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Basics and instruments

Courses 1 and 2 in a single file: saving, inflation, compound interest, risk, accounts, bonds, shares, funds and costs.

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Course 1 — The basics: saving, inflation, risk

Five lessons for those starting from scratch: the difference between saving and investing, what inflation does to idle money, how compound interest works and why risk and return always go together.

Lesson 1. Saving and investing are not the same thing

Saving means not spending part of what you earn and setting it aside. The purpose of saving is to have money available when you need it: for an unexpected expense, for a planned purchase, for peace of mind. Saved money usually sits in simple, easily accessible products such as a current account or a savings account.

Investing means putting part of your savings into instruments that may grow in value over time, such as bonds, shares or funds, and accepting in exchange the possibility that their value falls. An investor gives up a certainty, the sum they have today, for a possibility: having more tomorrow. They may also end up with less.

The practical difference comes down to three questions. First: when will I need this money? Money you may need soon should not depend on how markets behave. Second: how much of a fall in value can I bear without having to sell at the worst moment? Third: do I already have a reserve for emergencies? Only after answering these does it make sense to ask whether, and how much, to invest.

There is no answer that fits everyone. A person with a stable job and no debt is in a different position from someone with an irregular income or a heavy mortgage. That is why financial education does not tell you what to do: it helps you understand the right questions, so that the decision, taken alone or with an authorised adviser, is an informed one.

In three points

- Saving is about availability and safety; investing accepts risk in exchange for a chance of growth.
- Three things matter before investing: when the money will be needed, how much risk you can bear, and whether an emergency reserve exists.
- No choice is right for everyone: it depends on personal circumstances.

Lesson 2. Inflation: why idle money loses value

Inflation is the general rise in prices over time. If a hundred euros fill a shopping trolley today and in a few years the same hundred euros fill only part of it, there has been inflation in the meantime. The hundred euros are still a hundred, but they buy fewer things: their purchasing power has fallen.

Inflation is measured by tracking over time the price of a basket of goods and services that represents household spending: food, energy, transport, rent and so on. Statistical offices regularly publish the change in this index. Central banks, in the euro area the European Central Bank, have among their tasks keeping prices stable over the medium term.

The effect shows mostly over long periods. A hypothetical example: with inflation at 2% a year, after ten years you need about 122 euros to buy what costs 100 today. Put the other way round, 100 euros left idle will have the purchasing power of about 82 of today's euros. With higher inflation the effect is faster; with lower inflation, slower. Nobody can know in advance what inflation will be over the coming years.

This does not mean holding cash is wrong: an emergency reserve must be available immediately, and that availability has value. It does mean that, when thinking over long periods, even the choice of doing nothing has a cost. Understanding inflation helps you compare alternatives by looking at purchasing power, not only at the figure on your statement.

In three points

- Inflation is the general rise in prices: the same sum buys fewer things.
- The effect is small year by year but becomes significant over long periods.
- Holding cash has a clear purpose; over long horizons it also has a cost worth knowing.

Lesson 3. Compound interest, explained with an example

When a sum earns interest, one of two things can happen: the interest is withdrawn, or it is left together with the original sum. In the second case, the following year interest is calculated on a larger base, which includes the interest already earned. This mechanism is called compound interest, or compounding.

A hypothetical example helps. Imagine 1,000 euros earning 3% a year, with no costs and no taxes, simply to see the mechanism. After the first year they become 1,030. In the second year the 3% is calculated on 1,030, not on 1,000: the total reaches 1,060.90. The difference from simple interest is 90 cents. It looks like nothing. But after thirty years the sum would be about 2,427 euros, against 1,900 with simple interest.

Two things follow. The first is that time weighs enormously: growth is slow at the start and accelerates later, because each year the base is larger. The second is that the example only works on paper. In reality returns are not constant, can be negative in some years, and costs and taxes must be deducted. A fixed return for thirty years is a calculation assumption, not a forecast.

The same mechanism also works in reverse. On debts, especially those with high rates such as some consumer loans or overdrafts, interest is added to the debt and generates further interest. It works on costs too: a fee that looks small, charged every year for many years, reduces the final result in a compound way. Knowing compound interest therefore helps you read both opportunities and costs more clearly.

In three points

- With compound interest, the interest earned generates interest in turn.
- Time is the factor that weighs most; constant-rate examples are assumptions, not forecasts.
- The mechanism applies to debts and costs as well, which accumulate in the same way.

Lesson 4. Risk and return always go together

In finance, return is what an investment gives back above, or below, what was put in. Risk is the uncertainty about that result: the possibility that it turns out different, even very different, from what was expected. The two are linked. Whoever accepts more uncertainty asks in exchange for the possibility of a higher return; whoever wants more certainty must settle for less.

This link is the most important rule to remember, because it protects against fraud. If someone offers a return that is high, safe and quick, one of the three is not true. Supervisory authorities repeat it in every information campaign: the promise of high gains without risk is the most typical sign of an offer to stay away from.

Risk has many faces. There is market risk: prices go up and down. There is credit risk: the issuer of a bond may fail to repay it. There is liquidity risk: not being able to sell when you want, or only at a low price. There is currency risk for instruments in another currency. And there is inflation risk, which also affects money left idle.

Then there is the difference between the risk an instrument carries and the risk a person can bear. The capacity to bear risk depends on the time available, on income, on existing commitments and also on temperament: someone who sells everything at the first fall turns a temporary decline into a permanent loss. Knowing yourself on this point is as much part of financial education as knowing the instruments.

In three points

- A higher expected return always comes with higher risk.
- High, safe and quick together do not exist: it is the typical sign of a scam.
- Risks come in different types (market, credit, liquidity, currency, inflation) and each must be weighed against your own situation.

Lesson 5. The emergency fund: the first thing to build

Before talking about investments there is a step that always comes first: having a reserve of money for the unexpected. A car repair, a medical bill, a few months without work. Without a reserve, an unexpected event forces you either to borrow or to sell what you have, perhaps at the least favourable moment.

How large should it be? Financial education materials often refer to a sum equal to several months of essential expenses, but there is no number that suits everyone. A household with a stable income and two salaries can reason differently from someone who is self-employed or has dependants. The starting point is knowing how much you actually spend each month on essentials.

Where is it kept? The feature that matters is availability: the money must be withdrawable at once and without losing value. That is why the reserve usually sits in simple, liquid products rather than in instruments whose price fluctuates. The fact that it earns little is not a flaw: its job is not to earn, it is to be there when needed.

Building the reserve takes time, and that is fine. Setting aside a small but regular amount, better still automatically right after your salary arrives, is the simplest way. Only when the reserve exists, and there are

no expensive debts to pay off, does it make sense to ask what to do with any remaining savings.

In three points

- The emergency reserve comes before any investment.
- Its size depends on essential expenses and income stability: there is no figure valid for all.
- It must be available at once and free of value swings: earning is not its purpose.

Institutional sources for further reading

- ESMA — Investor Corner — <https://www.esma.europa.eu/investor-corner>
- Financial Conduct Authority (UK) — Consumers — <https://www.fca.org.uk/consumers>
- European Central Bank — Explainers — <https://www.ecb.europa.eu/ecb-and-you/explainers/html/index.en.html>

Course 2 — The instruments: how they work

Five lessons on what accounts and deposits, bonds, shares, funds and ETFs actually are, and how to read costs. No specific products, only how things work.

Lesson 1. Current accounts and deposits

A current account is the tool for managing everyday money: you receive your salary, pay bills, use your card. It is not designed to make money grow: the interest paid is usually low or zero, and there may be account fees. Its value lies in the services and in immediate availability.

A savings or deposit account, by contrast, is a savings product: the bank pays interest on the sums left with it, sometimes on condition that they stay locked in for a set period. With a fixed term the interest is generally higher, but early withdrawal may be impossible or mean losing the interest. Before opening one it is worth reading the withdrawal conditions carefully, not just the rate, and remembering that interest is normally taxed.

In the European Union and in many other countries, bank deposits are protected by guarantee schemes, up to a limit per depositor and per bank set by law. This protection covers deposits, not investments: shares, bonds and funds bought through the bank are not covered by deposit protection, because their value depends on the market. It is a distinction worth being clear about.

Accounts and deposits are therefore the tools of liquidity and of the reserve. They do not protect against inflation over the long term, but that is not their job. They are the starting point: the place for everyday money and for money that must stay available for the unexpected.

In three points

- A current account manages payments; a deposit account rewards savings, often with a lock-in.
- With a fixed-term deposit, the withdrawal conditions matter as much as the rate.
- Deposit protection covers deposits up to a legal limit, not investments.

Lesson 2. Bonds: lending money

A bond is a loan. The buyer lends money to the issuer, which may be a government or a company. In return the issuer undertakes to pay interest, called the coupon, and to repay the capital on a set date, the maturity. Government bonds are bonds issued by a state.

The first risk is that the issuer cannot pay: this is credit risk. Specialised agencies give an opinion on the soundness of issuers, the rating. In general, the sounder an issuer is considered, the less interest it has to offer to find lenders; a very high interest rate usually signals higher risk. A rating is an opinion, useful but not infallible.

The second risk concerns those who sell before maturity. The market price of a bond changes over time, and it moves in the opposite direction to interest rates. If rates rise, new bonds offer higher coupons and older ones must become cheaper in order to be sold. If rates fall, the opposite happens. The effect is stronger for bonds with distant maturities.

Whoever holds a bond to maturity receives, if the issuer does not default, the coupons and capital as agreed, regardless of the price swings in between. Inflation risk remains, however: a fixed coupon is worth less if prices have risen sharply in the meantime. Bonds are therefore generally less variable than shares, but they are not free of risk.

In three points

- A bond is a loan to a government or company, with a coupon and a maturity.
- Credit risk is that the issuer fails to pay; a very high interest rate generally signals higher risk.
- Prices move opposite to interest rates: this matters most to those who sell before maturity.

Lesson 3. Shares: becoming a part-owner

A share is a unit of ownership in a company. Whoever buys one becomes a part-owner, in a small way: they take part in the company's results, for better or worse. Unlike a bondholder, a shareholder is not entitled to interest or to the repayment of a sum: they are entitled to a part of what the company is worth and, if distributed, to a part of the profits.

The return on a share can come in two ways. The first is the dividend, the part of profits the company decides to distribute to shareholders; it is not owed and can be reduced or cancelled. The second is the change in price: if the share is sold at a higher price than it was bought for there is a gain, otherwise a loss.

Share prices change every day because they reflect the expectations of millions of people about the future of companies and of the economy. News, financial results, interest rates, confidence and fear move prices, sometimes abruptly. In the short term swings can be wide, and a single company can even go bankrupt, wiping out the value of its shares.

This is why shares are considered higher-risk instruments than bonds, and those who study them insist on two ideas: a long time horizon and diversification, that is, not depending on the fortunes of a single company. Neither removes risk. And the fact that stock markets have grown over very long periods in the past does not guarantee that it will happen again, nor does it say when.

In three points

- A share is a unit of ownership: no interest owed, no capital to be repaid.
- Return can come from dividends, which are not guaranteed, and from changes in price.
- Swings can be wide; a long horizon and diversification reduce some risks but do not remove them.

Lesson 4. Mutual funds and ETFs

An investment fund pools the money of many savers and invests it in a set of instruments: shares, bonds or others, according to a stated policy. Participants own units and share the results in proportion. The main advantage is that a modest sum gives access to a broad set of securities, which would be costly and complicated to build alone.

Funds differ in how they are managed. With active management, a manager picks securities with the aim of beating a benchmark index; this work is paid for with higher fees, and the aim is not necessarily achieved. With passive management, the fund simply tracks an index, for example the largest companies in a market: costs are generally lower and the result follows that of the index, up and down.

ETFs are funds, usually passively managed, whose units are bought and sold on an exchange like a share, during the trading day. They track an index and generally have low costs. Being easy to buy does not make them risk-free: an equity ETF falls when the market it tracks falls, and there are also complex ones, for instance leveraged, which are unsuitable for anyone who does not understand them thoroughly.

For every fund or ETF offered to the public in the European Union and the United Kingdom there is a short, standardised document with the key information: objectives, risk level on a scale, costs and performance scenarios. Reading it before any decision is the simplest way to compare different instruments on a like-for-like basis. The scenarios it contains are estimates, not promises.

In three points

- A fund pools the money of many and invests it in a broad set of securities.
- Active management tries to beat an index at higher cost; passive management tracks an index, generally at lower cost.
- An ETF trades on an exchange; it is easy to buy but carries the risks of the market it tracks. Read the key information document first.

Lesson 5. Costs: small numbers, large effect

Every financial instrument has costs, and they are not always obvious. Some are paid once, such as entry or dealing fees. Some recur, such as a fund's management fee, which is taken from the fund's assets every year and so never appears as a charge on your statement. Some relate to the service, such as advice or custody fees, and then there are taxes.

Recurring costs deserve the most attention, precisely because they are barely visible and they repeat. The reason is compound interest, which also works in reverse. A hypothetical example: two identical instruments, both returning 4% a year before costs for twenty-five years. The first costs 0.3% a year, the second 1.8%. On an initial 10,000 euros, the first would reach about 24,800 euros, the second about 17,200.

The difference, more than 7,000 euros, does not depend on anyone's skill: it depends only on costs. Of course this is a constant-rate example, which does not exist in reality, and a higher cost may pay for an additional

service that some people value. The point is not that the cheapest is always the best, but that cost must be known and weighed.

Where are costs found? In the key information document, which shows total costs and their effect on return, and in the annual statement that the intermediary must send to the client with all costs incurred, in money and as a percentage. Asking "how much does this cost me in total, every year?" is a legitimate question to which you are entitled to a clear answer.

In three points

- There are one-off costs, recurring costs, service costs and taxes.
- Recurring costs compound: small differences become large over time.
- Total costs are shown in the information documents and in the annual statement: you have a right to know them.

Institutional sources for further reading

- European Central Bank — Explainers — <https://www.ecb.europa.eu/ecb-and-you/explainers/html/index.en.html>
- Financial Conduct Authority (UK) — Consumers — <https://www.fca.org.uk/consumers>
- ESMA — Investor Corner — <https://www.esma.europa.eu/investor-corner>

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