Different types of investment

Investing can seem complicated with a lot of different things that you could choose to put your money into. The most common are shares, fixed income securities, property and cash.

These are all things that your money could be invested in through one of NEST's funds. This factsheet looks at the main types of investment with an explanation of what each means, and how it works.

Shares

A 'share' is exactly what the name implies, a share in a company. As a shareholder you own part of the company, including its assets. You are also entitled to a share of the profits. If you own the shares directly this may be paid directly to you in the form of a dividend, normally distributed twice a year.

As well as sharing the profits, people also invest in shares to make money from changes in the share price. Share prices are quoted on the stock market.

The share price is not set by an authority or organisation in the way that the price of a bottle of milk is set by a shop. Instead, it represents the amount that someone is prepared to pay for that share. The price you see quoted is, typically, the last price that was paid for that share by an investor.

As the share price rises, so will the value of your investment, although if the share price falls the value of your investment falls with it. To convert your shares back into cash, you have to sell them to someone else in the stock market. The price you get depends on a number of things such as what other investors think the future value of the share is likely to be.

Owning certain types of share means you can also have a say in how that company is run. Shareholders are entitled to vote on certain decisions at the company's annual general meeting (or AGM). A fund manager may sometimes take advantage of their right to vote to influence the way a company is run.

Shares are also known as 'equities'.

Fixed income securities (gilts and bonds)

A fixed income security is a type of loan. Like any loan, it has a repayment date and charges interest.

They are used by governments or companies to raise money in the same way that you might borrow money from the bank to buy a car or a house, or some other large purchase. They are often just called bonds, but UK government bonds are also known as gilt-edged securities or 'gilts', and bonds issued by companies are known as corporate bonds.

Bonds usually pay regular interest and are repaid in full on the repayment date. Because of this they can be useful for managers of investment funds to control income within the fund.

Bonds are often bought and sold after they have been issued but before they are due to be repaid. A seller might decide they need their money back before the repayment date, and a buyer might want the regular income that the interest payments bring.

[1] In this document NEST means NEST's pension scheme but occasionally it is used to refer to NEST's trustee, NEST Corporation.

Property

A lot of people invest in property, whether it's the value of a family home or by buying a second property to rent out. It's been a very profitable type of investment over the last 10 years or so, but direct property investment of this sort can be quite risky and hard to cash in if the property market falls.

Fund managers also invest in property. They won't often buy properties directly, although they might do depending on the nature of their investment fund. More often they will invest in companies that manage properties. They might also invest in other funds that specialise in property investing, known as real-estate investment trusts (called REITs).

Commodities

A commodity is a natural resource that can be processed and sold. Commodities that are tracked in the financial markets include agricultural goods, metals, energy and minerals, among others. There are two general categories of commodities, soft and hard commodities. Soft commodities are typically grown, whereas hard commodities are usually mined or extracted.

There are several ways to consider investing in commodities. One way is to purchase varying amounts of physical raw commodities. This isn't the most favourable option for institutional investors, as you can invest through the use of futures contracts.

A future contract is an agreement between two parties to exchange, at some fixed future date, a given quantity of a commodity for a price defined when the contract is finalised. Futures contracts do not trade in shares as stocks do, rather they trade in standardized contracts through an exchange, this is known as a future exchange. Each futures contract has a standard size that has been set by the futures exchange on which it trades.

Another way to gain exposure to commodities is through a mixed equity and futures investment funds. These funds usually invest in a variety of commodities as well as commodity-related businesses. For instance, a fund could own equity shares in companies involved in storage, machinery or distribution while also holding future contracts in wood, coffee and iron.

Liquidity funds (cash)

Most investment funds have an allocation to 'cash', but this doesn't mean that the manager is keeping piles of fifty pound notes in his/her drawer. What cash actually means in this context is closer to the types of fixed-interest savings you might know about from your bank or organisations such as National Savings.

These types of investment are also known as money market or liquidity funds. 'Liquidity' means how easy it is to sell a particular asset. These are called 'liquidity funds' because they are very easy to convert to cash when the fund manager needs it. They carry very little investment risk, as they always pay a set amount, but they can be subject to inflation risk.

Liquidity funds have two uses in an investment fund.

Firstly, they can be used to protect the value of your money when other assets – such as shares or bonds – are behaving in an unpredictable way. At these times the manager will put a larger proportion of money into investments that have a guaranteed return.

Secondly, they form a reserve from which the manager can buy other types of asset and pay out to investors when they want their money back.