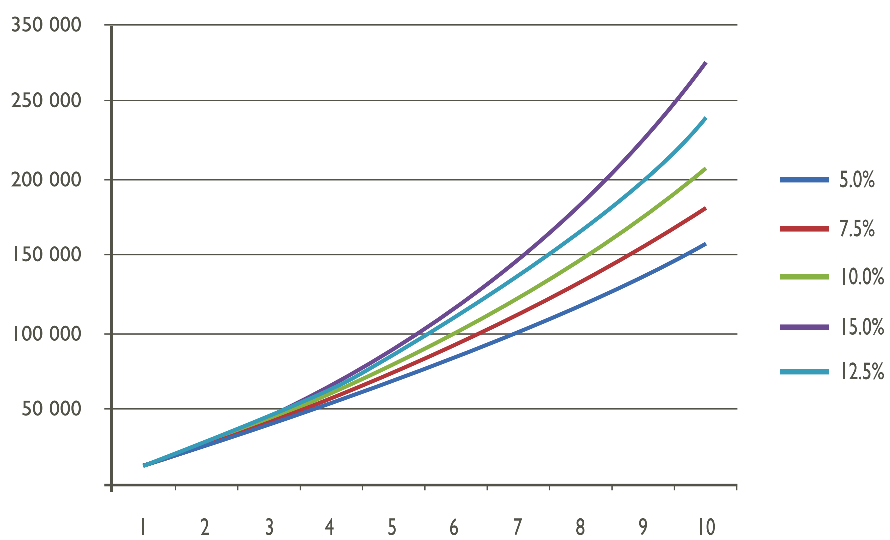
Research shows that disciplined investing over long periods of time produce the best results.

5. The Concept of Compounding

Albert Einstein called compounding the 8^{th} wonder of the world. Compounding is the ability of an asset to generate earnings, which are then reinvested in order to generate their own earnings. In other words, compounding refers to generating earnings from previous earnings. Perhaps compounding is best explained by an example. Suppose you invest AED10,000 in a bank account that pays 5% profit annually. If you left these funds in the account how much would you have after 10 years? Compounding the profits would mean you would earn AED1,000 more, or 10% more after ten years of investing.

Year \ Interest rate	With 5% Investment Profit		Without 5%	
1	10 000	500	10 000	500
2	10 500	525	10 500	500
3	11 025	551	11 000	500
4	11 576	579	11 500	500
5	12 155	608	12 000	500
6	12 763	638	12 500	500
7	13 401	670	13 000	500
8	14 071	704	13 500	500
9	14 775	739	14 000	500
10	15 513	776	14 500	500
Advantage of compounding			1013	10%

To demonstrate the power of compounding, let's assume you were able to save AED1,000 per month for 10 years. How much would you accumulate if you simply allowed these savings to compound at 5%, 7.5%, 10%, 12.5%, or 15%? The chart below shows how quickly your investment can grow.



6. The Need for a Disciplined Approach

A routine and consistent pattern of investing is critical for success. This means establishing a monthly plan and following it. There are proven strategies for doing this such as "cost averaging" that will be discussed later. Following a disciplined approach will differentiate you from the average investor and improve your performance over time.

7. The Theory of Efficient Markets

An investment theory that states it is impossible to "beat the market" because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. According to the this theory, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices. As such, it should be nearly impossible to outperform the overall market through market timing, and that the only way an investor can possibly obtain higher returns is through a longer term strategy. It should be noted that while not all experts agree about this theory, it does support the notions of discipline and a long term perspective, both of which are critical for successful personal financial management.

8. The Power of Diversification

Diversification is a powerful investment principle that can reduce risk by spreading your money among different investments. Diversification is a risk management technique that mixes a wide variety of investments within a portfolio (or group of investments). The rationale behind this technique contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio.

Diversification strives to smooth out unsystematic risk (risk related to individual investments) events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. Therefore, the benefits of diversification will hold only if the securities in the portfolio are different or not perfectly correlated.

9. The Significance of Asset Allocation

Asset allocation is the act of distributing your investments among various types of investments or asset classes. This can also reduce risk. By allocating investments to different types of investments we can adopt a strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance and investment horizon.

The three main asset classes normally considered in asset allocation – equities, fixed-income, and cash and equivalents – have different levels of risk and return, so each will behave differently over time.

There is no simple formula that can find the right asset allocation for every individual. However, the consensus among most financial professionals is that asset allocation is one of the most important decisions that investors make. In other words, your selection of individual securities is secondary to the way you allocate your investment in stocks, bonds, and cash and equivalents, which will be the principal determinants of your investment results.

Asset-allocation mutual funds, also known as life-cycle, or target-date, funds, are an attempt to provide investors with portfolio structures that address an investor's age, risk appetite and investment objectives with an appropriate apportionment of asset classes. However, critics of this approach point out that arriving at a standardized solution for allocating portfolio assets is problematic because individual investors require individual solutions.

10. Monitoring/Utilizing Expert Services

Finally, as you can probably surmise by now, investing is a complicated and involved process. One way to deal with this complexity is to select an investment management firm to handle your investments for you. Investment professionals can lead you through the investment planning process, and while not inexpensive, provide significant benefits.

Selecting an investment manager is a critical step, and due diligence should be taken before handing your funds to anyone. This includes reference checking, evaluating past historical performance, verifying they are properly registered, and asking for their credentials. Credentials can include CFA (Certified Financial Analyst) or CFP (Certified Financial Planner).

Some key questions you can ask any investment management firm include:

1. Is there a Separation of Advisory and Asset Management functions?
2. Is there a reputable Audit firm that provides an independent audit report?
3. How are strategy and performance for investments reported?