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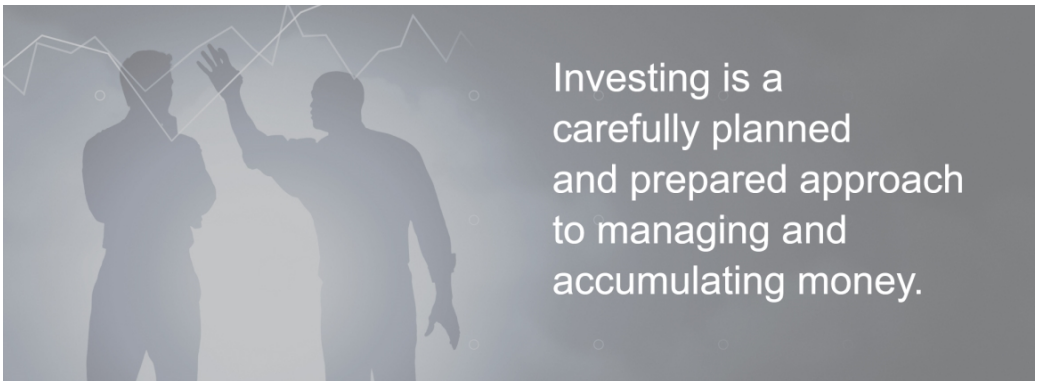
Investment Basics

What Is Investing?



Why invest?

To keep ahead of inflation

Inflation has the effect of reducing the purchasing power of your dollars over time. According to the U.S. Department of Labor, the average annual rate of inflation since 1914 has been approximately 3%. At 3% annual inflation, something that costs $100 today would cost $181 in 20 years.

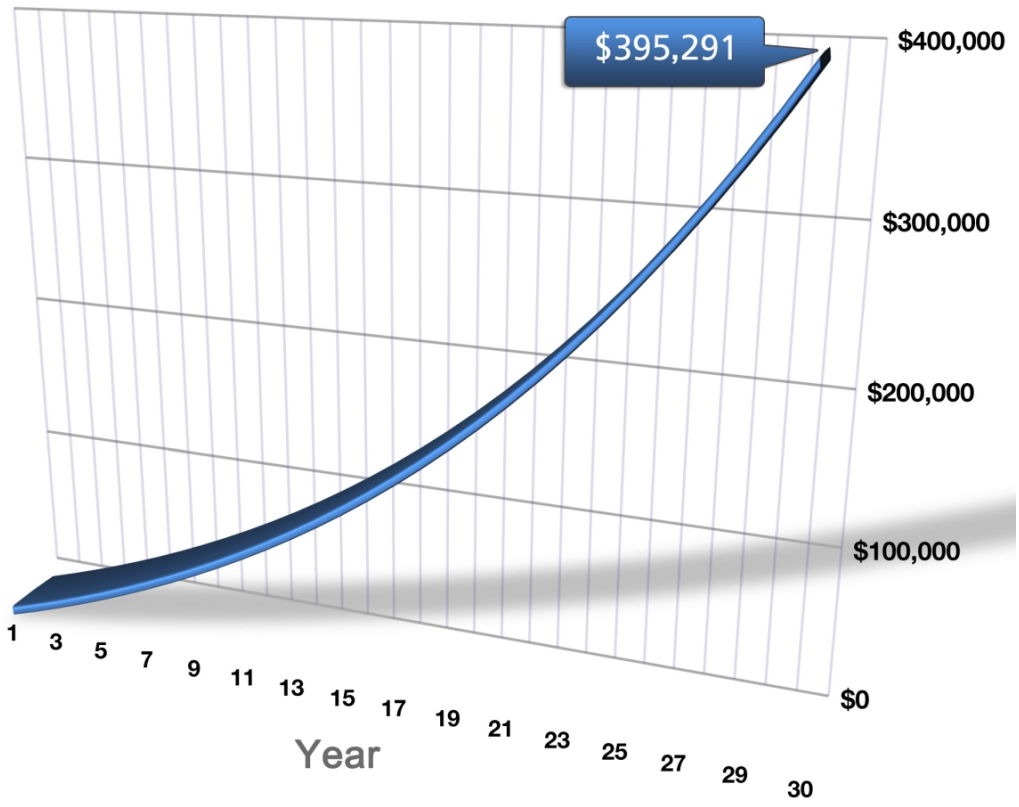
To take advantage of compound interest

Anyone who has a savings account understands the basics of compounding: the funds in your savings account earn interest, and that interest is added to your account balance; the next time interest is calculated, it's based on the increased value of your account. In effect, you earn interest on your interest. Many people, however, don't fully appreciate the impact that compounded earnings can have, especially over a long period of time.

To benefit from the longest possible investment period

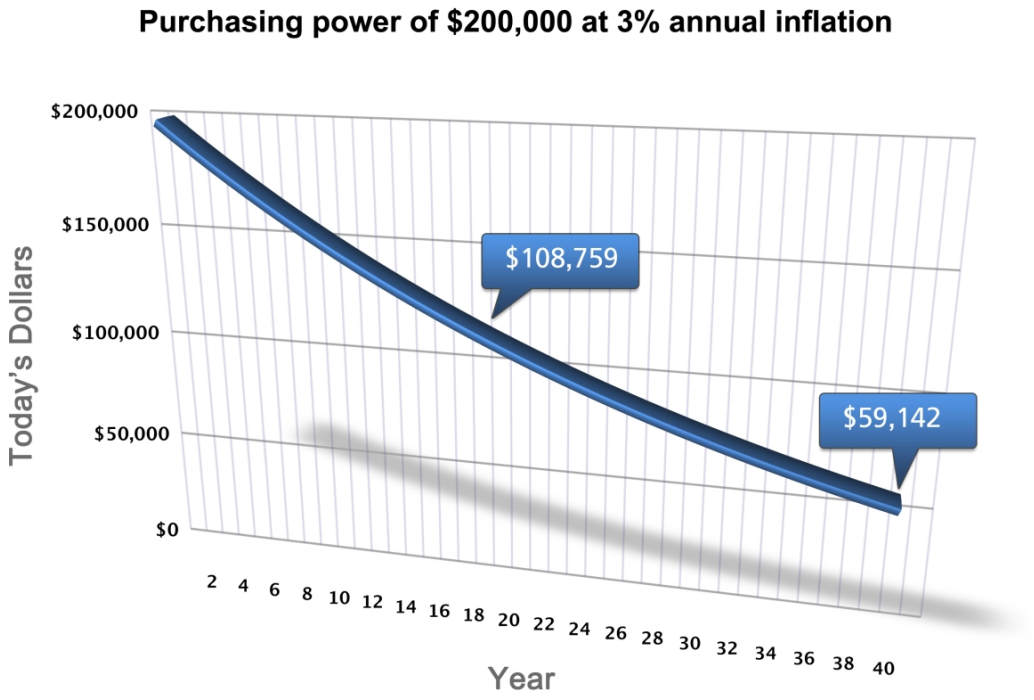
The sooner you start investing, the more time your investments have for potential growth. Waiting too long can make it very difficult to catch up. Consider the examples on the following pages.

Growth of annual $5,000 in investments (made at the end of each year) at 6% annual return



Let's say you invest $5,000 a year for 30 years. After 30 years, you will have invested a total of $150,000. Yet, assuming your funds grow at exactly 6% each year, because of compounding, you will have over $395,000 after 30 years.

This is a hypothetical example and is not intended to reflect the actual performance of any specific investment. Taxes and investment fees and expenses are not reflected. If they were, the results would have been lower.



This chart shows how just a 3% inflation rate can erode your purchasing power over time.

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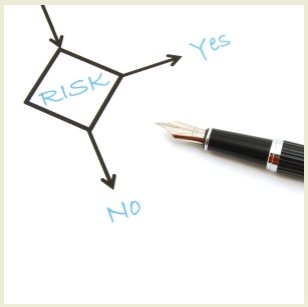


Risky Business? The Nature of Investing

Investing is different for every individual. The investment plan that's right for you depends largely on the level of comfort that you have when it comes to risk. You can't completely avoid risk when it comes to investing, but it's possible for you to manage it.

Investors are typically grouped into three categories for purposes of discussing risk tolerance:

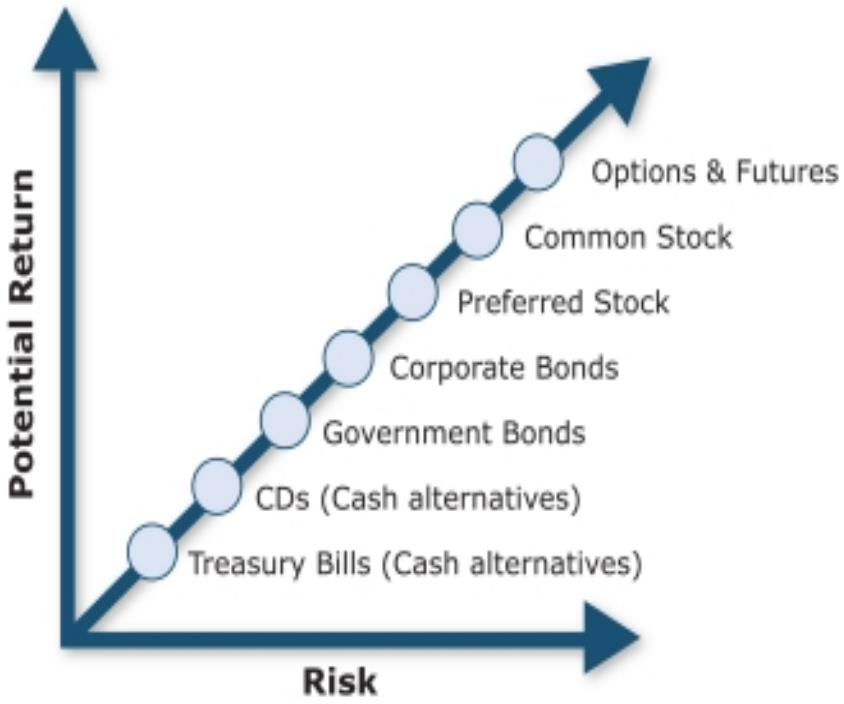
- **Aggressive:** those who have a high degree of risk tolerance
- **Moderate:** those willing to accept a modest amount of risk
- **Conservative:** those who have low risk tolerance

Two aspects of risk tolerance

1. The capacity of your investment plan itself to absorb losses
2. How comfortable you are personally with risk

When it comes to investing, there's a direct relationship between risk and potential return. This is true for investment portfolios as well as for individual investments. More risk means a greater potential return, but also a greater chance of loss. Conversely, less risk means lower potential returns, but less likelihood of loss as well. This is known as the risk/return tradeoff.

Risk/return relationship

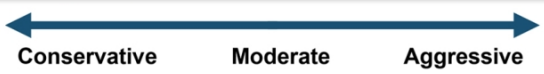


You can't have it all. There's a relationship between growth, income, and the stability of our investments, and when we move closer to one, we generally move away from another. This is a dilemma all investors face.

Managing Risk

Only you can know what your level of risk tolerance is when it comes to investing. For each item, circle the response that's appropriate for you.

Risk Tolerance Questionnaire				
When do you plan to take withdrawals of principal from your portfolio?	In 3-5 years	In 6-10 years	In 11-15 years	After more than 15 years
What is your age?	Over 65	55-64	35-54	Under 35
When making a long-term investment, you plan to hold it for:	1-2 years	3-4 years	5-8 years	9+ years
In October 1987, stocks fell by more than 20% in one day. If you owned an investment that fell 20% over a short period, what would you do?	Sell all the remaining investment	Sell a portion of the remaining investment	Hold on to the remaining investment and sell nothing	Buy more of the investment
Generally, you prefer an investment with little or no fluctuation in value, and you are willing to accept the lower returns associated with these investments.	I strongly agree	I agree	I somewhat agree	I disagree
During periods of market decline, you tend to sell some of your riskier assets and put the money into safer assets.	I strongly agree	I agree	I somewhat agree	I disagree
How stable are your current and future income sources (salary, Social Security, pension)?	Very unstable	Unstable	Somewhat stable	Stable
When it comes to investing in stocks, bonds, or mutual funds, you would describe yourself as a:	Very inexperienced investor	Somewhat inexperienced investor	Somewhat experienced investor	Experienced investor
How would rising and falling market fluctuations affect you emotionally?	Dramatically affect me	Directly affect me	Indirectly affect me	Minimally affect me
Which of these investments would you feel most comfortable owning?	Certificates of deposit	U.S. government bonds	Stocks of older, established companies	Stocks of newer, growing companies
How optimistic are you about long-term economic prospects?	Pessimistic	Unsure	Somewhat optimistic	Very optimistic
What do you anticipate your portfolio value will be in 10 years?	The same as it is today	A little more than it is today	Moderately greater	Much greater
What is your current income requirement from this portfolio?	More than 3%	2% to 3%	1% to 2%	0 to 1%



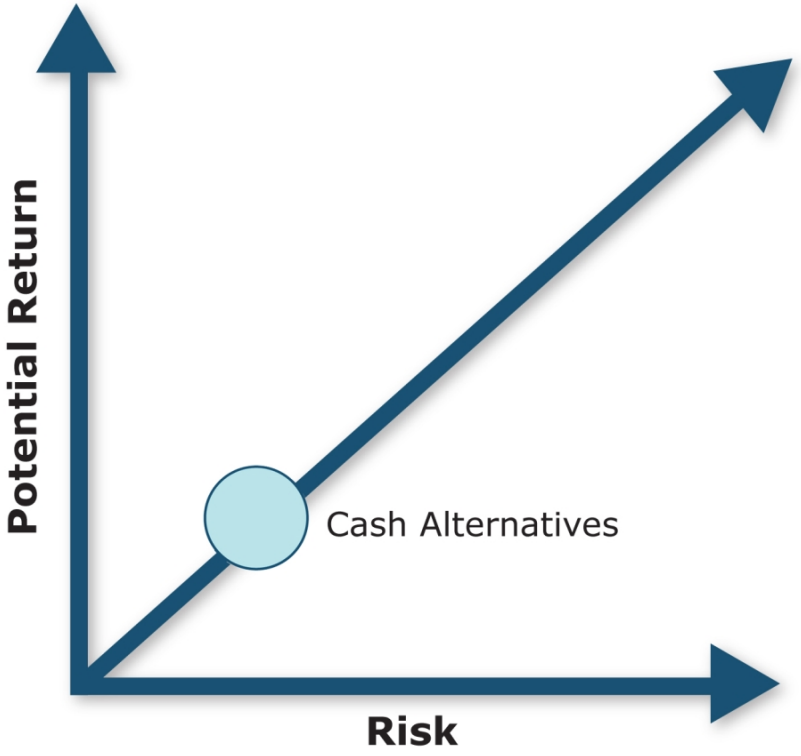
If the items you've circled tend to be to the right, your tolerance for risk may be high. On the other hand, if more of the items you've circled are to the left, your tolerance for risk may be low.

Types of Investments

Cash alternatives

Cash alternatives are low-risk, short-term, and relatively liquid instruments that you may use:

- To provide you with relative stability
- To maintain a ready source of cash for emergencies or other purposes
- To serve as a temporary parking place for assets until you decide where to put your money longer term



Advantages	Disadvantages
• Predictable earnings • Highly liquid • Little risk to principal	• Relatively low returns • May not keep up with inflation

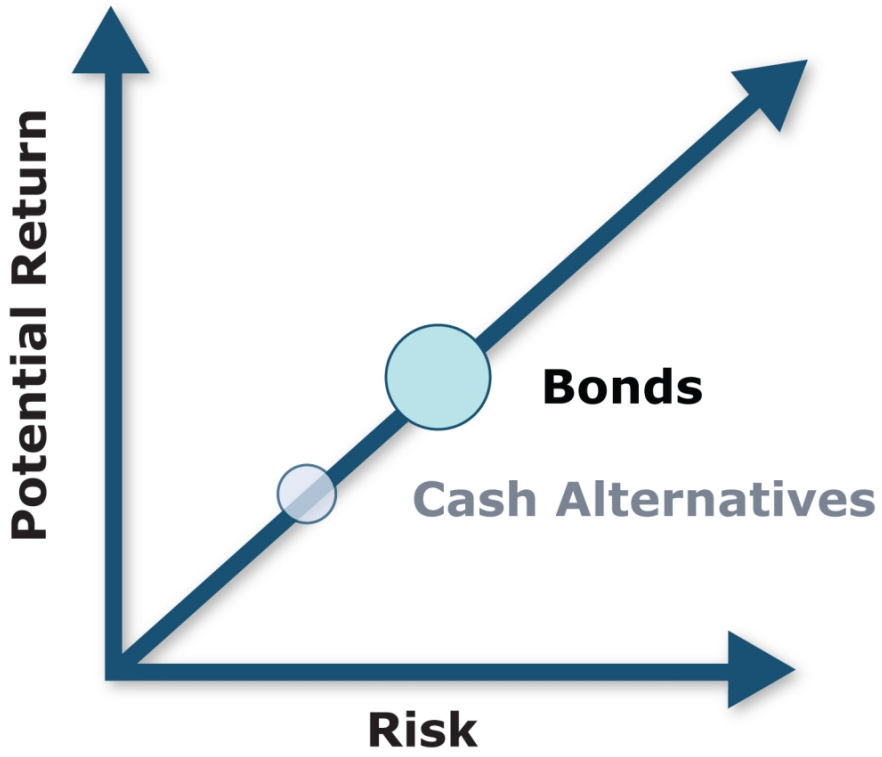
Examples of cash alternatives include:

- ***Certificates of deposit (CDs)***
- ***Money market deposit accounts***
- ***Money market mutual funds***
- ***U.S. Treasury bills (T-bills)***

Bonds include:

- *U.S. government securities*
- *Agency bonds*
- *Municipal bonds*
- *Corporate bonds*

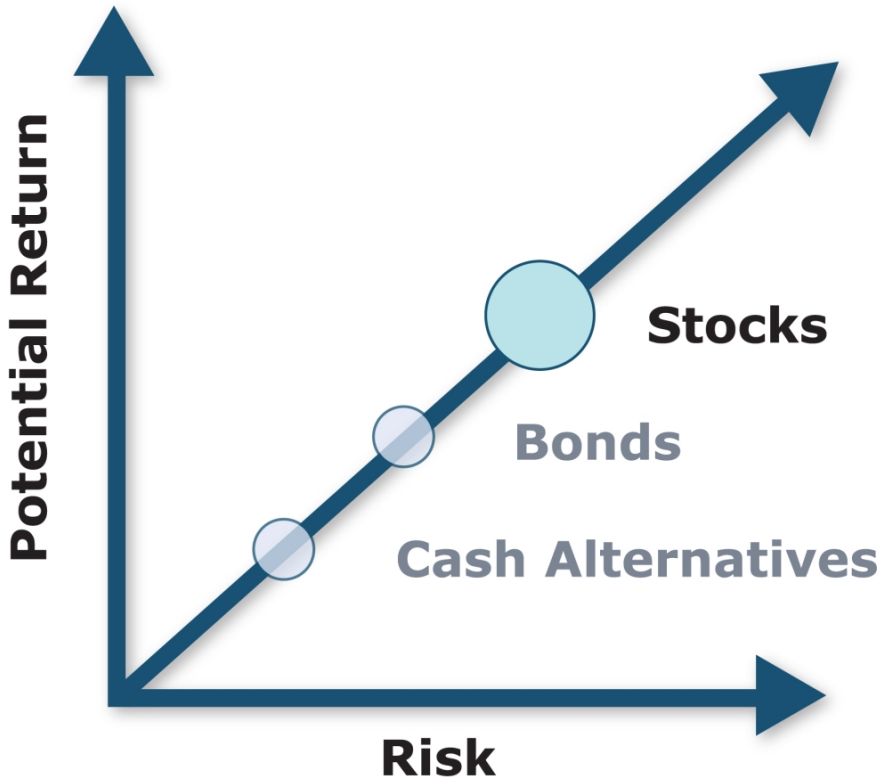
Bonds



Bonds are essentially loans to a government or corporation, which is why they're called "debt instruments." Bonds are issued in denominations as low as $1,000. The interest rate (or coupon rate), which can be fixed or floating, is set in advance, and interest payments are generally paid semiannually. Bond maturity dates range from 1 to 30 years. However, bonds don't need to be held until they mature. Once issued, they can be traded like any other type of security.

Advantages	Disadvantages
• Generally, steady, predictable stream of income • Income is typically higher than cash alternatives • Low correlation to stock market	• Risk of default is greater than cash alternatives (especially corporate bonds) • Bond values fluctuate with interest rates

Stocks



When you buy company stock, you're actually purchasing a share of ownership in that business. Investors who purchase stock are known as the company's stockholders or shareholders. Your percentage of ownership in a company also represents your share of the risks taken and profits generated by the company. If the company does well, your share of the total earnings will be proportionate to how much of the company's stock you own. The flip side, of course, is that your share of any loss will be similarly proportionate to your percentage of ownership.

If you purchase stock, you can make money in one of two ways. First, corporate earnings may be distributed in the form of dividends, usually paid quarterly. Second, you can sell your shares. If the value of the company's stock has increased since you purchased it, you will make a profit. Of course, if the value of the stock has declined, you'll lose money.

Types of stock

- Stock is commonly categorized by the market value of the company that issues the stock. For example, large-cap stocks describe shares issued by the largest corporations. Other general categories include midcap, small cap, and microcap.
- Growth stocks are usually characterized by corporate earnings that are increasing at a faster rate than their industry average or the overall market.
- Value stocks are typically characterized by selling at a low multiple of a company's sales, earnings, or book value.
- Income stocks generally offer higher dividend yields than market averages and typically fall into the utility and financial sectors, as well as other well-established industries.

Common vs. preferred stock

Common stockholders hold many rights, including the right to vote. However, common stockholders are last in line to claim the earnings and assets of the company. They receive dividends at the discretion of the board of directors and only after all other claims on profits have been satisfied.

Preferred stockholders are given priority over holders of common stock when it comes to dividends and assets. However, preferred stockholders do not receive all of the privileges of ownership given to common stockholders, including the right to vote. Preferred stockholders typically receive a fixed dividend payment, usually on a quarterly basis. For preferred stockholders, there is less return potential than for common stockholders; there is also less risk.

Advantages	Disadvantages
• Historically, stocks have provided higher long-term total return than cash alternatives or bonds • Easy to buy and sell • Can provide regular income through dividends as well as capital appreciation • Ownership rights	• Poor company performance affects dividends/value of shares • Greater risk to principal • May not be appropriate for short-term investment horizons • Subject to market volatility

Mutual Funds

The principle behind a mutual fund is quite simple. Your money is pooled, along with the money of other investors, into a fund, which then invests in certain securities according to a stated investment strategy. The fund is managed by a fund manager who reports to a board of directors.

By investing in the fund, you own a piece of the total portfolio of its securities, which could be anywhere from a few dozen to hundreds of stocks. This provides you with both a convenient way to obtain professional money management and instant diversification that would be more difficult and expensive to achieve on your own.

Advantages	Disadvantages
• Professional money management • Small investment amounts • Diversification • Liquidity	• Fluctuating share values • Portion of fund dollars tied up in cash for liquidity needs • Potential tax inefficiency • Mutual fund fees and expenses

Active vs. passive management

An actively managed fund is one in which the fund manager uses his or her knowledge and research to actively buy and sell securities in an attempt to beat a benchmark. A passively managed account, called an index fund, typically buys and holds most or all of the securities represented in a specific index (for example, the S&P 500 index). The objective of an index fund is to try to obtain roughly the same rate of return as the index it mimics.

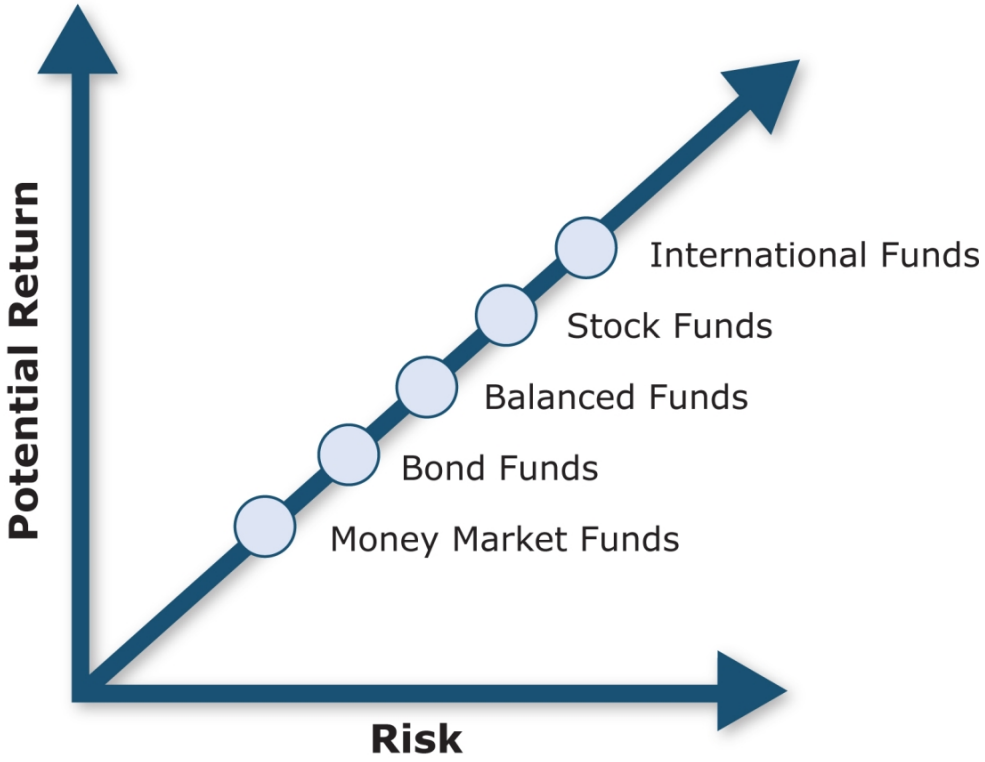
Some types of mutual funds

Funds are commonly named and classified according to their investment style or objective:

- **Money market mutual funds** invest solely in cash or cash alternatives.
- **Bond funds** invest solely in bonds.
- **Stock funds** invest exclusively in stocks. Stock mutual funds can also be classified based on the size of the companies in which the fund invests--for example, large cap, midcap, and small cap.
- **Balanced funds** invest in both bonds and stocks.
- **International funds** seek investment opportunities outside the U.S.

Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Get a copy and review it carefully before investing.

Types of mutual funds by risk level

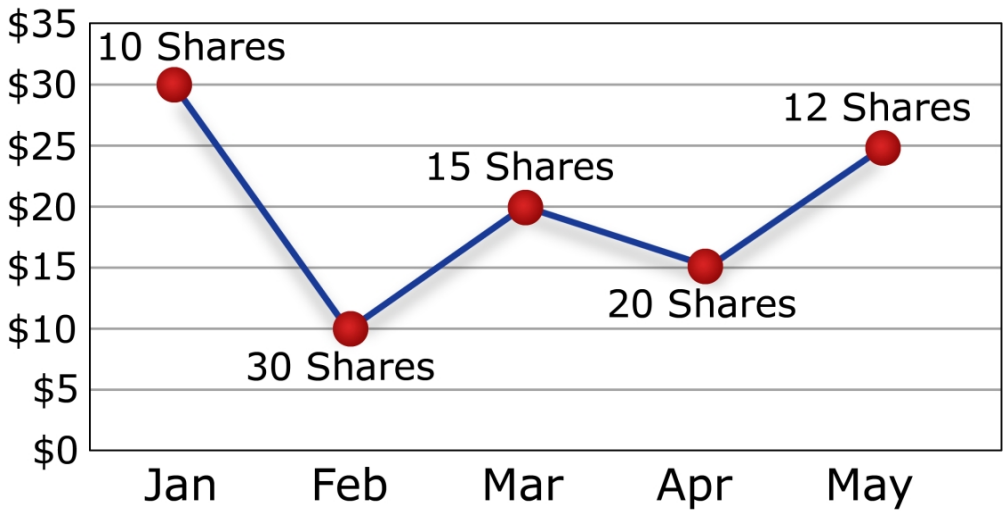


Dollar Cost Averaging

Many mutual fund investors use an investment strategy called dollar cost averaging. With dollar cost averaging, rather than investing a single lump sum, you invest smaller amounts of money at regular intervals, no matter how the market is performing. Your goal is to purchase more shares when the price is low and fewer shares when the price is high. Although dollar cost averaging can't guarantee you a profit or avoid a loss, a regular fixed dollar investment may result over time in a lower average cost per share than if you had bought a fixed number of shares each time, assuming you continue to invest through all types of markets.

For example, let's say that you decide to invest $300 each month toward your child's college education. Because you invest the same amount each month, you automatically buy more shares when prices are low and fewer shares when prices are high. You find that your average cost per share is actually less than the average market price per share over the time that you invested. (See illustration below.)

Five hypothetical investments



Average market price per share
($30 + $10 + $20 + $15 + $25) ÷ 5 = **$20**
Investor's average cost per share
$1,500 total investment ÷ 87 shares purchased = **$17.24**

This is a hypothetical example and does not reflect the performance of any specific investment. Dollar cost averaging can't guarantee you a profit or protect you against a loss if the market is declining.

Before attempting to dollar cost average, you should consider your financial ability to make ongoing purchases, regardless of price fluctuations. If you stop investing when prices are low, you lose much of the benefit of dollar cost averaging.

Factors that should be considered:

- ***Diversification***
- ***Risk tolerance***
- ***Investment time frames***
- ***Personal financial situation***
- ***Liquidity needs***

Asset Allocation

It's an almost universally accepted concept that any portfolio should include a mix of investments. That is, a portfolio should contain investments with varying levels of risk to help minimize exposure.

Asset allocation is one of the first steps in creating a diversified investment portfolio. Asset allocation is the concept of deciding how your investment dollars should be allocated among broad investment classes, such as stocks, bonds, and cash alternatives. The underlying principle is that different classes of investments have shown different rates of return and levels of price volatility over time. Also, since different asset classes often respond differently to the same news, your stocks may go down while your bonds go up, or vice versa. Diversifying your investments over non-correlated or low-correlated asset classes can help you lower the overall volatility of your portfolio. However, diversification does not ensure a profit or guarantee against the possibility of loss.

How do you choose the mix that's right for you?

A number of resources are available to assist in asset allocation, including interactive tools and sample allocation models. Most of these take into account a number of variables:

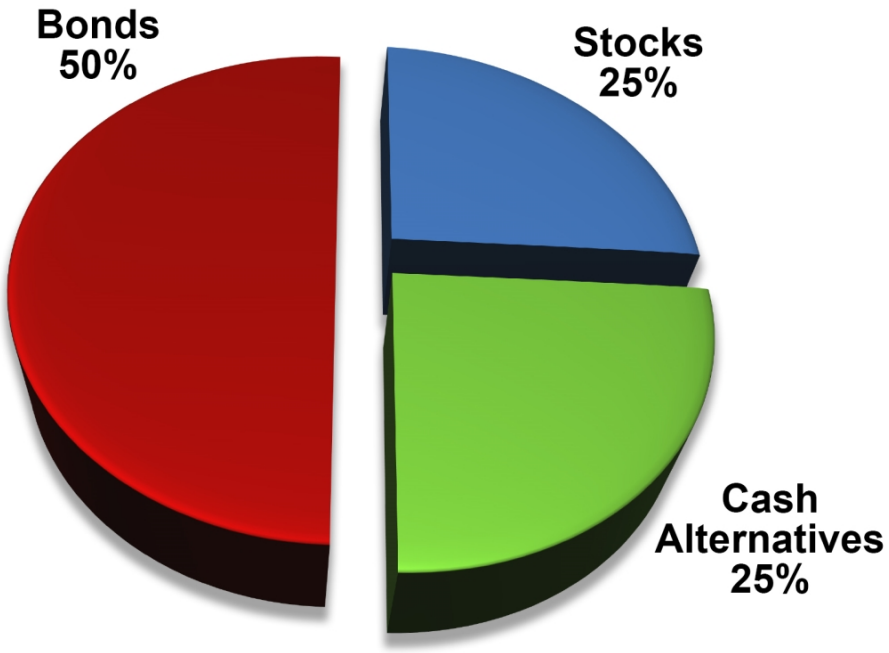
- Objective variables (e.g., your age, the financial resources available to you, your time frames, your need for liquidity)
- Subjective variables (e.g., your tolerance for risk, your outlook on the economy)

Ultimately, though, you'll want to choose a mix of investments that has the potential to provide the return you want at the level of risk you feel comfortable with. For that reason, it makes sense to work with a financial professional to gauge your risk tolerance, then tailor a portfolio to your risk profile and financial situation.

Asset Allocation--Sample Models

Conservative

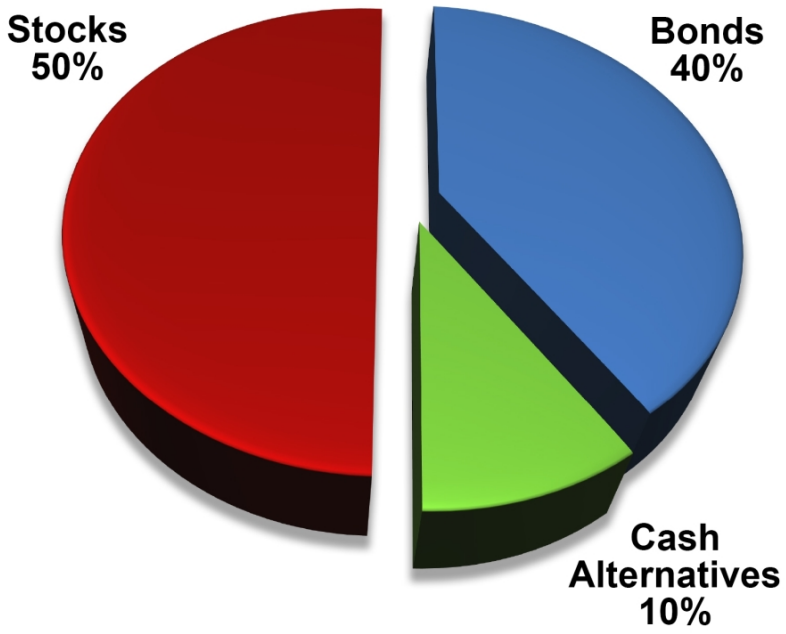
Everyone's situation is unique. Nevertheless, in general, conservative asset allocation models will invest heavily in bonds and cash alternatives, with the primary goal of preserving principal.



This asset allocation suggestion should be used as a guide only and is not intended as financial advice. It should not be relied upon. Past performance is not a guarantee of future results.

Moderate

In comparison, a moderate asset allocation model will attempt to balance income and growth by allocating significant investment dollars to both stocks and bonds.



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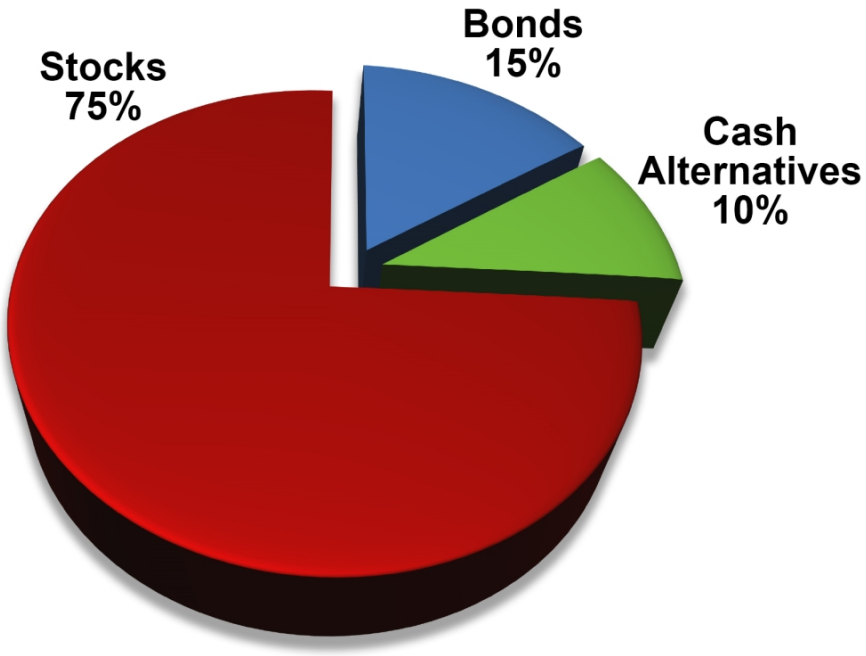
Aggressive

An aggressive asset allocation model will tend to concentrate heavily in stocks, focusing on potential growth.



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What's your mix?	
Cash alternatives	____%
Bonds	____%
Stocks	____%
Total	100%

How a Financial Professional Can Help

As you've seen, there's a lot to consider when it comes to investing. A financial professional can help you:

- Determine your investment goals, timelines, and risk tolerance
- Evaluate markets and investments
- Create an asset allocation model
- Select specific investments
- Manage and monitor your portfolio
- Modify your portfolio when necessary

Pursuing your financial goals

Here are some goals you may wish to discuss when talking to a financial professional.

Priority	Financial Goals	Time Frame	Amount Needed
	Build savings		
	Buy house		
	Accumulate college fund		
	Invest for retirement		
	Save for luxury items, e.g., boat, vacation home		
	Other _____		

NOTES

IMPORTANT DISCLOSURES

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