

## 1) The basics of investing



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## 1. The purpose of investing

This document introduces some basic insights into why investing is important and why being a saver (placing bank deposits) rather than an investor (investing in bonds and equities) is likely to be a riskier strategy in the longer term.

Most people today face the prospect of having to fund some or all of their retirement income from assets that they have accumulated over time. At its most basic, investing is a process of deferring spending in one stage of your life, often the time you are working, in order to build a pot from which you can draw funds to support your lifestyle choices at a time when your income from work decreases, perhaps as you move to part-time work or full retirement. Some investors have a range of goals for their money, such as funding university for their children or grandchildren, or simply building a nest egg for themselves or to pass on to future generations.

## 2. Inflation is a tax on your wealth

The first thing to remember is that any money put aside is vulnerable to inflation i.e. the rise in consumer prices. Most people are now very aware of the damage that inflation can cause, having gone through the high inflation of 2022 and 2023. Let us look at a very simple, yet powerful example of how inflation has impacted purchasing power. The example is self-explanatory.

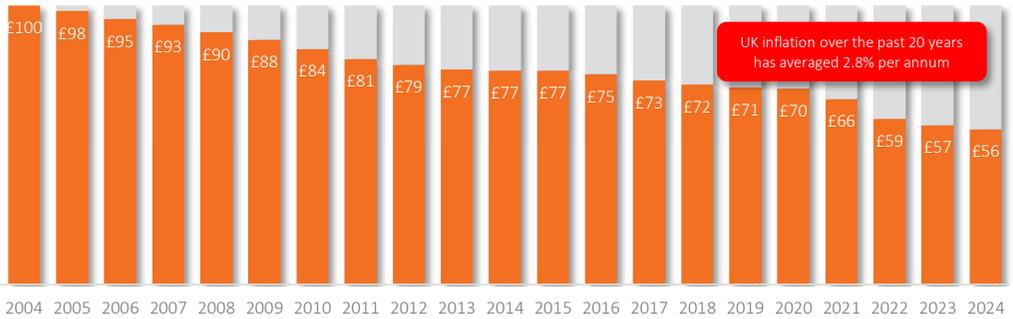
**Figure 1: Pints of draught lager that £20 could buy**



Data source: UK RPI: Ave price - Draught lager, per pint.

Looking a bit more specifically at inflation in the UK – as measured by the UK Consumer Price Index (UK CPI) – one can see in figure 2 that the purchasing power of £100 has fallen quite materially in the past 20 years. Persistent, low levels of inflation can, over time, be as detrimental to your money as short bursts of high inflation.

**Figure 2: The erosion of purchasing power from 2005 to 2024 in the UK.**



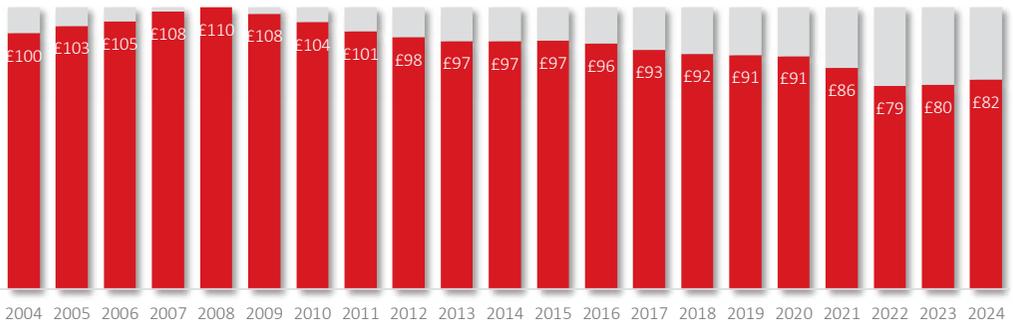
Source: Bank of England. Data: Inflation – UK CPI.

Although 2.8% on average does not sound much, it is the cumulative effect that is so damaging. The key message is that anyone putting money aside for the future and hoping that their pot of money will maintain its purchasing power will need to make sure that they take inflation into account.

### 3. Cash will not get you there

For those building a pot for retirement, protecting their wealth from inflation – and hopefully growing its after inflation value (this is sometimes referred to as its ‘real’ value) – is very important. The first thing to do is to become an investor, not a saver. For some, today’s elevated deposit rates returning above-inflation interest may look appealing. Unfortunately, cash has had a very poor track record of holding its ‘real’ value, as figure 3 illustrates. Over the same twenty-year period, cash has lost around 20% of its purchasing power.

**Figure 3: Cash has done a poor job of protecting savers’ spending power.**

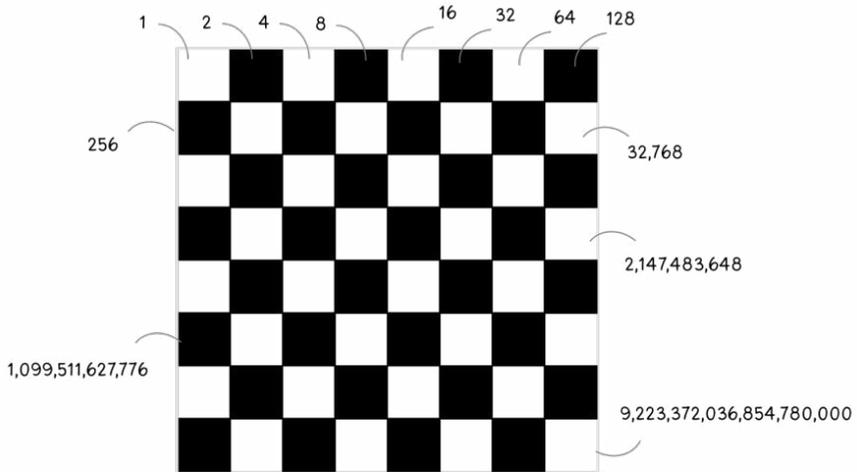


Source: Bank of England. Data: Inflation – UK CPI. Cash - DB SONIA.

## 4. The power of compounding over time

The next and very important basic insight is the power of compounding over time (i.e. interest on interest). In Indian folklore, a minister and wiseman called Sessa, apparently invented chess for his King, and in return asked for payment in grains of wheat: one grain on the first square, two on the second and doubling each square thereafter. The King laughed at him, for asking for such a small prize, obviously not realising that on the 64th square it would be  $2^{63}$  (i.e. two to the power of 63) grains of wheat! It was Sessa who got the last laugh.

**Figure 4: Doubling grains of wheat on each square of a chess board.**

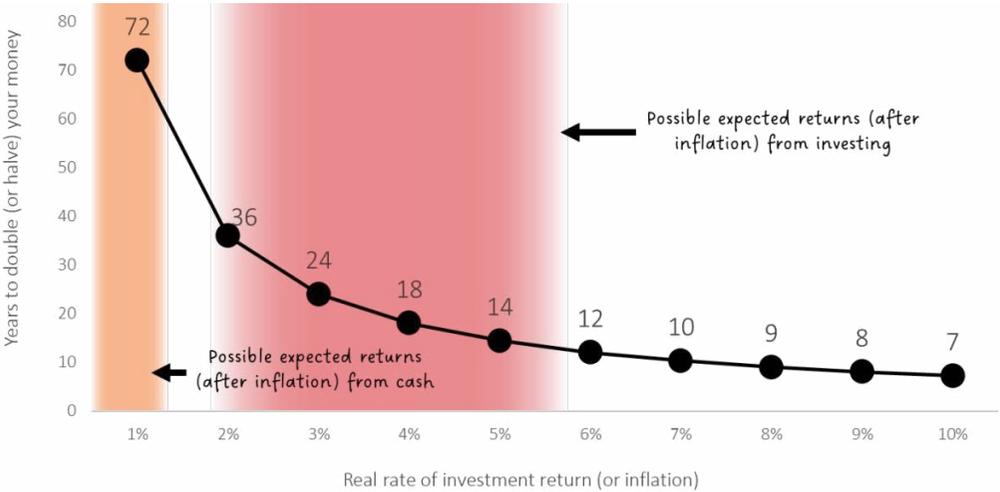


Source: Albion Strategic Consulting

It has been estimated that this represents around 200 times the global wheat harvest today! Obviously, investing is unlikely to double your money every year, except in very extreme cases, usually being a recovery after a very large market fall. We have to content ourselves with much lower mid to low single digits returns on average after inflation when we invest. Yet when investing, small returns – and differences in returns – can grow into large differences in the value of your wealth. On the upside these might be positive returns from an investment portfolio. On the downside, these may be from costs that you incur or from inflation.

There is a nifty rule called the ‘Rule of 72’ that you can use to see how quickly you will double your money based on the returns that you achieve, or alternatively how quickly the value of money will be halved by inflation. All you need to do is divide 72 by the rate of return, or inflation. So, a return of 3% will double your money in 24 years ( $72/3=24$ ).

**Figure 5: The Rule of 72 – how long it takes to double your spending power using after-inflation (real) returns.**



Source: Albion Strategic Consulting

## 5. Participate in the rewards of capitalism

In the chart above, the rightmost shaded area indicates the level of returns – above inflation or ‘real’ returns as they are known – on average, over the long-term that one might expect from a sensible investment portfolio. The investment returns are the rewards owed to you for providing your capital to others. In essence, there are only really two key ways in which you can generate these rewards. The first is by lending your money to a company or government. In return, they give you an IOU, promising to pay you back at the maturity of your loan to them, paying interest at specified dates along the way. Such IOUs are known as ‘bonds’ or ‘fixed income’ securities (as the interest payments – otherwise known as coupons – are usually fixed). The two main choices you face as an investor are who you lend to and how long you lend for. Higher-quality and shorter-dated bonds are more certain.

### Technical Note

To get just a little more technical, if the interest the market demands for owning such bonds (known as its yield) changes, then because the interest payments are fixed, the price of the bond has to change to reflect the new yields demanded. Changes in yields move in the opposite direction to bond prices, a bit like sitting on a see-saw. If bond yields rise, bond prices fall and vice versa. The longer the time you have left before you are repaid your money i.e. the maturity date of the bonds, the further out on the see-saw you are effectively sitting. Longer dated bonds are more sensitive to changes in yields than shorter-dated bonds.

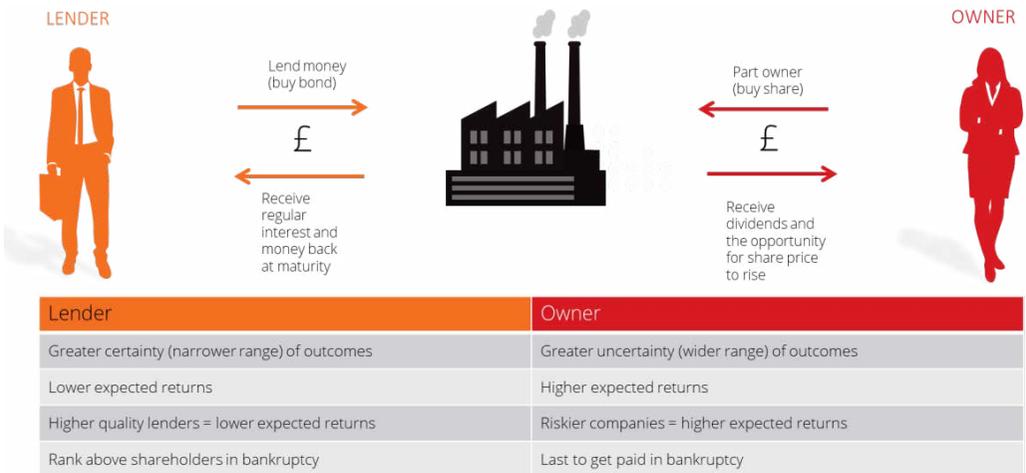
The other thing that you can do is to provide capital to companies in return for shares and receive the rewards of becoming a part owner. In return you receive regular cash flows from companies in the form of dividends paid on the shares you own. You also hope to benefit from the rise in the share price of the firm from its growth in earnings over time as its management and employees execute the company’s strategy. Unlike bonds, where your cash flows are known in advance, nothing is certain about being an owner in a company. As such, diversification by owning many companies across a broad range of sectors and markets becomes an important part of investing sensibly.

### Technical Note

To get just a little more technical, when you own shares – also known as stocks or equities - in a portfolio your money is usually buying shares that are already listed on a stock exchange, having previously been issued when the company needed to raise more capital. Your capital does not go to the company, but to the person or entity selling their shares to you. This is known as the secondary market. The primary market on the other hand is when the shares are first issued either at an initial public offering (IPO) or at a further round of equity issuance.

With the greater uncertainty of cashflows and the fact that if a company fails shareholders are the last to get paid out, equities should carry a higher expected return than bonds.

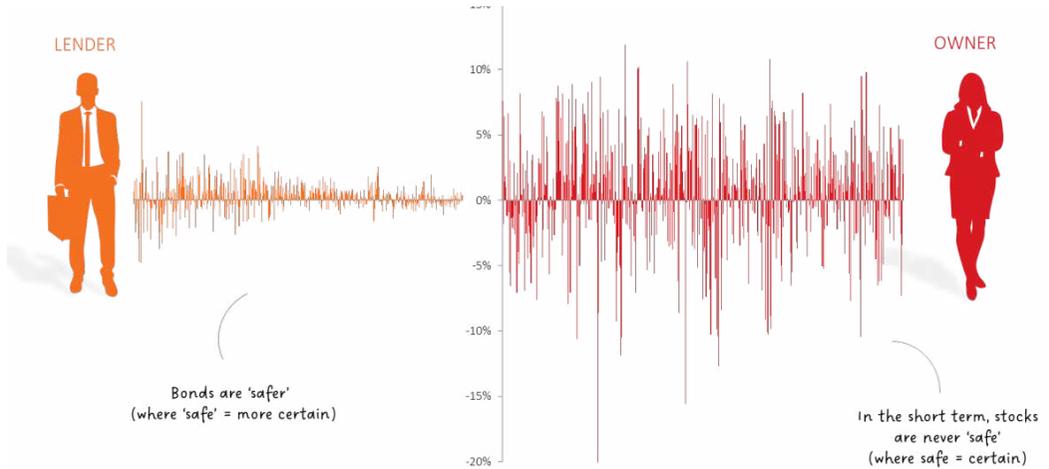
**Figure 6: Participate in the rewards of capitalism – be a lender to companies and/or governments and an owner of companies.**



Source: Albion Strategic Consulting

The outcomes that the lender (bond holder) will experience will tend to be much narrower than outcomes that an owner of company shares will experience. It is this greater uncertainty that delivers the higher expected returns of equities over bonds. Figure 7 compares monthly after-inflation outcomes of shorter-dated, higher-quality bonds against global equities.

**Figure 7: Participate in the rewards of capitalism – equity outcomes are less certain than bond outcomes from 1/1976 to 12/2024.**

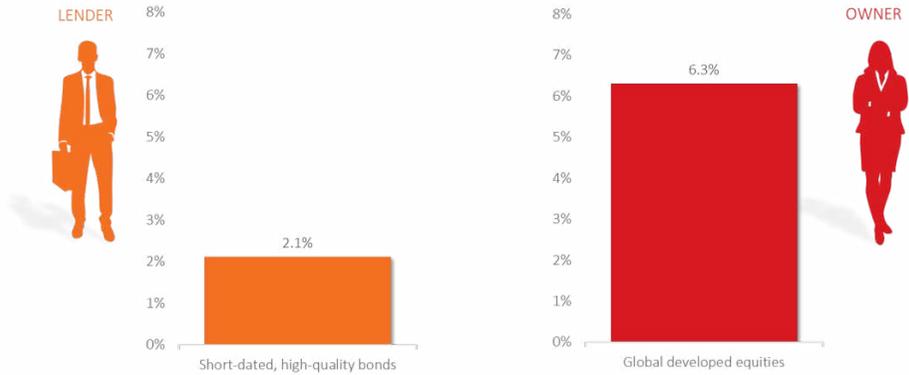


Returns after inflation – 1/1976 to 6/2025. MSCI World Index and FTSE British Government (Up to 5), adjusted for UK RPI prior to Jan-88 and UK CPI thereafter. Morningstar Direct.

So, when you hear media commentators talking about unprecedented volatility in the equity markets, remember the bars on the right! Equity markets are always volatile. Note that after inflation, bond returns can be negative too but rarely to the same degree as equities.

If we take each of these after-inflation monthly returns, we can calculate the annualised returns (i.e. per annum) that the lenders and the owners would have received over nearly the past half century.

**Figure 8: Participate in the rewards of capitalism – annualised after-inflation returns (% p.a.) of lending and ownership 1/1976 to 12/2024.**



Returns after inflation – 1/1976 to 6/2025. MSCI World Index and FTSE British Government (Up to 5), adjusted for UK RPI prior to Jan-88 and UK CPI thereafter. Morningstar Direct.

As you can see from figure 9, £100 invested in the equity of companies grew to more than £2,000 in purchasing power terms. As a lender £100 became less than £300. So, going back to the principle of compounding over time, what seems to be a three-fold difference between the rewards of being a lender and those of being an owner, ends up as a more than seven-fold difference over the period, due to the impact of compounding returns. That is a substantially different outcome in anyone's eyes.

**Figure 9: Participate in the rewards of capitalism – growth of £100 of spending power from lending and ownership 1/1976 to 12/2024.**



Returns after inflation – 1/1976 to 6/2025. MSCI World Index and FTSE British Government (Up to 5), adjusted for UK RPI prior to Jan-88 and UK CPI thereafter. Morningstar Direct.

## 6. Conclusion

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Hopefully this note provides a useful high-level insight into some of the basic concepts that underpin the importance of investing rather than saving. The harsh reality is that for most people, keeping your money in cash is unlikely to be able to support the growth of their purchasing power both when accumulating assets and then creating an ongoing income from them. Understanding the head wind of inflation and how damaging it can be to purchasing power – particularly to those holding cash – and the need to capture the rewards of capitalism, and let compounding work its magic on small numbers over time, will stand you in good stead. If you want to know more about how to invest sensibly and how we build portfolios, please ask for more information. ■

### *Important notes*

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#### *Data series used*

Global equities and global bond data from Hale, T. (2023) 'Smarter Investing'

#### *Products referred to in this document*

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