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understand your investments

Simplicity can be a real drawcard when it comes to choosing your investments. If you have to make a serious effort to understand how an investment works, you're probably better off walking away.

After several decades in the financial planning business, I've come across all sorts of investments – some good, some not so good, and some that are just plain incomprehensible. There's no single rule as to what makes an investment good or bad, but it's fair to say that the more complex the investment, the greater the chance something could go wrong.

A great example of this was the packaging of dodgy residential mortgages – or 'sub-prime' loans, as an appealing investment in the United States. There are plenty of reports to suggest that investors simply didn't understand what they were tipping their money into, but many threw caution to the wind, lured by the promise of high returns.

Unless you have a firm grasp of how an investment works it's very hard to know what the risks are, and that's a fundamental starting point for any investment decision.

I reckon a fair test of whether an investment is complicated, and more to the point, if you understand it, is how well you can explain it to others. If you can't explain in

simple terms how you will make money, and how you could lose money, chances are you don't have a sufficient grasp of how the investment works. If that's the case, it's not a bad idea to pass it up.

Most of us understand how investments like term deposits and savings accounts work. Similarly, it's not too hard to get the picture on the property market. But when it comes to shares, people often face a stumbling block.

In essence, shares are a straightforward investment. When you purchase shares, you are buying a very small slice of a business. And few of us would invest in a business we wouldn't understand.

It's easy to see how our big banks make money, or how retail chains like Woolworths turn a profit. The way our leading resource companies like BHP Billiton or Rio Tinto make money is pretty easy to grasp. Unless you're a seasoned sharemarket investor it pays to stick with well-known companies like these because at least you can weigh up the risks against the potential return.

With more than 2,000 companies listed on the Australian Stock Exchange, thousands of managed funds and untold numbers of investment properties on offer, there's no shortage of investments

to choose from that are straightforward, easy to research and just as importantly, simple to understand.

Stick with these and you'll be able to make an informed investment decision, and that's one of the best defenses you have against losing money.

Paul Clitheroe's 'Making Money' for the week beginning 8 March 2010



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