Financial Literacy: Investing

Stocks: When you own stock in a company, the number of shares you own represent equity, also called ownership, in the company. The value of your investment is then based on the value of the company.

Bonds: When you purchase a bond, you are actually acting as a lender to companies and governments. Just like you pay interest when you borrow money from a lender, you will earn money in a similar fashion when you purchase a bond.

Cash: Cash investments have the least amount of risk because you value cannot go below what you deposited into the account unless the financial institution you deposited your money in is not insured by the FDIC. Never put your cash into a cash investment with a financial institution which is not insured by the FDIC.

Portfolio: Your portfolio is the total of assets you own, whether stocks, bonds, cash investments, other types of investment, or a combination of categories.

Commission: A commission is a fee paid to an investment broker or agent who purchases or sells stocks or bonds on your behalf. The commission may be a flat fee per trade or it may be a percentage of how much you are buying or selling.

Trade: Trade is the term used to describe the buying and selling of stocks or bonds on the capital market.

Capital Market: The capital market, which includes the stock market and the bond market, is the marketplace where securities are bought and sold, allowing companies and governments to raise long-term funds. Financial regulators, such as the U.S. Securities and Exchange Commission, oversee the capital markets to ensure investors are protected against fraud. The capital markets consist of the primary market, where new issues of stocks and bonds are distributed to investors, and the secondary market, where existing securities are traded.

Bear Market: A decline in the capital market's overall value occurs which reflects a substantial drop in a range of issues over a defined period of time. These issues may include high or rising unemployment, high or rising inflation, or economic problems, causing the consumer to spend little to no money on the extra things they enjoy buying.

Bull Market: An increase in the capital market's overall value occurs which reflects an increase in the value of the companies represented in the market. This may be brought on by issues including low or decreasing unemployment, low or decreasing inflation, and positives in the general economy allowing consumers to spend money more freely.

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Types of Risks in Investing

Risk in Investing: Investment risk is the possibility or probability of an asset experiencing loss of value or below-expectation performance. Both the likelihood and the magnitude of possible outcomes should be considered when weighing risk.

Low-risk Investments: Investments providing a guaranteed "return of principal" to the investor in addition to interest earned during the investment period. Examples include treasury bonds and bills, money market funds, and bank certificates of deposits — basically cash investments.

Limited-risk Investments: Investment in companies and governments who are well -established, pay dividends and are known for their consistent growth. Even if growth slows, the probability of substantial loss is not high. Examples include blue-chip stocks, high-rated corporate bonds, high-rated municipal bonds and balanced mutual funds.

Moderate-risk Investments: Generally, investments in companies who have room for growth. These companies are usually younger than blue-chip companies so they are not as established in the marketplace or they are still trying to persuade more of the marketplace to buy their products or use their services. These companies normally do not pay dividends so your increased value comes with any growth in value the company experiences.

High-risk Investments: Generally, speculative investments, such a futures, brand new companies and high-yield bonds. The return on these types of investments can be high if, for instance, the company takes off and grows quickly. However, the return can also be devastating if, for instance, the company fails. In other words, the likelihood of losing everything invested is as probable as making a large return.

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Types of Approaches in Investing

Diversification: Nearly all investors agree diversification, or the practice of distributing investments among several types of assets and markets, is important. Different investments perform differently at any point in time, so a mix of investments creates more stability in a portfolio. This way, the entire portfolio does not suffer as much with the decline of any one investment. Basically, it is the simple practice of "not putting all of your eggs in one basket".

Conservative: With a conservative approach, the investor seeks consistent and dependable income rather than huge returns and takes only limited risk by concentrating on low- and limited-risk investments. This approach is likely to earn steady income, but unlikely to earn a high return. Investors who cannot afford substantial losses are typically conservative investors. For example, after years of investing for retirement, an investor getting close to retirement age cannot afford to lose the investment, therefore, the investor should move investments toward this conservative approach.

Moderate: With a moderate approach, the investor attempts to balance the amount of risk and return in the portfolio by balancing high-risk, moderate-risk, limited-risk and low-risk investments. By creating a diverse portfolio, moderate investors are somewhat protected against the volatility of the market, but still have some opportunity for considerable returns. Moderate investors are often those whose investments are more long-term meaning short-term losses can be tolerated. For example, a person in his or her 30s who is saving for retirement might take the moderate approach.

Speculative or Aggressive: With an aggressive or speculative approach, the investor focuses on generating high returns by taking more risk and investing a larger portion of the portfolio in high-risk investments. The unpredictable nature of this approach can make it dangerous, so an investor should think about how much loss can be tolerated and how sensitive the investor is to fluctuations in the market.

Dollar Cost Averaging: One of the most popular approaches to investing, with this approach the investor invests a fixed dollar amount at set time intervals, regardless of the condition of the market. For example, someone who invests $100 per month may get 50 shares one month because the market value was $2 per share, but only gets 25 shares the next month because the value has risen. Over time, an investor can calculate the average price of a share based on total invested and the value total shares accumulated. This is essentially how many 401(k) programs work. Dollar cost averaging is an approach which conservative, moderate and aggressive investors can apply.

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How You Make and/or Lose Money When You Invest

Dividends: Dividends are paid to investors on a per-share basis when a company earns profits beyond those needed to continue building the business. New and small companies do not usually pay investors a dividend because management feels reinvesting profits to achieve further growth will offer the investor a higher return than paying dividends would. However, virtually all companies slow in growth as they attain a large market value. At a certain point, a company gets so large management can no longer expect incredible growth rates. This is when the company will start paying dividends. Companies which pay out dividends are seen as lower-risk investments than those which do not, and a steadily increasing dividend payout is viewed as a strong indication of a company's continuing success.

Example:
You purchased 100 shares of XYZ stock and will receive an annual dividend of $0.25 per share in the first year. Therefore, you will receive a dividend of $25 for the year.

Growth and Negative Growth: When people invest, they are, very simply put, betting the commodity they invest in will grow in value. For low-risk investments this is often guaranteed. When someone buys a Treasury bond, he/she can count on the investment amount being returned with interest, making it worth more than the original investment amount. He/she does not need to worry about a company growing in order to see a return on the investment. For limited-, moderate- and high-risk investments, this becomes more uncertain. When someone buys stock in a company, he/she is betting the company will grow, and the stock will increase in value. However, he/she must also be aware of the possibility of the company declining and the stock dropping in value. Based on a stock's growth or decline, stockholders will buy and/or sell stocks. Investors attempt to invest (buy) for less than they believe they will one day sell and sell for more than they invested (bought). This growth, or negative growth, is one way investors make, or lose, money on investments.

Example:
You and your friend each invested in ABC Co. by purchasing 100 shares of ABC Co. stock for the market price of $100 per share. This means each of you invested $10,000. At the end of one year, the market price for the ABC stock is $130 per share. You decide to sell all 100 shares and you collect $13,000, earning you a return (profit) of $3,000. Your friend does not sell, hoping the stock price will continue to increase. Instead, the stock price decreases over the next year to $80. Your friend sells and collects $8,000. The $2,000 lost on the investment is known as a negative return or loss.

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How You Make and/or Lose Money When You Invest (continued)

Interest: When people invest in cash investments of bonds, they earn interest on their investment. Interest is basically the fee you are charging the institution for holding onto your money. When you take out a loan, you are charged interest for using the lender's money, and when you make a cash investment or pay for a bond, the institution pays you for being able to use your money. This is usually a set percentage of the amount invested. Institutions often use the term yield to refer to the interest rate offered.

Example:
You purchase a $2,500 bond with an annual yield, or interest rate, of five percent to be paid semi-annually. You hold (or own) the bond for six months, long enough to receive one interest payment. With an annual yield of five percent, the yield for half a year is two-and-a-half percent (5 percent divided by 2). Two-and-a-half percent multiplied by your investment of $2,500 earns you $62.50 in interest. This is the amount of interest you earn each six months.

Discount Rate: Sometimes bonds are sold at a discount rate instead of a guaranteed interest rate. In other words, rather than offering interest for an investment, the institution selling the bond offers it at a lower price than its face value. This way, rather than earning interest, the investor simply earns a lump sum equal to the discount amount received.

Example:
You purchase a $1,000 bond at a discount rate of 15 percent. The $1,000 face value of the bond is discounted by 15 percent, taking $150 off and making the bond cost $850. Then, when you choose to sell the bond, you will receive its full face value of $1,000, creating an investment return of $150.

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Stock Splits

All companies with publicly traded stock have set number of shares. Sometimes a company's stock value can get so high, investors stop buying the stock or the high value is not realistic to the true value of the company. This is when the company could consider a stock split. With a stock split, the number of shares increases and the price of each share decreases proportionately. Similarly, if a company's stock prices become so low they lose respectability in the market, a reverse stock split may occur. In this case, the number of shares decreases and the price of each share increases proportionately. Investors which already have shares will own more or less shares after a split, but the value of the shares owned will be the same as before the split. The primary motive of stock splits and reverse stock splits is to make the shares more attractive to current and potential investors even though the value of the company has not changed.

Examples:
Company A has 1 million shares in the market, and each share is valued at $100. Compared to the price levels of shares of similar companies, this price is too high to be attractive to investors. The company can issue more shares into the market through a 2:1 stock split. This means they will double the number of shares in the market and the value of the shares will be cut in half. There are now 2 million shares in the market worth $50 per share. The total market value of the company's shares is still the same ($100 million), but there are more shares at a lower price.

Company B has 1 million shares in the market, and each share is valued at $10. Compared to the price levels of shares of similar companies, this price is too low to be attractive to investors. The company decides a reverse stock split is beneficial and applies a 1:2 split. This means the number of shares is cut in half and the value of the shares doubles. There are now 500,000 shares valued at $20 per share. The total market value of the company's shares is still the same ($10 million), but there are less shares at a higher price.

Regardless of the type of the stock split, the total market value of the company's shares remains the same.

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Basic Types of Mutual Funds

There are many types of mutual funds available to investors. These are some of the most basic. For more information on types and characteristics of mutual funds, speak to a professional financial or investment advisor.

Aggressive Growth Funds: These invest in companies demonstrating high growth potential, but the companies often have high volatility in share price. They perform well in economic booms, but perform very poorly in economic downturns. They are high-risk investments and should be avoided by the average investor.

Growth Funds: These funds invest in companies showing above average growth potential, with little or no dividend payouts. These are moderate- to high-risk investments depending on the companies in which the fund invests.

Income Funds: These invest in companies which routinely pay good dividends or interest. Their purpose is to provide income on a steady basis. These are considered relatively low-risk investments.

Growth and Income Funds: These funds invest in some companies which pay good dividends and some which have great potential for growth. They are popular among balanced investors because they attempt to combine the benefits of growth funds and income funds. They are moderate-risk investments.

Balanced Funds: These invest in a mix of bonds, preferred stock and common stocks. Their objective is to provide a balanced mix of safety, income and capital appreciation. Generally, they maintain a fixed ratio of cash investments to capital market investments. They are typically moderate risk, but risk level often depends on the ratio used.

Money Market Funds: These invest in highly liquid, short-term assets. Because they mostly consist of cash investments, they are considered the least risky type of fund.

Bond Funds: These invest in numerous individual bonds. Each fund typically has a stated objective and specialization, such as government securities or high-yield bonds. Risk is usually moderate for these funds, but it greatly depends on the fund's focus.

High-Yield Bond Funds: These funds invest in high-risk, high-yield bonds. The bonds are higher risk because of a low credit rating and possibility of default. However, to compensate for this risk, yields, or interest, is high as well. They are moderate-risk investments.

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Basic Types of Mutual Funds (continued)

International/Global Funds: These invest in markets outside of the United States. These are often considered high-risk due to specific country and political risks, but some investors view them as a good choice for increased diversification because fluctuations in the U.S. economy may affect them less.

Specialty Funds: These focus investment in a certain segment. Examples include: sector funds, which focus on a sector of the economy; regional funds, which focus on a geographical region; and ethical funds, which focus on socially responsible companies. These are high-risk investments due to the lack of diversification, but often investors with great knowledge of the fund's specialty prefer them.

Basic Guidelines for Mutual Funds Research

When looking at mutual funds, think first about how much risk you are willing to take. Are you focused on collecting reliable income or are you willing to take more risk in hopes of higher returns? Next, find the top-performing funds which correlate to your risk tolerance. Look at five to seven of the top-performing funds, and compare their costs and benefits against each other. If you are buying through an investment adviser, they will most likely be load funds. What are the fees? What are you receiving in return for fees paid? You might feel the fees you pay are worth the advice and guidance you receive, or you may decide you would rather not pay fees and handle everything yourself. Basically, you should try to find the most cost-effective fund which has a return performance which pleases you.