What is an asset class?

Asset classes consist of a group of securities with varying degrees of risk. There are 6 main asset classes.

- Equities
- Bonds (also referred to as fixed income)
- Cash
- Property
- Commodities
- Derivatives

Each asset class has different investment characteristics, for example, the level of risk and potential for delivering returns and performance in different market conditions. I have below detailed a brief overview of the asset classes, if you would like further details please let me know info@pragmaticinvesting.co.uk.

Equities

Equities (also known as 'ordinary shares', or 'shares') are issued by a public limited company, and are traded on the stock market e.g FTSE 100. When you invest in an equity, you buy a share in a company, and become a shareholder. Equities have the potential to make you money in two ways: you can receive capital growth through increases in the share price, or you can receive income in the form of dividends. Neither of these is guaranteed and there is always the risk that the share price will fall below the level at which you invested.

Bonds

Bonds also referred to as fixed income securities, are issued by companies and governments as a way of raising money and are effectively an 'I.O.U'. Bonds provide a regular stream of income (which is normally a fixed amount) over a specified period of time, and promise to return investors their capital on a set date in the future. Once bonds have been issued, they're bought and sold between investors without the involvement of the issuer. Bonds are generally considered to offer stable returns, and to be lower risk than equities – and hence deliver lower returns than equities.

Property

Investing in property can be done in 3 different ways.

1. Buying a property bricks and mortar either residentially or commercially.
2. Investing in company shares (equities) in companies that own the properties.

3. In a pooled approach via a fund i.e. With a mix of investors monies to allow a spread of properties and provide some protection to things like empty properties and interest rates increase when you physically own the asset yourself.

Generally in a pooled approach as stated in point 3 the income stream from the tenants should be viewed as the long term return of the portfolio, with the possibility of a capital uplift as and when properties get sold.

Commodities

Commodities are raw materials that are either consumed directly, such as food, or used as building blocks to create other products. These materials include energy sources like oil and gas, natural resources like timber and agricultural products, or precious metals like gold and platinum. In investments these are general useful from a portfolio perspective as an inflation hedge and to diversify correlation to equity markets.

Cash

Cash tends to be held within a bank account where interest can be gained. Alternatively, cash funds use their market power to get better rates of return on deposits than you would get in an ordinary bank account. They often invest in very short-term bonds known as ‘money market instruments’, which are essentially banks lending money to each other. In addition, cash funds can provide exposure to global currencies, which may not be easy to purchase on the open market and could be costly transactions.

Derivatives

A fairly new approach in the retail markets these are instruments that derive their value from an underlying asset this could be a stock market e.g FTSE 100, Currency e.g Sterling, Bonds, currency etc. They are essentially a contract between 2 parties for an asset set in a contract format. This is used for hedging out risk exposure and come in various formats options, futures, forwards and swaps.

Options

This is a contract drawn up between 2 parties that gives the buyer an option to buy something at a set price on and agreed time. There is the option to buy and not the obligation.

So for example there is a contract drawn up between 2 parties allowing the buyer the obligation to buy gold at future price. So with the current price of gold is £1.00 the buyer of the contract wants to buy 100,000 tonnes at 1.50 in for years time believing the price is more likely to reach 2 and as such wants the option to lock in a 50p discount. The contract costs 10p so in total 40p discount. The seller of the option believes the prices is going to drop to 50p and thus the buyer would not take up the contract as has lost 10p for the contract which the seller profits.

Futures

Similar principal to options but this time the contract at a price agreed today for a set number of assets, there is the obligation to fulfill the contract rather than the option. The buyer is obliged to pay up in future the seller is also obliged to sell the assets as agreed. The agreement between the 2 parties is a standardised contract that is traded on the exchange.

Forwards

Similar to futures, the contract is drawn up by the 2 parties concerned in this and isn’t done via the exchange. This allow a customised approach to the contract in terms of size of order, delivery dates, price of contract but forwards carry the risk of default by one of the parties, with the forwards there are none as they are traded and cleared the exchanges.

Swaps

This is a contractual agreement to exchange cash flows over a period of time for example in its most simple form lets says a UK investor will give away 5% per annum interest on a fixed rate to another UK investor who is offering a variable rate over a 5 year period. The holder of the fixed rate believe say the variable rate if going to go to 6% for example and they will therefore can an extra 1% over the term. The variable rate holder things the opposite and the rate will go to 4% for each and they will can the extra 1% by buying the 5% rate.

There are some more technical points around the derivatives and asset classes and I will go into more detail in my blogs available as part of the services.