# The Fundamentals of Investing

## Advanced Level

Saving money for future consumption is an important factor of your financial plan. You can save money in a savings tool (savings account at your depository institution) or in an investment. **Investments** are assets purchased with the goal of providing additional income from the asset itself but with the risk of loss. Your financial plan would not be complete without <u>both</u> savings and investments.

## Saving vs. Investing

You shouldn't use investments for savings or short-term goals/expenses because of two primary reasons:

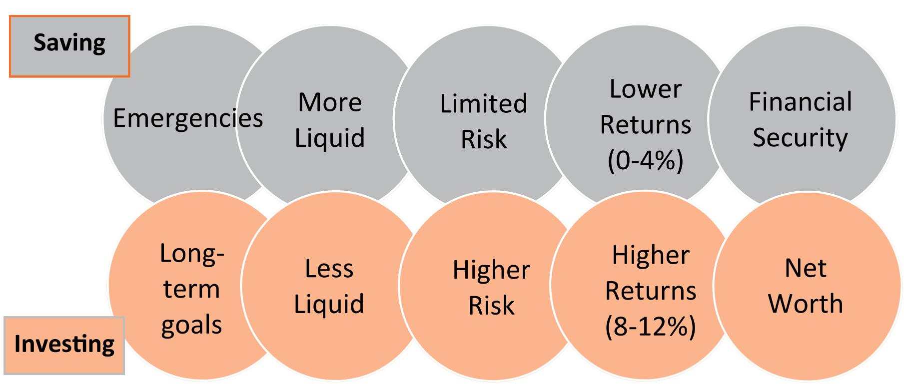
1. Unlike insured savings tools, investments are not secure. There is a chance that some or all of your money invested could be lost.
2. Investments are less liquid than savings tools. That is, investments may not be easily converted to cash or you may have to pay a penalty to access the money. In fact, with some investments you may have to wait a long time, even years, to access the funds.

> *Investing helps you cope with risk and uncertainty.* Knowledge of the general risk level for investment returns helps you manage your risk.

Investments help build your net worth because they have the potential to earn higher returns than savings tools. A **return** is the profit or income generated by saving and investing. Your trade-off to earning higher returns is higher investment risk. **Risk** is the chance of loss from an event that cannot be entirely controlled. Unlike savings tools, all investments carry **investment risk**, which is the possibility that an investment will fail to pay the expected return or fail to pay a return at all. As the potential return rises, generally, so does the investment risk involved.

Investments are assets because they have monetary value. On your Statement of Financial Position, investments are listed as investment assets. Saving tools are listed as monetary assets, assets that can be quickly and easily converted into cash.

As a result of the potential for higher returns and low liquidity, money invested is usually used to pay for long-term (more than five years) goals and expenses such as a down payment for a house in ten years, a young child's higher education in fifteen years, or retirement income in thirty years. As a guide to spending, it is recommended that you dedicate at least 10% of net income to savings and investments each time income is received.





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## Rate of Return

The amount of return you earn on a savings tool or investment is determined by calculating the **rate of return**, the total return expressed as a percentage of the amount of money saved.

**Total Return** ÷ **Amount of Money Invested** = **Rate of Return**

**Example:** Mandy saved $2,200 in a money market deposit account. After one year, she has a return of $110. What is Mandy's rate of return?

**$110** ÷ **$2,200** = **.05 = 5%**

You should strive to have the rate of return earned on an investment be higher than the rate of inflation. **Inflation** is the rise in the general level of prices. If you invest money at a 2% interest rate, and the inflation rate is 2%, then your purchasing power will not be increased. In fact, after you pay taxes on your investment income, you will actually be losing money**. Inflation risk** is the danger that money won't be worth as much in the future as it is today. Inflation risk is a concern with investments because it defeats the objective of providing for future financial security by building net worth.

**Bond example:**

A $1,000 five year bond with a 5% annual interest rate.

You should receive: $50 in interest each year for five years and at the end of five years, your $1000 principal investment.

## Most Common Types of Investments

***Bond***

A **bond** is a form of lending to a company or the government (city, state, or federal). When you purchase a bond, you are lending money to an organization in return for a fixed interest rate. The organization (usually a company or the government) pays interest (usually bi-annually or annually) to you until the maturity date is reached. The **maturity date** is the specified time in the future when the principal amount of the bond is repaid to the bondholder. In general, bonds have the least amount of investment risk. Bonds are the most predictable investment since bonds are purchased with a fixed interest rate. However, there is a risk that interest won't be paid and/or the principal amount of the bond won't be repaid. The specific investment risk level depends on the type of bond; higher risk bonds tend to have higher interest rates.

***Stock***

**Stock** is a share of ownership in a company, and the owner of the stock is called the **stockholder** or **shareholder.** The amount of stock you purchase determines how much of the company you own (usually a small percentage). If the company makes a profit, then you may receive part of that profit as a return. This is called a **dividend**, which is the share of profits distributed in cash. When you own a stock, you expect that the **market price** (the current price that a buyer is willing to pay) of the stock will increase. Therefore, if you are able to sell stocks for a market price higher than what was paid, you will receive a return, known as a **capital gain** (unearned income received from the sale of an asset above its purchase price). In general, capital gains have the highest investment risk of all returns, but also have the potential for the highest amount of return. For example, if the company performs poorly or goes out of business, you could lose part or all of your principal investment, depending on the market price at which you were able to sell the stocks.


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## More Types of Investments

### *Real Estate*

Real estate can include ownership of residential or commercial property or land as well as the rights accompanying that land. When you invest in real estate, you may earn returns in the form of capital gains and rents. Capital gains come from selling the real estate for more than what you paid. **Rent** is charged for the use of the property or land. For example, if you own a residential real estate property you can rent it to a family in exchange for them living there. Real estate can be more time consuming than other forms of investing.

Many experts recommend that a primary residence not be considered an investment asset. However, this depends on several factors including where you live and your personal financial situation.

### *Speculative Investments*

Speculative investments have very high levels of investment risk. **Speculative investments** have the potential for significant fluctuations in return over a short period of time. Some examples of speculative investments are futures, options, and collectibles. These are recommended for people with an aggressive investment philosophy and a high level of financial security.

### *Mutual Funds*

A **mutual fund** is created when a company combines the funds of many different investors and then invests that money in a diversified portfolio of investments. Mutual funds may include stocks, bonds, real estate, and/or speculative investments. The return from a mutual fund may include interest, dividends, rents, and/or capital gains. When you invest in a mutual fund you receive a percentage of the total return based upon the amount of mutual fund owned. Mutual funds reduce your investment risk by spreading risk among a variety of investments. If one investment within the mutual fund fails to pay a return, chances are high that another investment within the fund will still pay a return. Mutual funds save you time, because time is not spent choosing individual investments. Instead, a group of mutual fund managers constantly evaluate which investments to buy and sell. Therefore, mutual fund managers charge fees which can be higher than if you purchased individual investments. However, fees charged vary depending upon the type of mutual fund and the company that offers it.

### *Index Funds*

An **index fund** is a type of mutual fund that was designed to reduce fees by investing in the stocks and bonds that make up an index. An **index** is a group of similar stocks and bonds. For example, the Standard and Poor 500 is an index that includes the 500 largest companies that sell stock. By buying and holding a specific set of stocks and bonds, index funds require very little management compared to mutual funds and can charge lower fees.

What is an example of an investment goal you have?
What types of investment tools would you use to achieve that goal and why?


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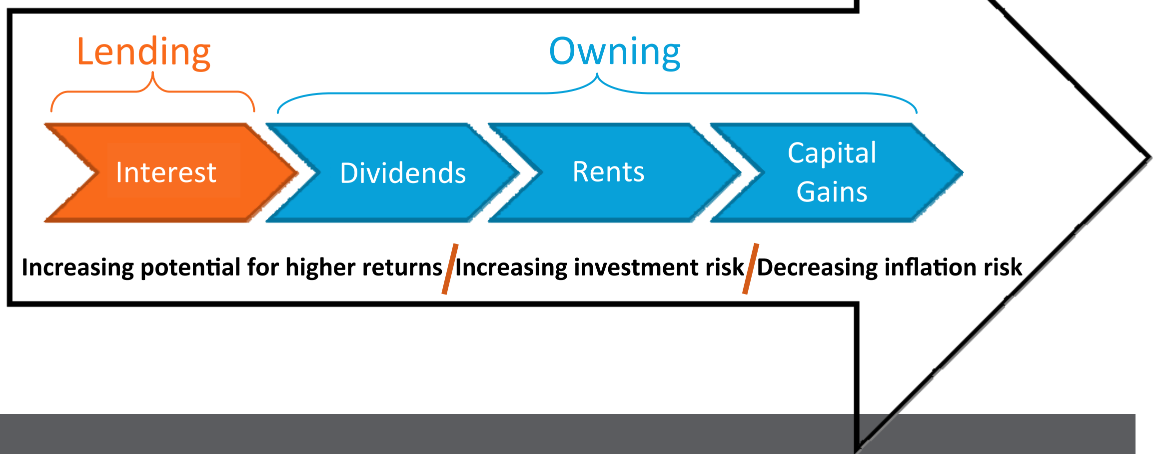
## Lending vs. Owning

You are lending money with some investments, such as bonds. Your returns are in the form of interest. You own something with other investments, such as stocks, real estate, and speculative. When you own an investment, your returns are in the form of dividends, rents, and capital gains.

Typically, when you lend, both your returns and level of investment risk are lower. On the other hand, when you own you have greater investment risk, but also the potential to earn higher returns and experience the least inflation risk.




## Investment Philosophy

The potential for higher returns can be what motivates you to accept higher amounts of investment risk. Everyone has a personal tolerance level for the amount of investment risk they are willing to assume. This is known as an **investment philosophy**, or an individual's general approach to investment risk. Investment philosophies are generally divided into three main categories: conservative, moderate, and aggressive. If you have an aggressive philosophy you are willing to take on more investment risk for the potential of higher returns. The amount of time you have may also influence your investment philosophy. Your philosophy may be different with a fifteen year investment than a thirty year investment.

Portfolio diversification is a method to assist you with risk reduction. **Portfolio diversification** reduces your risk by spreading money among a wide array of investments. Chances are if one investment is losing money, another will be earning a return. The goal of diversification is to create a collection of investments that will provide you with both an acceptable return and an acceptable exposure to risk. Most people diversify their portfolio according to their investment philosophy. For example, a person with an aggressive investment philosophy will most likely include a larger amount of high investment risk in his/her portfolio.

What type of investment philosophy would you have?

## How Do You Purchase Investments?

When you purchase an investment (except for real estate and some speculative investments) you are doing so from a stock exchange. A **stock exchange** provides an organized, central service to buy and sell stocks, bonds, and other investments that are traded. Worldwide, there are many different stock exchanges and a limited number of people are allowed to buy and sell <u>directly</u> from each stock exchange. Therefore, if you want to purchase an investment, a brokerage firm must be utilized. A **brokerage firm** facilitates the buying and selling of investments from a stock exchange. Brokerage firms act as an intermediary between the stock exchange and the investor. You will pay a brokerage firm a fee for their services. There are two types of brokerage firms that differ in the fees charged and services provided:

**<u>Discount brokerage firm</u>** - provides limited services. A discount brokerage firm only completes orders you give them to buy and sell investments; they do not provide you with advice as to which investments to buy and sell. Because of this, discount brokerage firms usually charge lower fees and/or commissions than full-service brokerage firms.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**Full-service brokerage firm** (also known as traditional brokerage firms) – offer you investment transactions as well as investment advice and a financial advisor. A **financial advisor** is a trained professional that helps people make investing decisions.

Edward Jones and Merrill Lynch are examples of full-service brokerage firms. E*TRADE is an example of an online discount brokerage firm. Many discount brokerage firms are online only.

The process of investing is complex. Choosing investments and creating a personal investing plan requires knowledge of the market/economy, knowledge of the specific investment, time to monitor the investment, etc. An advantage to a full-service brokerage firm is that you have access to financial advisors who use their expertise to help you with the investing process as well as ensure you are meeting personal financial goals. Financial advisors may also inform you of investment options that you may have not known about otherwise. For many, the advice and time of a financial advisor are worth the fees paid.

Just as with saving, investing money is most successful when you make it automatic. Brokerage firms provide automatic transfers/deposits to make investing automatic. You may find that developing a relationship with a financial advisor also helps you stay on track with a personal financial plan because it creates accountability and adds discipline.

**What are two advantages and disadvantages to a discount broker** and full-service brokerage firm?

| Discount Broker | Full-service Brokerage Firm |
|---|---|
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| | |

## Choosing a Brokerage Firm

When choosing a brokerage firm, you should understand how that firm charges fees. Full-service and discount brokerage firms charge fees in different ways:

- Discount brokerage firm – Will usually charge a fee for completing a buy/sell transaction for you (often referred to as an order). Other fees will vary but may include:
  - Service fee – This is usually a quarterly or annual fee charged to the consumer to use the service.
  - Maintenance fee – This fee is usually charged if the value of an investment(s) is below a specific minimum balance requirement.
  - Inactivity fee – If you haven't completed an order within a certain period of time.
  - Fees specific to an investment – Discount brokers may charge fees specific to the type of investment you are trading (stock, bond, mutual fund, etc.).
- Full-service brokerage firm – Financial advisors for full-service brokerage firms are compensated for the time and knowledge provided to investors. Therefore, fees are charged in a different manner than discount brokerage firms:
  - A percentage of the investment value – Financial advisors receive a percentage of the total value of an investment. For example, an investor's mutual fund is worth $1,000.00. A financial advisor charging a 2% value fee would earn $20 ($1,000.00 * .02).
  - A percentage of the amount deposited – financial advisors receive a percentage of the amount invested. For example, an investor contributes $1,000.00 to an investment worth $5,000.00. A financial advisor charging a 4% deposit fee would earn $40.00 ($1,000.00 * .02=4).
  - Hourly rate and flat fee – A brokerage firm will charge the consumer an hourly rate or flat fee to give advice or complete a project.

*Most financial advisors charge a percentage on <u>either</u> the value of the investment or amount deposited – not both.*

## Choosing a Brokerage Firm continued…

In addition to fees, financial advisors may earn commissions. The investor does not pay commissions; companies pay commissions. For example, if you decide to invest in a specific company's mutual fund through a financial advisor, the company will pay the financial advisor a commission. Even though commissions aren't a direct cost to you it is still important to know whether or not a financial advisor is compensated via commissions. A financial advisor that earns commissions may be biased towards a specific product rather than offering investing advice that is best for your financial goals.

How financial advisors are compensated (fees and/or commissions) depends on the brokerage firm the financial advisor works for. Therefore, when choosing a financial advisor, begin by researching brokerage firms.

It is very important to research a financial advisor and the firm he/she works for. The FINRA Broker Check (http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm) is a free tool to help investors research the professional backgrounds of brokerage firms and financial advisors.

| | |
|---|---|
| Questions To ask: | How are the firm's financial advisors compensated? |
| | How long has the firm been in business? |
| | Does the firm have a history of positive reviews and success? |
| | How does the firm rank in comparison to other brokerage firms? |

**Always ask financial advisors for a clear explanation of how they will be compensated.**

## Tax-Advantaged Investments

Savings and investments are a form of unearned income and are therefore subject to income tax. However, the government encourages you to invest in certain types of investments by making them tax-advantaged. **Tax-advantaged investments** are structured with tax benefits to investors in mind. Tax-advantaged investments are usually not tax free and instead reduce, defer, or adjust the current year tax liability. You most likely pay taxes the year money is put into the investment or the year money is taken out, whereas other investments are subject to income tax <u>every year</u>. The money that you would have paid in taxes can remain in the tax-advantaged investment to earn interest on interest and increase value faster. The most common tax-advantaged investments are offered for those who wish to invest in retirement and education; however, there are tax-advantaged investments for other purposes.

What are two reasons you would want to use a tax-advantaged investment?

**Tax-advantaged investments reduce, defer or adjust the current year tax liability**

**Most common:**
- **Retirement**
- **Education**

**There are usually limits to the amount of money per year that can be invested in a tax-advantaged investment.**


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# Investing for Retirement

***It is recommended to utilize employer-sponsored retirement accounts as much as possible if available.***

Investing for retirement is an important financial goal and must be carefully planned over a long period of time.

To help you invest in retirement, the government and many employers have created investment plans specifically for retirement. The investing process is similar to other investments. You choose investments, which are usually mutual funds. Then, the money contributed is deposited into the investment(s) of your choice. Retirement plans are tax-advantaged to encourage you to save for retirement. If it is an employer-sponsored retirement plan, the employer helps you invest by automatically deducting money to invest from wages earned. The employer may also contribute a portion of money to the investment (also known as matching funds) with no additional cost to you.

However, the trade-off to the tax advantages is that most retirement plans have penalties if money is withdrawn before you reach a specific retirement age (the specific age depends on many factors). The most common retirement plans are:

- Employer sponsored retirement plans
    - The most common employee sponsored retirement plans are called a 401(k) and 403(b). Both plans are very similar; the specific plan your employer offers will depend on what type of employer you have (a private business, public entity, non-profit organization, etc.). 403(b) plans are designed for tax-exempt organizations.
- Personal retirement accounts
    - There are retirement plans that offer tax benefits without employer sponsorship. The most common personal retirement accounts are the Traditional IRA (Individual Retirement Account) and the Roth IRA. The difference between a Traditional IRA and Roth IRA is when taxes are paid on the investment. Taxes are paid on a Traditional IRA in the year money is <u>withdrawn</u> from the account. Taxes are paid on a Roth IRA in the year money is <u>deposited</u> into the account. Your personal financial situation will determine if a Traditional IRA, Roth IRA, or a mixture of both accounts is best for you.

***When available, use an employer-sponsored retirement account as much as possible.***

There are many other types of retirement plans. Your employment status as well as your personal financial situation will determine which retirement plan(s) is best for you.

***Your present self impacts your future self!***

Investments have the potential to earn higher returns than savings tools and are thus important to building net worth (wealth). However, a trade-off to higher returns is lower liquidity and higher investment risk. This makes investments ideal for a long-term time frame (generally more than five years). Discussing your financial goals with a financial advisor is a great step to begin investing. Taking advantage of portfolio diversification, tax-advantaged investments, and the benefits of employer-sponsored retirement plans will maximize your return.


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