Investing Basics

The Characteristics of an Achievable Investment Goal

Well defined: states what you want, when you want it, and how much it will cost.
Measurable: assign a dollar figure to your goal
Time frame: tells you when you expect to achieve your goal
Reasonable: with the time and money available, can you make it happen?

The Effect of Saving Small Sums Consistently

- Large sums can grow from small but steady savings consistently invested over time. For example, if you decide to give up your daily "drive-through" coffee and doughnut or any other "money gobbler" that costs you about $8 a day, at the end of the year you will have $2,920 in your 'coffee savings fund'. If you invest this money and continue to give up coffee until you retire, how much will all those foregone coffee and doughnuts be worth? The answer depends on two factors: How many years until you retire? And what rate of return will your money earn?

- If you have 20 years until retirement and your rate of return is 8%, you will have an extra $133,619 at retirement in exchange for giving up coffee and doughnuts!

What are your Money Gobblers? What spending do you do out of habit that doesn't really bring you pleasure?

Saving versus Investing

- The goal of saving is to preserve one's principal, or original dollars saved, so that it will be available whenever it is needed; the goal of investing is to increase the principal and get a greater return.

- While most types of savings are readily accessible, some have a maturity date and require a penalty for early withdrawal; however, most investments are not easily accessible and carry a penalty for early withdrawal.

- Savings are used to meet current emergencies and short-term goals, as well as to set aside money to invest. Investments are used to meet long-term goals such as planning for retirement or financing a child's college education.

Lending and Owning Investments

Lending: agreement to loan your money to a bank, corporation, or government in exchange for their promise to pay you a certain amount of interest for a certain time period.

Lending assets are used for both investing and saving. Examples of lending instruments include savings accounts; certificates of deposit; money market accounts; corporate bonds; municipal bonds; U.S. savings bonds; and U.S. treasury bills, notes and bonds.

- Lending investments -- often considered to be 'conservative' because the investor's goal is to conserve capital, or not lose the principal or initial investment, while getting a reasonable rate of return.
- The trade-off for safety of principal is usually a lower rate of return than could be obtained with a riskier alternative; however, some forms of lending, such as corporate or municipal bonds, do carry risk with a potential to lose principal dollars.

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Owning: almost always associated with investments, rather than savings. For example, you could buy a whole company, shares of a corporation, or shares of a mutual fund that buys stocks of many different corporations. Or you could own real estate by buying a rental house, an apartment complex, or shares of a real estate investment trust (REIT).

When you own something, you participate in both good markets and bad. If the price of a stock you own falls, you lose money; if it climbs, you gain, at least on paper.

Why are diversification and asset allocation important?

The principle of **diversification** involves spreading your money across a variety of investment types so when one falters, others may fare better. Money set aside for the future should be divided between owning and lending assets in order to minimize risk.

Asset allocation refers to how your savings and investments, often referred to as your investment portfolio, are divided between investment categories of stocks, bonds, cash and sometimes what are called "hard" or "real" assets, such as precious metals, commodities and real estate.

The relative portions of a portfolio invested in different investment categories can be changed to meet current market conditions, one's investment goals and one's lifestyle changes, but the need to maintain diversification never changes; this is the key difference between diversification and asset allocation.

The five main types of risk

- **Interest rate risk:** the risk that interest rates will rise higher than the fixed rate of interest you are receiving, making your savings or investments less valuable. If you lock into a fixed rate of return right now you may very well experience interest rate risk. Interest rate risk is a most crucial consideration for bondholders. When interest rates go up, bond values in the secondary market will fall, and vice versa. One can benefit from interest rate risk by locking into fixed rate of return investments when rates are at a high point in the interest rate cycle. When you believe we are near the top of the interest rate cycle, you may wish to increase the portion of your portfolio that is committed to lending type investments, such as CDs and bonds.

- **Inflation risk:** the risk of losing purchasing power. If prices increase, more money will be needed to buy the same items. Inflation risk is the type of risk you face when you put your money in a low interest savings account. In general, ownership types of investments move ahead with inflation, at least when inflation is not too high, while holders of fixed return lending alternatives may suffer from inflation.

- **Economic risk**: the risk that the economy will turn down, pulling investment values down as well. Economic risk is a risk that most companies cannot control. A business may produce a great product but if the economy is in a slump, the business will have a bad year. Politics, weather, disasters, war and other external conditions can affect the economy. Economic risk tends to hurt holders of ownership investments rather than lenders.

- **Business risk:** the risk that a business or industry could fail. Competitors can force a company out of business or it could fail to produce the products consumers want. Negative news about individual companies can also have an negative impact on the stock price of other companies in the same industry and sometimes on the stock market as a whole. Business risk is greatest for holders of ownership investments.

- **Financial risk:** the risk associated with a company's, or government's ability to repay its debt. A firm or government borrows money to expand or meet expenses. If cash flow is poor, it may be unable to repay its debt and may have to seek bankruptcy protection. When a company seeks to restructure its debts under the protection of the bankruptcy court, it will have a negative effect on both its stock and bond prices. Like economic and business risk, financial risk also hurts holders of ownership investments more so than it does holders of lending investments.

The Rule of 72

$$\frac{72}{\text{Rate of Return}} = \text{Years for an investment to double}$$

For example, if your savings are earning 3%, they will double in 24 years, (72 divided by 3 equals 24).

Characteristics of Stock

- a share of ownership in a company
- pays investors when price increases – called capital appreciation
- some pay dividends – portion of company earnings paid to its stockholders
- many people buy stock through mutual funds

Types of Stock

- **Income stock:** consistently pay dividends. People buy these stocks for the income they generate, although appreciation may occur as well. Income stocks are less likely to experience extreme fluctuations in price than other stocks as long as the dividend is maintained. These companies often have a long history of good earnings which translate into consistent dividends. An example of an income stock is a utility company stock.

- **Growth stock:** have a record of faster than average earnings growth. They tend to have high price to earnings (PE) ratios as their prices are bid up in anticipation of even greater earnings increases. They rarely pay dividends. Investors buy them with the expectation of great capital appreciation. Microsoft is an example of a growth stock.

- **Speculative stock:** stocks of companies which have potential for earnings but actual earnings are small, erratic, or non-existent. They have extremely high or infinite PE ratios and, of course, do not pay dividends. Their high prices are based on the hope that this company will be the next Microsoft or Walmart. Speculative companies may come from industries such as internet venders, genetic engineering firms, and biotechnology companies.

- **Value stock:** often growth or income stocks whose price has fallen significantly but have earnings and assets that make them appear to be a bargain. They are often out of favor with investors, as reflected in their low PE ratios. External factors, such as a workers strike or even a catastrophic event like 9-11, may cause a company's price to fall below what some perceive to be a reasonable price in the short run. If the reason for the decline proves to be less of a concern than originally believed and the company is fundamentally sound, the stock price will rebound.

- **Cyclical stock:** describes a company whose profits move with the business cycle; when times are good the company prospers; when times are hard, its profits fall too. Companies that provide consumer-oriented products like cars, housing, airlines, and publishing as well as basic industries such as retailing, steel, tires, and heavy machinery are usually cyclical stocks.

- **Defensive stock:** stocks that perform well even in a poor economic environment. Because their products are always in demand, the stock of these companies tend to do better than, or at least not as poorly as, stocks of companies that are more cyclical. Examples of defensive stocks companies include manufacturers of cigarettes, soft drinks, pet products, food, electric utilities, and even gold mining.

Characteristics of Bonds

- fixed interest or coupon rate
- a face or par value of $1000
- a fixed date of maturity when the company will buy the bond back for the face value of $1000

Bond Risks

- Interest rate risk -- greatest risk bondholders assume; if interest rates rise, bonds become less valuable and more difficult to sell before maturity
- Financial risk -- also an important consideration for bondholders; if the company that issued the bond experiences financial difficulty, the bond may be downgraded by rating companies.

Types of Bonds

- Corporate -- issued by a corporation
- Municipal -- issued by a local, state, federal or quasi-governmental agency

What are mutual funds?

A mutual fund pools investors' money and uses that money to buy a portfolio of individual investments, such as stocks, bonds, money market instruments, real estate and precious metals, to name the most common ones. There are thousands of funds from which to choose. Some offer investments in a single category, such as a stock only fund, while others have a mix of investments. For example, some funds contain both stocks and bonds. These are often called balanced funds.

Fees Associated With Mutual Funds

- Loads -- commission charged by some, not all, mutual fund companies to purchase and/or sell bonds; used to compensate the sales person. Shop around for a no-load mutual fund.
- Expense fees -- can range from as low as .18% to over 2%. Look for a mutual fund with low expense fees.

Advantages of Mutual Funds

- professionally managed
- offer diversification
- easy transfer between funds within a mutual fund company
- money easily withdrawn from fund
- easily monitored by checking newspaper, web, or the company's automated phone system
- regular account statements provided

Disadvantages of Mutual Funds

- price may be low at time funds are liquidated – similar to stocks and bonds
- annual appreciation and interest earned taxable each year unless in tax-sheltered account such as an IRA

Worksheet 1 - Investing Goals

On the worksheet below, list each of your savings and investment goals. A well-defined goal is:

- Specific - state what it is that you want and write it in the first column
- Measurable - determine the total dollars you will need and put that figure in the third column
- Within a time frame - list your target date in the second column
- Reasonable - calculate the amount you will need to save per month to reach that goal and write that figure in the last column

If goals for total saving and investing per month are greater than your income will currently allow, you may want to examine your spending to "find" extra dollars to save.

Goal	Target Date	Total Amount Needed	Savings Per Year	Savings Per Month

Worksheet 2 - Description of Your Assets: Savings and Investments

Categorize the dollars you have set aside as savings or investments. Next to each asset, list an approximate annual rate of return

Savings		Investments	
Name of Asset	Approx. Annual Rate of Return	Name of Asset	Approx. Annual Rate of Return
Example: Certificate of Deposit	6.0%	GM Stock	10%

Into which column do most of your assets fall?

Can you reach your long-term financial goals with your current mix of saving and investing?

Worksheet 3 - Description of Your Assets: Owning and Lending

Categorize your savings and investments as either OWNING or LENDING assets. Include an approximate annual rate of return next to each asset.

Owning		**Lending**	
Name of Asset	Approx. Annual Rate of Return	Name of Asset	Approx. Annual Rate of Return
Example: GM Stock	10%	GM Bond	8%

Into which column do most of your current assets fall?

Worksheet 4 - Saving Power Estimator

Rate of Return	Value of $8 Per Day for x Years			
	20	30	40	50
6%	$107,414	$230,850	$ 451,905	$ 847,781
8%	$133,625	$330,787	$ 756,445	$1,675,409
10%	$167,243	$480,323	$1,292,370	$3,398,613
12%	$210,393	$704,691	$2,239,907	$7,008,053

How much will saving $8 per day ($2,920 per year) be worth in the future?

This table shows how much saving $8 a day at a given interest rate will be worth 20, 30, 40, or 50 years from now. For example, if a 20 year old who starts saving $8 a day for retirement receives an average rate of return of 12%, that $8 a day will be worth $7,008,053 when he or she retires at age 70.

How much can you save per day?

The Center for Personal Financial Education is an educational resource and research center whose mission is to advance the adoption of sound personal financial practices by developing and delivering personal financial education programs and conducting related research. The Center, established in 1996, is a joint venture between the University of Rhode Island and the Consumer Credit Counseling Service of Southern New England.

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