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| Lesson 5  Benefits and Risks of Investing in the Sharemarket  and the Importance of Diversification |
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## Income Benefits of Investing in the Sharemarket

One of the main benefits of investing in the sharemarket is the anticipated income in the form of dividends. Dividends are a type of income that an investor receives from investing, based on the profits made by that company, which are then distributed amongst their shareholders depending on how many shares individual investors own.

## Tax Benefits of Investing in the Sharemarket

There are many benefits to investing in the sharemarket, with many investors identifying the tax benefits of investing as one of their main reasons for choosing this investment type. If shares are sold at a price higher than what they were initially purchased, the shares would have increased in value. This is known as a capital gain and with the owner having to pay a capital gains tax. However, if shares are held for 12 months or more, the owner may qualify for a 50% discount in capital gains tax payable.

If dividends are earned (the income made by the owner of the shares from the company after it has made a profit), then the owner may have to pay income tax on the dividend amount. However, if the company has already paid tax on their profits, the shareholder may be eligible for tax credits known as franking credits that may reduce the tax payable on the dividend amount.

## Liquidity Benefits of Investing in the Sharemarket

Liquidity is the ease to which assets can be converted into cash quickly. Cash is seen as the most liquid of assets as it can be used to purchase anything quickly, giving the owner flexibility. Shares can be purchased very easily and can also be sold very easily, with cash returned to the owner quickly. Most other assets such as artworks or property (land), may take several months or longer to be sold, making them less liquid.

**Risks of Investing in the Sharemarket**

There are several risks associated with investing in the Sharemarket that all investors should be aware of. These include loss of capital, timing issues, receiving poor financial advice, changes in legislation, and movements in currency values due to fluctuations on international money markets. Additional information on the benefits and risks of investing can be found here: [Risks and benefits (asx.com.au)](https://www2.asx.com.au/investors/learn-about-our-investment-solutions/shares/risks-and-benefits)

Activity 1: Diversifying Risk ­– Industry

When markets are in a general decline most prices will fall. However by spreading your shares across different industries, risk may be reduced. The table below shows how different sectors performed over 2020/21 and 2021/22.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 31 December 2020 to  31 December 2021 | Percentage  Change |  |  | 31 December 2021 to  30 December 2022 | Percentage  Change |
| XDJ | Consumer Discretionary | -21.31% |  | XDJ | Consumer Discretionary | -22.65% |
| XEJ | Energy | -1.97% |  | XEJ | Energy | 39.71% |
| XFJ | Financials | 20.20% |  | XFJ | Financials | -2.72% |
| XHJ | Health Care | 7.98% |  | XHJ | Health Care | -8.41% |
| XNJ | Industrials | 11.24% |  | XNJ | Industrials | -6.18% |
| XIJ | Information Technology | -2.79% |  | XIJ | Information Technology | -34.25% |
| XMJ | Materials | 6.84% |  | XMJ | Materials | 4.79% |
| XSJ | Consumer Staples | 7.13% |  | XSJ | Consumer Staples | -7.39% |
| XTJ | Telecommunications | 28.46% |  | XTJ | Telecommunications | -13.43% |
| XUJ | Utilities | 4.56% |  | XUJ | Utilities | 24.19% |
| XAO | (All Ordinaries) | 13.55% |  | XAO | (All Ordinaries) | -7.17% |

**Analyse** the above charts and fill in the below table:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Top Performing Industry  2020/21 | Percentage  Change |  | Top Performing Industry  2021/22 | Percentage  Change |
| 1. |  |  | 1. |  |
| 2. |  |  | 2. |  |
| 3. |  |  | 3. |  |

Using your knowledge and research skills, **explain** why there was a change in top performing industry from year to year?

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## Diversifying risk in the share market

Every company is different on the share market with different products being produced and sold. This difference can mean that certain shares can go up and down based on supply and demand, leading to market volatility. This can be identified by looking at a chart of their share price movement. It is therefore important to monitor a company’s share performance and to regularly re-evaluate whether they continue to be a good investment. Diversification, a strategy where an investor reduces risk by buying shares in lots of different companies may be one way investors may reduce the risk of losing money. Another is by purchasing shares in only well-established companies with historically stable performance, known as blue chip companies. This may give an investor an expectation of greater reliability or security. Some investors may prefer to purchase more speculative stocks, shares which have a higher level of risk, with the hope that this increased risk will lead to possible greater returns. It is important for an investor to remember that past performance does not guarantee future performance.

Investing in many companies may lead to additional costs due to brokerage fees (the fee paid to a stockbroker to buy and sell shares). There is no correct number of companies for spreading risk through diversification, this is dependent on the opinion of the investor.

Activity 2

## The importance of diversification within a share portfolio.

This activity will involve conducting an experiment over one week to see the importance of diversification. Starting with $10,000 choose one company and invest $10,000 (experiment A). At the same time, invest around $2,000 in five different companies in the same industry (eg. Mining) (experiment B). Finally, at the same time invest roughly $2,000 in five companies from different sectors (eg financial services, industrials, healthcare, mining, telecommunications, energy) of the sharemarket (experiment C). At the end of the week **identify** which of the three scenarios performed the best.

To begin researching, go to [www2.asx.com.au](https://www2.asx.com.au), click on the ‘Markets’ tab and then on ‘Company Directory’. Search for a company by its three-letter code (ticker code) or by name to find the closing share price from the previous day to help fill in this table. At the end of the week **calculate** what the initial $10,000 invested in each experiment is now worth.

**Experiment A:** Starting cash $10,000 (invested on only one company)

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Company | No. of shares | Day 1 Price | Day 2 Price | Day 3 Price | Day 4 Price | Day 5 Price | No. of Shares X Day 5 price = $ |
|  |  |  |  |  |  |  |  |

**Experiment B:** Starting cash $10,000 (invested over five companies within the one industry)

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| --- | --- | --- | --- | --- | --- | --- | --- |
| Company | No. of shares | Day 1 Price | Day 2 Price | Day 3 Price | Day 4 Price | Day 5 Price | No. of Shares X Day 5 price = $ |
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**Experiment C:** Starting cash $10,000 (invested over five companies from five different industries)

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| --- | --- | --- | --- | --- | --- | --- | --- |
| Company | No. of shares | Day 1 Price | Day 2 Price | Day 3 Price | Day 4 Price | Day 5 Price | No. of Shares X Day 5 price = $ |
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**Identify** the experiment that performed the best over the one week period.

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Experiments A & B may have increased in value at a greater rate than Experiment C over the period of a week. If an investor had a longer period of time to invest, possibly over years, **explain** how this result may differ and why.

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## Assessing appetite for risk and setting investment goals

Different investors have differing appetites for risk depending on their personal preferences and the stage of life they are in. Generally, the younger an investor, the more likely they are to take risks as they have less to lose (with a smaller initial investment) and a longer time to recover any losses if needed. Higher risks generally mean there is more chance of greater reward, but a greater chance of possibly losing your initial investment. Conversely, the lower the risk, the lower the potential reward but a greater chance of retaining the initial investment. The appetite for risk is a personal preference.

Before investing in shares, it is advisable for a series of questions to be considered to confirm if an investment strategy is appropriate:

* What do you want to achieve from your investments? Do you want a return in the form of income (such as dividends) or capital growth (buying shares at a lower price than you paid for them)?
* Are you prepared to risk some of your investment capital for the opportunity to make higher returns?

Your age and time frame for investing may affect your long-term and short-term goals. For example, a single person with no dependents may be willing to accept more investment risk in return for higher growth. Retirees are often very concerned about not losing their savings. It is important to identify your goals so you can plan towards achieving them.

Activity 3

You have been hired as a financial advisor for the following three people. Advise them on what companies they should buy shares in using your knowledge of high and low risk options. (These scenarios may be set as role play by the teacher).

Read the first three case studies and mark on the scale below the level of risk you think each investor is prepared to take. Give reasons for your answer.

High Risk

Low Risk

## Scenario 1:

Alec has just turned eighteen and has $5,000 to invest.

He wants to achieve a very high return and will keep his shares for at least two years.

Alec wants you as his adviser to recommend three companies that have a high potential for capital growth, and is willing to invest in more speculative stocks. He is aware that he may potentially be risking his initial $5000 but is hoping with high risk there is higher return. Alec is prepared to sacrifice security for the potential of a greater return.

As an advisor to Alec, **recommend** three companies that may be ideal for his situation and **explain** why this is a good company for him to invest in.

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## Scenario 2:

Maya is in her late 50s and is hoping to retire in the next decade. She has $12,000 to invest and is looking for three companies that will be lower in risk as she does not want to risk losing her initial investment. She does however want a good rate of return in the form of income from dividends. **Recommend** three companies Maya should invest in.

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## Scenario 3:

Serene is in her early 20s and has just finished university. She has $3000 and would like to invest in the Sharemarket for the long term, over 5 to 10 years. She is hoping to have strong capital growth and is not so worried about dividends. She wants to invest in companies that are well-known and less risky. She knows that the market will fluctuate but believes her long-term approach to investment will reduce her long-term risk.

**Recommend** three companies that may fit her situation, explaining why this is the case.

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## Activity 4: Personal Goal Setting

Discuss and then fill in the below table, taking into account the needs or wants of a typical person in this age group. (Your teacher may ask you to do this in pairs or in small groups).

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| --- | --- | --- |
|  | Short-term Financial Goals | Long-term Financial Goals |
| Age 15 years |  |  |
| Age 18 years |  |  |
| Age 21 years |  |  |
| Age 30 years |  |  |
| Age 40 years |  |  |
| Age 50 years |  |  |
| Age 67 years (retirement) |  |  |

## Terminology (skill directives)

**Calculate** – Ascertain/determine from given facts, figures or information.

**Identify** – Recognise and name; Establish or indicate who or what someone or something is.

**Explain** – Relate cause and effect; make the relationships between things evident; provide why and/or how.

**Recommend** – Provide reasons in favour.

**Analyse** – Identify components and the relationship between them; draw out and relate implications.

## Glossary

**Investing –** using money to buy something that has the potential to make more money by growing in value or through returns.

**Savings –** Putting money away and not spending it.

**Market volatility –** a high possibility that shares will move up and down dramatically in value.

**Realised loss –** When an asset is sold for a price below the price it was paid for initially.

**Speculative stocks –** shares which have a high potential for dramatic success or failure.

**Risk –** the possibility of losing money on an investment.

**Diversification –** A strategy that mixes a wide variety of investments types and sectors within a portfolio for the purpose of minimising risk.

**Return –** The amount of money made on an investment relative to how much the initial investment was worth.

**Capital Gains Tax** **–** Is the tax paid on the increased value of an asset by an investor at the point in which they sell their asset. For example, if a person purchases $1000 worth of shares and sells them in a year for $1500, they may need to pay tax on the $500 increase in value in the asset.