Know the Objectives of Investing

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The main objective of investing is to earn a satisfactory return. However the return you should expect depends on the risk that you have taken. Different investment options entail different levels of risk. Therefore the investment objectives should include returns expectations as well as the risk expectations. Therefore, any investor should understand and articulate clearly the risk and return objectives prior to investing, in order to avoid any unexpected results emanating from investments.

Risk objectives

The risk objective is determined by the willingness and the ability of the investor to take risks. It quantifies the risk tolerance of an investor as high, medium or low. For instance high networth individuals with a long-term investment time horizon have a greater ability to take risks. However an investor saving/investing to put up a house may have a lower ability to take risks due to the relatively low investment time horizon. The willingness to take risks depend on the investor's risk appetite (whether he/she is a risk taker or risk averse) irrespective of his/her ability to take risks.

Return objectives

A person's return objective may be stated in terms of a percentage return. For example, a person may have stated return goals as "double the value of my investment in four years". But the objective may also be stated in terms of a general goal, such as capital preservation, current income, capital appreciation, or total return. In any case before such an investment objective is made, the investor must be fully aware of the risks associated with such a goal, including the possibility of making a loss.

Capital preservation

Capital preservation ensures that the investor maintains his purchasing power (increasing the value of investments at a rate close to the rate of inflation). Generally, this strategy is strongly recommended for investors with a low risk tolerance. Investors who use capital preservation tend to invest mainly in fixed deposits, treasury securities and savings accounts.

Capital appreciation

Capital appreciation is an appropriate objective when the investors want the value of the investments to grow at a higher rate (compared to the rate of inflation). This is an aggressive strategy for investors, who possess a high level of risk tolerance. For example, you purchase a share for Rs.10 and a year later you sell it for Rs.15 to make a capital gain of Rs.5 (or 50% return). However the risk is higher as there is no guarantee that the share price would increase.

Total return

Total return objective seeks to increase the value of the investment through both capital gains and current income. Current income takes the form of dividends in the case of share investments, and interest in the case of treasury bonds. This strategy's risk exposure lies between that of the capital preservation and capital appreciation strategies. In the above example explained under capital appreciation, if the stock pays a dividend of Rs.1, which could result in a current income of 10%, a total return of a 60 % could be achieved.

Most importantly, the investor should always remember that a potential high return investment option entails an additional risk.