Saving Vs. Investing

What is the difference between someone that is saving money and someone that is investing their money? The question seems easy on the surface, but requires some deeper thought.

Saving is of course related to spending. If he did not spend all of your income by default, you have to be saving some of your income. In the sense saving by depositing your funds in a bank or putting them underneath your pillow at night ensures that your capital is going to be returned to you when you need it to consume to buy or sell something. When you go to the bank or look under your pillow, you know it's always going to be there.

Now investing takes savings one step further. Of course you have to save in order to invest, but saving generates a return all of your capital investing is designed to generate a return on your capital. This means that instead of just having the amount of money that you save, investing is designed to help you grow your investment or your savings overtime. In the long run and investors should be better off than a saver because the investors money is growing and the savers money will not.

So for now let's ignore the role of inflation, at least for the time being. How do you calculate a return on investment? Or put another way, how does investing return more than saving does well?

The simple answer is because investors are being rewarded for taking on some sort of a risk, and the risk is well, at some point you might receive your capital and another cases you might not receive your capital. And in order to accommodate for that, the price or the return has to adjust. So let's take an example.

There are also a number of other reasons that investments can fail. Now the question is, are you willing to pay the same amount for investment A with a guaranteed return as you are for investment B with a non guaranteed or risky return? Well, the answer is no. That would be crazy right?

You would be willing to pay less for investment be in order to compensate you, the investor for the risk of not receiving your investment or your funds back. So this simple example should show you how a higher risk. Could be or should be linked to higher return 'cause the price that we haven't quite talked about yet. For investment B will be lower, the expected return for this investment should also be higher.

There are many different types of investments.

Most of these will sound familiar. Stocks. They represent an equity stake in a firm or in a project. Bonds represent the debts, take their options and futures and derivatives that are usually derivatives of stocks and or bonds, or even something like real estate. Now, each one of these investments has their own individual risk and return profile.

For instance, bonds are usually less risky than stocks, but the reason that bonds are less risky than stocks are that bonds received the 1st dollar from a firm and equity holders received the last dollar only after all of the bondholders have been repaid to stockholders get repaid.

In this sense, bonds are generally less risky than stocks.

However, non investment grade or junk bonds could be riskier than equities for site large firms, so in this case the equity of a large firm that's doing well might be less risky than the bonds for affirm that aren't doing well.

Importantly, each one of these investments has to be judged on its own merit and not on the average of all of the investments of any particular type.