SESSION III

Investing Basics

Mary had a little cash
In fives and tens and such
And every dollar Mary saved
Made her retirement fund more flush.

What will be covered in Session III

Investment Lessons

1. Setting Goals and Finding Solutions
2. Understanding and Accepting Risk
3. Investment Choices—Stocks, Bonds, and Mutual Funds
4. What Are Stocks and Why Should You Own Them?
5. What Are Bonds and Why Should You Own Them?
6. What Are Mutual Funds and Why Should You Own Them?

Terms to Learn *(bolded in the text)*

Bond
Diversification
Dividend reinvestment plan
Expense ratio
Load
Maturity
Mutual fund
No-load
Stock
Taxable distribution

Exercises

1. $mart Financial Goal Setting
2. What Kind of Investor Are You?
3. Finding Your Comfort Zone
4. Comparing Stock Investments
5. Comparing Fixed-Income Investments
6. Mutual Funds with a Growth Objective
7. Mutual Funds with an Income Objective
8. Mutual Funds with Both Growth and Income Objectives
9. Mutual Funds with a Preservation of Capital Objective
10. Mutual Funds with All Four Objectives
11. Comparing Mutual Fund Investments
12. Your Personal Investment Statement

From the 192-page book *Money Talk: A Financial Guide for Women*, NRAES-160
Available from PALS Publishing, www.palspublishing.com/moneytalk, Ph. 607-255-7654

Setting Goals and Finding Solutions

Mary is a 57-year-old human resource manager who plans to retire in 5 years, yet she has no idea (1) how much money she will need to supplement her employer benefits and maintain her current standard of living and (2) how long her savings must last.

In Session I, financial goal setting was introduced. The topic is further expanded below as it relates to investment decisions.

"Not setting measurable goals" is the biggest error Americans make with their money, according to a survey by the Certified Financial Planner Board of Standards. Even among people who have sought out professional financial help, less than one-third actually know what they'd like their money to accomplish.

Why should goal setting be important to you? The answer: research shows that it works. Setting milestones for your money is similar to setting goals for your career (promotion to manager in 2 years), your health (lose 10 pounds in 3 months and exercise 1 hour, three times a week). If you don't set goals, you'll have no way to measure your success.

To establish financial goals, learn how to create $MART goals using the following criteria:

$ Goals must be **specific** and indicate dollar amounts, dates, and resources to be used in reaching the goals.

M Goals must be **measurable**. Determine regular amounts to set aside weekly, biweekly, or monthly. Another good "M" word to consider is mutual. Goals that are mutual, or shared with other family members, will be easier to achieve. It also is important to think about how you will keep yourself and other family members motivated to achieve goals, especially long-term goals.

A Your goals must be **attainable** given your financial situation.

R It is important that your goals be **realistic**. What resources are available for you to use in achieving your goals? Review and revise your goals periodically as necessary.

T You must indicate a specific **time** period for accomplishing your goals. You must also be willing to make trade offs in your financial life. Know the difference between "needs" and "wants." Prioritize your goals because there is never enough money to fund all of your financial goals at one time.

Take the time to put your goals in writing. Use the worksheet *$MART Financial Goal Setting,* (Exercise III-1, page 73) to help you list short- and long-term financial goals. Then, to stay motivated, visualize how you will feel when you accomplish your goals. Last, regularly set aside a predetermined sum of money for each specific financial goal.

Depending upon your goals and time frame, you can select investments that provide income, growth, or tax savings, or preserve your capital (the amount initially invested).

- If you don't require additional income to meet your everyday expenses or you are looking to fund your retirement 30 years from now, long-term growth would be your primary objective. You would choose investments that can offer growth over a long period. Because of the longer time frame, you could afford some risk.
- You may be planning to replace your car in 3 years, so your objective would be preservation of capital. You need to know the money will be there when you need it.
- You may be looking for tax savings to help you shelter as much money as possible.
- If you are nearing retirement, you might begin converting some growth or tax-sheltered investments into those that produce income.

You may find that a combination of objectives, such as growth and income, is best for you because no single investment will provide all four benefits.

EXERCISE III-1

$MART Financial Goal Setting

$ = Specific; **M** = Measurable; **A** = Attainable; **R** = Realistic; and **T** =Time period.

Directions: $MART goals need to be written down on paper to reinforce their importance. Use the worksheet below to set some short- and long-term financial goals that follow the $MART goal format. To keep the calculations simple, a 0% interest rate and inflation rate are assumed and taxes are excluded. A sample goal for each category is provided.

To get where you want to go in life, decide in advance how you will get there. Goals are signposts on the highway of the future. They serve as your road map to personal, career, and financial success.

By keeping specific goals in view, you can direct your energies toward achieving your goals.

Short-term goals (less than 3 years)

Goal	Total cost	Target date	Amount to save/month
House down payment	$15,000	3 years	$417.00*

* $15,000 ÷ 36 months = $417.00/month

Intermediate-term goals (3–10 years)

Goal	Total cost	Target date	Amount to save/month
New car	$20,000	5 years	$333.33

Long-term goals (longer than 10 years)

Goal	Total cost	Target date	Amount to save/month
College tuition	$75,000	15 years	$417.00*

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Understanding and Accepting Risk

Investments come with varying degrees of risk, as shown on the Risk Ladder on page 75. Table III-1 shows combinations of stocks, bonds, and cash in the best and worst years from 1926 to 2007. Note the greater average annual return—and greater chance of loss—as the percentage of stock increases.

Any investment involves some risk. But if you have taught yourself to recognize and evaluate the risks you may incur, you will be better able to balance your investment objectives and tolerance for risk.

The Major Investment Risks

Market risk. This refers to the risk that prices of individual investments will be affected by the volatility of financial markets in general. This means a stock's price may fall simply because the overall stock market has dropped.

> Higher risks (more stock) generally equate with higher long-term average returns; a long time horizon helps to lower risk.

Business risk. This is the risk caused by events that affect only a specific company or industry, thereby influencing the value of an investment. Some examples are a class action lawsuit against a company, the death or firing of a company's chief executive officer, or the failure to get expected U.S. Food and Drug Administration approval for a company's new drug.

Interest rate risk. An inverse relationship usually exists between bond and stock prices and interest rates. When interest rates rise, stock prices usually fall. Bond values will also fall. Some investments, such as

TABLE III-1

Asset Mixes and Their Past Performance: 1926–2007

Portfolio Allocation Stock%/Bond %	Average Annual Return (%)	Worst One-Year Loss (%)	Number of Years Out of 82 With Losses
100% bonds	5.5%	-8.1% (1969)	13 of 82
20% stocks and 80% bonds	6.8%	-10.3% (1974)	11 of 82
30% stocks and 70% bonds	7.4%	-14.2 % (1931)	13 of 82
40% stocks and 60% bonds	7.9%	-18.4% (1931)	15 of 82
50% stocks and 50% bonds	8.4%	-22.5% (1931)	16 of 82
60% stocks and 40% bonds	8.9%	-26.6% (1931)	20 of 82
70% stocks and 30% bonds	9.3%	-30.7% (1931)	21 of 82
80% stock and 20% bonds	9.7%	-34.9% (1931)	22 of 82
100% stock	10.4%	-43.1% (1931)	24 of 82

* Stock returns are based on the Standard and Poor's 500 Index (S&P 500), which is a benchmark of the performance of the 500 largest U.S. companies. Bond returns are based on high-quality corporate bond indexes. Cash returns are based on the Citigroup 3-month Treasury Bill Index.

Source: The Vanguard Group https://personal.vanguard.com/us/planningeducation/general/PEdGPCreateTheRightMixContent.jsp

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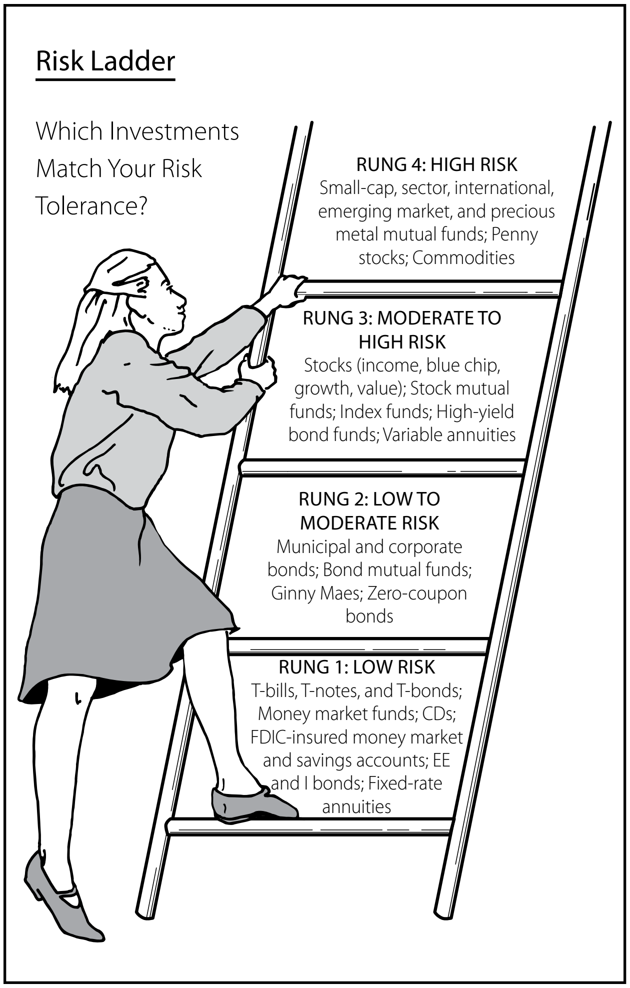

certificates of deposit (CDs) and bonds, have a fixed rate of return. This can be to your benefit if interest rates fall, but to your disadvantage if rates rise.

Inflation risk. Inflation risk refers to a loss of buying power, which can occur if the rate of inflation is higher than the rate of return on an investment. The rate of inflation averaged 3.1% over an 82-year period (1926–2007). Had you invested in long-term government bonds averaging 5.5% during that time,

> There's no such thing as a perfect, risk-free investment.

your after-inflation return would have been only 2.4% (5.5–3.1%).

Reinvestment risk. This is the risk of having to reinvest existing funds at a lower return than previously earned, resulting in a decline in income. Example: A high-interest CD matures and you can only renew it at a lower rate because interest rates have dropped.

Complete Exercise III-2, ***What Kind of Investor Are You?*** (page 76), and Exercise III-3, ***Finding Your Comfort Zone*** (page 77), to evaluate your tolerance for risk in your investments.

Loanership vs. Ownership

You can invest money in two basic ways. You can loan it to pay for a company's or the government's debt, OR you can own the investment yourself. When you loan your money to a company or the government, you receive income based upon a set interest rate for a set period of time. The entity promises to pay back your original principal plus interest. Loanership, or debt investments, include savings accounts and bonds; money market accounts and funds; Treasury bills, bonds, and notes; and certificates of deposit.

On the other hand...

When you own an investment or equity, you purchase part or all of it. The value of ownership assets will fluctuate with market conditions, potentially giving you a higher return than you might receive from loaning money. Ownership investments include stocks, stock-owning mutual funds, real estate, commodities, collectibles, and precious metals (gold coins).

EXERCISE III-2

What Kind of Investor Are You?

By understanding and coming to grips with your risk tolerance, you can eliminate or limit any type of investment that doesn't fit your criteria. Check those statements that apply.

You are a conservative investor if:

- ☐ You want your money safe at all times, and you don't want to lose any of it.
- ☐ Any decline in the value of your investment concerns you.
- ☐ You are uncomfortable with price volatility.
- ☐ You want to minimize losses and fluctuation in the value of your investments.
- ☐ You would invest in something safe that offers a fixed rate of return.
- ☐ You are willing to give up higher rates of return to keep most of your principal intact.
- ☐ You prefer investments that offer income opportunities without much exposure to principal loss.

You are a moderate investor if:

- ☐ You want your investment return to beat inflation by at least 2%.
- ☐ You select investments that have a moderate amount of volatility yet offer the opportunity to earn a higher rate of return than CDs or government bonds.
- ☐ Although a decline in the value of your investments is a concern, you can accept temporary market volatility in return for growth opportunities.
- ☐ You would like to moderately increase the value of your investments with limited exposure to risk.
- ☐ You want a balanced investment mix and are willing to tolerate some short-term fluctuation in value.

You are an aggressive investor if:

- ☐ You like to pursue substantial appreciation opportunities, even though it puts your capital at high risk.
- ☐ Temporary market fluctuations do not concern you because maximum appreciation is your primary long-term goal.
- ☐ You expect a return greater than the S&P 500 Index from your investments.
- ☐ You are financially able to accept lower liquidity in your investment portfolio.
- ☐ You can take calculated risks to ensure a potential for the highest return over time.
- ☐ You have the conviction necessary to hold on to your investment during those years when it could drop in value by 25% or more.

Conclusion: Based on my needs, concerns, and risk tolerance,
I consider myself to be a(n) ________________________ investor.

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EXERCISE III-3

Finding Your Comfort Zone

Answer the following questions to determine your comfort with risk or market volatility.

1. Based on the investment return over the last 82 years through 2007, it is reasonable to expect the following long-term market performance in excess of inflation:

Stocks	4–6%
Long-term bonds	2–3%
Treasury bills	0–1%

With your investment philosophy in mind, what is your rate of return objective? Inflation plus ______________%.

2. To reach your long-term investment goals, how much risk or decline in your investment portfolio would you be willing to tolerate in a given year?

___ None
___ 1–4%
___ 5–9%
___ 10–14%
___ 15–19%
___ 20% or more

3. If a $10,000 investment you made for a goal 5 years away lost value during the first year, at what dollar amount would you want to sell and move to a less volatile investment, rather than wait for a market turnaround?

___ $9,500
___ $9,000
___ $8,500
___ Less than $8,000
___ I would not sell

4. If you are investing for retirement in 20 years and the stock market drops 20% or more in a given year, would you:

___ Stop investing
___ Move equities to a money market or CDs
___ Put new contributions into fixed income
___ Buy more stocks
___ Continue to invest into equities predetermined amounts on a regular basis (dollar-cost-averaging)

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Investment Choices—Stocks, Bonds, and Mutual Funds

Mary, like many women, struggles with the risk vs. reward tradeoff that is a part of investing. She tends to choose investments so conservative that her money does not grow once taxes and inflation are factored in. For example, over the last 82 years, Treasury bills have paid an average annual return of 3.7%. If you subtract out 3.1% inflation, this leaves you with 0.6%, and you still haven't paid income taxes yet! You may find, after ongoing study of the different investments available, that you can gradually become more comfortable with risk and thus gain potentially more growth.

As shown on page 75, investments can be placed on a risk ladder for better understanding of their relative risks and rewards.

TABLE III-2

What Returns Can You Expect from Your Investments?

Investor profile	Type of investments	Expected return before inflation and taxes (%)
Conservative (low risk)	Significant allocation to fixed income (bonds, money markets, CDs, and savings accounts)	2–8
Moderate (medium risk)	Significant allocation to equities (stocks and mutual funds)	8–11
Aggressive (high risk)	Significant allocation to equities, including foreign, small cap, and sector funds	10–15

Rung 1—
Low-Risk (Conservative) Investments

Cash and Cash Equivalents

Savings accounts (regular passbook or statement). Easily opened at commercial banks, savings and loan (S&L) associations, and credit unions. Frequency of compounding of interest varies; accounts are usually government-insured and liquid (quickly converted to cash without loss of value).

Money market deposit accounts. Bank and credit union accounts that typically provide a slightly higher rate of return than savings accounts. **Money market deposit accounts** carry Federal Deposit Insurance Corporation (FDIC) or National Credit Union Administration insurance for balances of up to $100,000. You have slightly less access to your money (limited number of checks and withdrawals per month) than with a savings account.

Money market mutual funds. Unlike money market deposit accounts (bank products), **money market mutual funds** are mutual funds available in taxable and tax-free versions. They invest in the lowest risk, shortest term, most highly rated debt securities such as Treasury bills and certificates of deposit and short-term municipal debt instruments (such as municipal bonds). Maturities (the date on which the principal amount of a bond or loan must be paid) are less than 90 days to provide safety from a change in short-term interest rates. Shares are worth $1.00 apiece. These funds are not federally insured, but are extremely safe and liquid and generally yield a bit more than money market deposit accounts.

Certificates of deposit. **CDs** are deposit accounts with strings attached. Depositors select the number of days, months, or years to fit their goals and needs. Available at banks, savings and loan associations, credit unions, and brokerage firms, the rate of return, depending on maturity, can be higher than what's available from money market funds. If you should withdraw your money early, you'll pay a 3–6-month interest penalty. Bank CDs are insured. However, CDs sold by brokerage firms may not be.

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U.S. Treasury Securities

"Treasury securities" is an umbrella term for three groups of securities with differing maturities.

Treasury bills (T-bills). These are types of short-term federal debt securities with maturities ranging from a few days to 52 weeks (1 year). You can buy a T-bill for a minimum of $100, with increments of $100. T-bills are purchased at a discount. For example, depending on the prevailing interest rate, you might buy a 6-month T-bill for $940. At maturity you get back $1,000. (In this example, your profit is approximately $60 or 6.4% ([$60 ÷ $940] x 100). Interest is exempt from state and local income tax.

U.S. Treasury notes and bonds. These kinds of investments are popular because of their safety and competitive interest rates. Interest on both kinds of investments is paid semiannually. This interest is subject to federal taxes but is free from state or local taxes. Treasury notes are issued with maturities of 2, 3, 5, and 10 years. Treasury bonds are long-term federal debt securities that mature in 30 years.

Treasury securities are available by phone without a sales fee from the Bureau of Public Debt, over the Internet using a plan called Treasury Direct, or for a small fee (about $50) from financial institutions. For more information about Treasury Direct, call 800-722-2678 or visit www.treasurydirect.gov.

U.S. Series EE bonds and I bonds. Series EE bonds are the lowest denomination securities issued by the federal government with the income earned exempt from state and local taxes. Federal taxes can be deferred for up to 30 years or until the owner cashes in the bond. Both the Series EE and inflation-adjusted I bonds are available at most banks and other financial institutions, as well as through payroll deduction, in denominations ranging from $50 to $5,000 (I bonds) or $10,000 (E bonds). The purchase price of EE bonds is one-half of their face value (e.g., $50 for a $100 bond). I Bonds are sold at face value in the same denominations as Series EE. The accrued interest on both series is paid when the bonds are redeemed. Bonds can be redeemed at most financial institutions. For further information, visit www.savingbonds.gov.

> **Note:** Earnings on both bond series are subject to federal tax but may be tax-free if cashed during a year in which the owner pays qualified education expenses and meets income guidelines (see Internal Revenue Service (IRS) publication 970, Tax Benefits for Education, for details).

Effective May 1, 2005, investors who buy Series EE savings bonds will receive whatever rate is in effect at the time of purchase for the life of the bond. Prior to this date, interest rates on Series EE bonds changed every six months based on current interest rates. The change to a fixed rate does not affect holders of Series EE bonds purchased before May 1, 2005, nor does it affect those holding Series I bonds, which are adjusted every six months for inflation.

Fixed-Rate Annuities

An **annuity** is a contract between an investor and a life insurance company. You invest in the contract by making a lump sum or periodic deposits in exchange for tax-deferred growth of principal. A guaranteed lifetime income is available if you "annuitize"—meaning you convert your annuity account into a monthly income stream. The investor is guaranteed a fixed rate of return while the savings grow. The income received is based on the amount invested, the length of time it grows, and the interest rate paid on savings.

Annuities are popular retirement investments for two reasons: they are tax-deferred, and the rate of return is usually better than that of CDs. The disadvantages include:

- Withdrawals before age 59½ may trigger an IRS penalty of 10%.
- Fixed-rate annuities normally carry a declining surrender fee (a type of commission whereby fees are gradually reduced over time) for 5–10 years.
- High expenses, including an annual contract maintenance fee and mortality charge (1.30% on average) to cover insurance company overhead and death benefits.

Buy annuities only from companies rated A or better (AAA is the top rating, then AA and A) by the recognized rating services for insurance companies (Table III-3) so you can ensure that the money you invest will be there when you want it.

Variable annuities invest in mutual funds and are explained in greater detail on page 82.

TABLE III-3

Rating Services of Insurance Companies

Rating company	Web site
Standard & Poor's	www.standardandpoors.com
Duff & Phelps	www.duffllc.com
Moody's	www.moodys.com
Weiss Research	www.weissratings.com
A.M. Best	www.ambest.com

Rung 2— Low- to Moderate-Risk Investments

Bonds

A bond promises the return of your capital, plus interest, if you hold it to its maturity date. When you buy a bond, you are loaning your money to the issuer.

The safest bonds in the low- to moderate-risk category (after the federally secured bonds described in the Rung 1 section) are those rated A or better by Moody's or Standard and Poor's rating services (see page 89). Bonds rated BBB are considered medium grade and those rated BB or lower are considered below investment grade or "junk" bonds.

Municipal bonds. "Munis" are loans by investors to a state or local government or related agency for the purpose of building schools, hospitals, roads, bridges, or other municipal projects. In turn, the government or agency must honor the repayment of the bonds. However, all munis are not equal in quality. The higher the rating (and safer the bond), the lower the yield. Interest earned is federally tax-free and, if issued in your state, state tax exempt. Generally, the yields on municipal bonds are lower than what corporate bonds pay.

Corporate bonds. Companies issue bonds to pay for all sorts of activities, from research and development to acquisitions. The risk in corporate bonds is higher than in Treasuries—but the return is higher, too. It is generally 1–4% higher than a comparable Treasury bond, depending on the credit risk of the company. Available through brokerage firms, the minimum investment is $1,000. The interest you earn on corporate bonds is taxable by both the state and federal governments.

Ginnie Mae funds (GNMAs). **GNMAs** are mortgage-backed securities issued by the Government National Mortgage Association. Investment is in repackaged debt from 30-year government-funded home mortgages issued by the Federal Housing Authority and by the Veterans Administration. GNMAs are considered a "pass through" security because mortgage principal and interest payments are distributed proportionately to investors. As homeowners pay their monthly mortgage, their money is passed through to Ginnie Mae investors—partly in interest and partly in return of principal. GNMAs offer the full faith and credit backing of the federal government and require a minimum investment of $25,000. They can be purchased through banks and brokerage firms. They can also be purchased for a lot less ($1,000–3,000) through a mutual fund or unit investment trust.

The major risk with GNMAs is that when interest rates fall people tend to refinance their mortgages. This causes larger amounts of principal to be returned to investors when interest rates drop, thus lowering the expected rate of return.

Bond funds. All types of bonds are available in mutual funds. Their value fluctuates according to business, market, and economic conditions and can be as unpredictable as stock funds. Since bond funds don't mature (the fund manager is constantly buying and selling the bonds), an investor's principal and income stream is always subject to interest rate risk. To preserve principal and earn a set amount of income for a particular period of time, investors should probably choose individual bonds if possible. The advantages of bond funds, however, are the diversification you get (the manager may buy hundreds of bonds), low investment minimums, the ability to reinvest dividends (the share of profits or earnings that a company passes on to its shareholders), ongoing professional management, and a monthly check if you decide not to reinvest in additional shares.

> **Note:** Mutual funds consisting of junk bonds, called high-yield bond funds, belong on Rung 3. Because they are lower quality, their share value fluctuates more like a stock.

Zero-coupon bonds. With **zero-coupon bonds**, the investor collects no (zero) interest during the life of the bond. Instead, the bond sells at a deep discount and each year the value of the bond increases. You get all your money at maturity instead of collecting a little each year. Corporations, municipalities, and the U.S. Treasury issue zero-coupon bonds. The downside is that you have to pay taxes on the interest earned each year even though you never put it in your pocket. Those taxes can be deferred or eliminated if the bond is put in an individual retirement account (IRA) or if you purchase a municipal zero-coupon bond. Interest on Treasury zero-coupon bonds is not subject to state or local taxes, and interest on municipal zeros is federally and/or state tax-exempt.

Rung 3—
Moderate- to High-Risk Investments

Ownership investments are assets that you buy and own as property. As a stockholder (partial owner) of a corporation or real estate, there is potential for growth if the value of the asset increases and a potential for loss if the value declines.

Stocks (a.k.a., equities) are the heart of a well-managed portfolio and the best hedge against inflation over the long run. Rung 3 investments are for long-term money only—goals with deadlines more than 5 years in the future.

Stock Types

Income stocks are issued by companies that expect to pay regular, relatively high (compared to other companies) dividends (e.g., utilities).

Blue-chip stocks are issued by large, stable companies with a record of profitability over many years; they generally pay a dividend.

Growth stocks are issued by successful companies with above-average earnings and tend to rise in value every year. Growth stocks have a higher price relative to earnings than stocks on average. The major risk is that price declines are inevitable. Many growth stock companies pay little or no dividends.

Value stocks can be issued by large or small companies and trade at prices that are low compared to their true worth or future prospects. Often these stocks are cheap because the companies have fallen out of favor. They are generally less risky to own than growth stocks because they have less to lose in a declining market and have room to rise if company earnings improve. They also carry lower price-earnings ratios and usually pay bigger dividends than growth stocks.

Stock mutual funds are investment companies that pool money from shareholders and invest in a variety of stocks, including large, small, value, growth, sector, and international. The investment company sells shares to investors. The shares provide investment returns in the form of dividends and capital gains (an investment's increase in value).

Because mutual funds contain many investments, they tend to be safer than individual stocks or bonds. The price per share will fluctuate with business, market, and economic conditions. Minimum investments range from $500 to $5,000, in most cases, but can be lower if payments are made automatically from your checking account.

Mutual funds are available through full-service brokerage firms for a sales charge ("load") or directly from discount brokers (fund "supermarkets" such as Charles Schwab's OneSource). You can also buy mutual funds directly through the fund companies themselves for lower sales charges or none at all ("low-load funds" or "no-load funds"). History shows that no-load funds perform as well as load funds.

Many mutual fund companies have good educational materials available on the Web or by mail.

Stock funds exist for every type of stock listed above.

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Other popular types of stock funds are *index funds*, which aim to match a particular market index (e.g., Standard & Poor's 500) by investing in the securities found in the index, *balanced funds*, which mix stocks and bonds; and *global funds*, which invest in foreign companies as well as U.S. companies.

Variable Annuities

In addition to fixed-rate annuities, there are also variable annuities, which belong on Rung 3 or Rung 4 of the Risk Ladder, depending on the investments in the account. A variable annuity is the same kind of insurance contract (available through an insurance company) as a fixed-rate annuity, except that the investor has the responsibility of managing the account and choosing investments from an array of mutual fund sub-accounts. The value of the annuity fluctuates based on market performance of the underlying mutual funds. Some variable annuities are offered without surrender fees and sales charges through mutual fund companies. However, all companies charge an annual management fee of 0.25–2%. The assets grow tax-deferred and earnings are taxed at ordinary income tax rates rather than at lower capital gains rates. Low expenses are absolutely critical here.

Rung 4—High-Risk Investments

Only aggressive mutual funds are included on Rung 4 of the Risk Ladder. The underlying individual securities would also belong in the high-risk category. These mutual funds are appropriate for investors who have a long time frame and can tolerate the most risk; these funds can experience dramatic price changes.

Small company (small cap) funds tend to make stellar gains in a rising market. Small companies are young and growing fast, and their dramatic gains are sometimes followed by sudden drops. Over time, however, these funds tend to return more than Rung 3 funds—if you can tolerate the volatility.

Sector funds focus on particular industries, such as technology, natural resources, health care, or financial services, and purchase only stocks in one industry.

Emerging markets funds focus on companies in developing countries. The funds are vulnerable to currency fluctuations and political conditions in those areas.

Gold and precious metals funds invest in the stock of companies related to gold and precious metals (e.g., mining).

International funds invest in stocks and bonds of companies located outside the United States.

Penny stocks are sold for $5 per share or less. If you invest in them, be prepared to lose all of your money. However, they can occasionally produce good returns.

Commodities are bulk goods, such as food, coffee, grain, livestock, and metals, that are traded on the Commodities Exchange.

Checking Up on Quality

If you are going to buy stocks, corporate bonds, shares in a mutual fund, or an annuity, you should first research their quality using the tools below. You want to verify that the company is financially stable and profitable. The authoritative ratings for each type of investment are available in most libraries or on the Internet.

Ranking Services and Sources

Bonds: *Standard & Poor's* and *Moody's*. Ratings are also available from brokers.
Annuities: *Standard & Poor's, Moody's*, and the other rating services listed on page 80.
Stocks: *Value Line Investment Survey* and *Standard & Poor's Stock Guide.*
Mutual Funds: *Morningstar* and *Value Line Mutual Fund Survey*

What Are Stocks and Why Should You Own Them?

Stock is an ownership asset. If you buy stock in a company, you are a partial owner of that company, even if it is only a minuscule piece.

> ***Stock.*** A security that represents a unit of ownership in a corporation.

How Does an Investor Make Money?

You can make money in two ways by owning stock in a company.

1. *Price appreciation (capital gain)*

Example: You buy a stock at $25 a share and sell it at $39 a share, which is $14 more than you paid for it. Multiply the number of shares you bought by $14 to figure your profit (capital gain).

2. *Dividends*. Dividends are the share of profits or earnings a company makes that it passes on to its shareholders.

Example: A company earned $15 million and had 10 million shares of stock outstanding. Divide $15 million by 10 million shares to get $1.50 per share of earnings. The company decides to distribute 80 cents of the earnings per share to shareholders as a dividend. If you owned 100 shares, you would receive $20 ($0.20 x 100) each quarter, for a total of $80 for the year.

In addition to ownership, the possibility for price appreciation, and dividends, a stock investor also gets a chance to help make corporate decisions by voting her proxy (giving authorization to vote on company business). An investor also has an opportunity to see company management at work at the annual meeting.

There are two types of stock: preferred and common.

Preferred stock has an established dividend that does not move up or down based on how well the company is doing. Preferred stockholders always get paid their dividends before common shareholders and, if a company should fail, would be paid off first.

Common stock offers voting rights and any dividends the company decides to pay. Dividends will fluctuate depending on the company's success or failure. These are the shares that most investors own.

Where to Buy and Sell Stocks

You can buy or sell stock through full-service brokerage firms, discount brokers, deep discount brokers, directly from a company, and online. A commission is charged for every purchase and sale.

All publicly traded stocks are listed on one or more exchanges or on the over-the-counter (OTC) market.

The three primary exchanges in the United States where investors trade stock are:

The New York Stock Exchange (NYSE). This is the largest and oldest of the U.S. stock exchanges (located in New York City); trades the shares of many large and well-established companies.

The American Stock Exchange. Also located in New York City, this exchange has less rigorous standards than the NYSE and lists smaller companies.

The National Association of Securities Dealers Automated Quotation System (NASDAQ or OTC). NASDAQ is sometimes called the OTC (over-the-counter) market because there is no actual trading floor as there is at the other exchanges. The NASDAQ is made up of brokers networked together around the country who trade stocks back and forth with computers. A lot of high-tech companies trade here, and volatility is generally the highest of the stock exchanges.

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Stocks by Size

The size of a company is described in "market lingo" as market capitalization, a.k.a., market cap. Market cap is determined by multiplying the current price of a share of stock by the number of outstanding shares.

> ***Capitalization (Cap).*** The total market value of all shares of a company's stock; calculated by multiplying the share price by the number of outstanding shares.

While exact definitions of market capitalization vary somewhat according to various sources, all companies can be classified into one of the following market cap ranges:

Mega-cap	Over $1 trillion
Large-cap	Over $10 billion
Mid-cap	Between $1 or $2 billion and $10 billion
Small-cap	Between $250 million and $1 billion or $2 billion
Micro-cap	Between $50 million and $250 million
Nano-cap	Below $50 million

How Stocks Measure Up— What to Look For

For investors, the best way to evaluate and learn about a stock is to use fundamental analysis, the study of information about a corporation's financial health and likelihood of success. By examining a company's management, its growth rate, how much it earns, and how much it spends to run its business, you can determine if it is a good buy or overpriced. This information can be found in company annual reports and the Value Line Investment Survey (available in library reference areas).

The most common stock measurements can reveal valuable information:

Cash flow per share. Cash flow is the stream of cash through a business. Bills need to be paid on time. Cash flow per share is simply a company's cash flow divided by the number of shares outstanding. It tells you what you are paying for a share of the company's cash flow.

Current ratio. This is one of the best measures of whether a company can pay its bills. It is calculated by dividing current assets by current liabilities. Current assets are items that are used up and replaced often, such as cash or inventory. Current liabilities are debt payments that are due usually within 1 year. Look for companies with a current ratio of at least 2:1.

Earnings per share. This is the most important of growth measures. It's the proverbial "bottom line" on a company's income statement and is calculated by dividing what the company earned last quarter (or last year) by the number of shares outstanding. Earnings reports can often cause a stock to rise or fall sharply.

Dividend yield. A stock's dividend yield is the annual cash dividend divided by the current stock price (this is always found in the newspaper). Usually the larger, well-established companies offer higher dividend yields and are considered to be safer stocks.

Price/book ratio. This ratio compares a stock's price to how much the stock is worth at that very moment if a company had to be sold. To arrive at the book value, the value of the company's belongings would be added up and then divided by the number of shares outstanding. Then the current price of the stock is divided by the book value to get the price/book ratio. If the ratio is less than 1, buyers pay less for the stock than its liquidation value, which is good.

Price/earnings ratio (PE). This is the most important measure of a stock's value. The price/earnings ratio of a stock is calculated by dividing the price of a stock by the earnings per share. It is riskier to invest in a stock with a high PE because of the greater difficulty of meeting the higher earnings expectations of analysts and investors. Companies with lower PEs generally pay dividends and are usually in slower growth industries. You'll often find very high PE ratios in the newer and riskier technology companies.

Winning Stock Market Strategies

Even though stocks have shown an upward trend since 1802, there have been lots of time periods when an investor's patience has been tried. But, in any case, there are several strategies that will reduce your risk and increase the possibility of higher growth.

Buy and hold. This is an investment strategy that involves long-term ownership of high quality securities. Don't try to time the markets. Market prices go up as well as down. Be prepared to keep your money in for the long haul, at least 5 years, and ignore the temporary ups and downs in the stock market. Trying to second-guess the market is about as sure as betting on a horse race. It is impossible to know what the market will do next week, next quarter, or next year. A buy-and-hold strategy minimizes taxes (you are taxed only when you finally sell) and transaction costs (multiple commissions) and eases tax preparation (you have only dividends to report). Over the long term, a sound stock investment should rise in value, dividends should increase, and the stock may split, giving you more shares.

Dollar-cost-averaging. This is a regular (e.g., monthly) investment of a predetermined amount (e.g., $50) of money regardless of whether securities markets are moving up or down. Dollar-cost-averaging is a disciplined way to invest in the stock market because you are making a commitment to yourself to add to your investments on a regular basis, regardless of market conditions. It takes the emotions out of investing. The set dollar amount you decide to invest periodically will buy more shares when the prices are down and fewer when the prices are high. When you average the cost of your shares over time, you will find that this method results in ownership of more shares at a lower average price per share. Dollar-cost- averaging is very easy to do with mutual fund automatic investment and stock dividend reinvestment plans (DRIPs). Table III-4 illustrates how regular investments lead to lower average share prices.

TABLE III-4

Dollar-Cost-Averaging Illustration

Month	Regular investment	Share price	Shares acquired
1	$100	$10.00	10.0
2	100	7.50	13.3
3	100	5.00	20.0
4	100	7.50	13.3
5	100	10.00	10.0
Total	$500	$40.00	66.6
Your average share cost: $500 ÷ 66.6 = $7.50			

Reinvest your dividends and capital gains—A DRIP is the easiest and least expensive way to buy new stock. By taking advantage of a direct investment plan, you can purchase additional shares of stock directly from a company without paying brokerage fees.

> ***Dividend reinvestment plan (DRIP).*** A stock or mutual fund purchase option that allows investors to automatically reinvest any dividends their stock or mutual fund pays in additional shares, as well as to invest optional lump sum cash payments.

Use Exercise III-4, *Comparing Stock Investments* (page 86), to determine the best deal among three stocks in which you are considering investing.

EXERCISE III-4

Comparing Stock Investments

Characteristic	Stock investment #1	Stock investment #2	Stock investment #3
Name			
Earnings per share			
Dividend yield			
Price/earnings ratio			
Stock category			
Stock size			
Long-term debt			
Cost per share			
Other features			

Your Minimum "Need to Knows" about Stocks

- Stocks are ownership investments. The value of your stocks will fluctuate with market conditions, potentially giving you a higher return than you might receive from loaned money (bonds).
- It is possible for an individual investor to build real wealth over time in the stock market.
- Buying the stock of a company allows you to profit from that company's future growth and earnings.
- Buy and hold stocks long-term—at least 5 years.
- Stocks are worth only as much as a buyer will pay.
- Don't invest more than 5% of your total portfolio in an individual company's stock.
- Do your homework. Don't skip research just to get in quickly.
- Earnings per share is the most important measure of a stock's quality.
- The best yardstick for a company's value is its price/earnings ratio.
- Investing a set amount of money in the same stock each month results in dollar-cost-averaging—a good way to buy stock over time.
- DRIPs permit you to buy a small number of shares of stock and to reinvest dividends directly into company shares.

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What Are Bonds and Why Should You Own Them?

Bonds are a very different type of investment from stock, but equally important. When you are younger, you'll focus less on bonds than you will when you are older. If you are in your 30s, you might have only 20% of your portfolio in bonds, but as a 65 year-old you might have 50–60% in bonds.

> ***Bond.*** A debt instrument or IOU issued by a corporation or government entity.

Why are bonds important? **Fixed-income investments—**ranging from long-term corporate bonds, Treasury notes and bills, CDs, and money market mutual funds—address certain financial goals better than others do (such as stocks or real estate). Being able to tap the money you need when you need it is the name of the game. Bonds also cushion your stock portfolio. In years when the stock market is moving down rather than up, a bond portfolio can often temper your overall losses.

Decision Time—
Individual Bonds or Bond Funds?

Individual bonds will give you:

- a set income stream (payable twice a year) over the period of the loan (when you invest in a bond, you're loaning your money to the holder of the bond).
- all of your principal back at the end (when the bond matures).

Bond mutual funds give you:

- a portfolio composed of bonds that has no maturity date. At no point in time are you guaranteed your full investment back. On the other hand, you are getting diversification. Instead of owning just one bond, you own pieces of many bonds, perhaps 100 or more.
- dividends that are paid out monthly instead of semiannually.
- the ability to cash out whenever you want.

> ***Diversification.*** The policy of spreading assets among different investments to reduce risk of a decline in the overall portfolio as well as a decline in any one investment.

The trade-off between owning bonds vs. bond funds is:

- you can lose principal in a bond fund, but you (usually) can't with an individual bond, as long as you hold it until maturity.
- you can purchase bond funds with no sales charge (commission). Not so with individual bonds (unless they are new issue). You'll pay a commission to buy, as well as to sell, if you redeem early.

> ***Maturity.*** The date on which the principal amount of a bond or loan must be paid.

> Advice: If you have less than $50,000 to invest in bonds, choose quality bond funds that have low management fees. They come in many varieties, as described earlier on page 80. It is difficult to build a diversified bond portfolio with less money.

If you have $50,000 or more to invest, create a bond portfolio with a combination of assets with different maturity dates. This is called **laddering** (Table III-5, page 88). As each bond matures, reinvest the proceeds at the longest time interval to maintain the ladder.

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TABLE III-5

Example of Laddering

Year 1			
Amount ($)	Yield (%)	Maturity (years)	Annual interest ($)
10,000	5.00	1	500
10,000	5.25	2	525
10,000	5.50	3	550
10,000	5.75	4	575
10,000	6.00	5	600
		Total	$2,750

How Bonds Work

Bonds are issued with a face value of $1,000 but are usually sold in increments of five (e.g., $5,000, $10,000). The length of time between when a bond is issued and when it matures varies significantly (e.g., short-term bonds mature in 2 years or less, intermediate bonds mature in 3–10 years, and long-term bonds mature up to 30 years after issue).

Some bonds are sold at face or "par" value ($1,000) and pay investors interest over the term of the bond. Others, such as Series EE U.S. savings bonds and zero-coupon bonds, are sold at a discount to their stated value. They return nothing until they mature, and at that time, give an investor the full face value.

Bond interest can be described in two ways. You'll need to understand the distinctions to avoid confusion when you actually begin to invest.

Coupon rate, a.k.a., the stated interest rate, is used to compute the interest payment in dollars that you will receive from the bond as a percentage of the bond's face value, e.g., $1,000.

> *Example:* A newly issued bond for $1,000 has a coupon rate of 8%, meaning that you receive a total of $80 of interest income for that year (payable in two $40 payments). Every year, you will collect $80 from the bond until it matures. At that point, you get back your $1,000.

Current yield is based on the current market price of the bond rather than the "par" or face value.

> *Example:* A bond with a face value of $1,000 drops in value to $900. You still earn your $80 of interest income based on the bond's stated rate of interest. Thus, the current yield of the bond is ([$80 ÷ $900] x 100) or 8.9%.

What Should You Look Out For?

The five major risks of bonds and bond funds are:

Call risk, which relates to the fact that the issuer of a bond can buy it back, or call it, from an investor prior to maturity. "Yield-to-call" is similar to "yield-to-maturity," but it assumes the bond issuer will stop paying interest on the call date. This is quite common with municipal and corporate bonds. Investors are forced to redeem their bonds at this point, as they will no longer earn interest.

Credit (or default) risk, which relates to the financial strength of the company that is issuing the bond and is based on the ability of the company to repay principal and interest on time. Look for highest quality as rated by Standard & Poor's and Moody's (Table III-6).

Interest rate risk, which confirms that interest rates and bond prices move in opposite directions. Think of this movement like a seesaw. When bond prices rise, interest rates go down. Conversely, when interest rates rise, bond prices fall. In the latter case, it means that your bond is losing value because new bonds are being issued at a higher interest rate (see figure on page 89).

> *Example:* If you could buy a newly issued $1,000 bond paying a stated interest rate of 9%, you certainly wouldn't offer your friend $1,000 for her bond paying 8%. So unless you can buy your friend's bond for less money, it's a bad deal.

Time risk, which means that the volatility of bond prices increases as their length of maturity increases. The risk is that you will be stuck with a lower pay-

TABLE III-6

Credit Quality Ratings and What They Mean

Moody's	Standard & Poor's	Fitch	Interpretation
Aaa	AAA	AAA	Outstanding quality. If everything that can go wrong goes wrong, the bond issuer can still service debt.
AA	AA	AA	Very high quality by all standards.
A	A	A	Investment grade; good quality.
Baa	BBB	BBB	Lowest investment-grade rating; satisfactory, but needs to be monitored.
Ba	BB	BB	Somewhat speculative; low grade.
B	B	B	Very speculative.
Caa	CCC	CCC	Even more speculative. Substantial risk.
Ca	CC	CC	Widely speculative. May be in default.
C	C	C	In default. Junk. No interest being paid or bankruptcy petition filed.
	D	D	In default

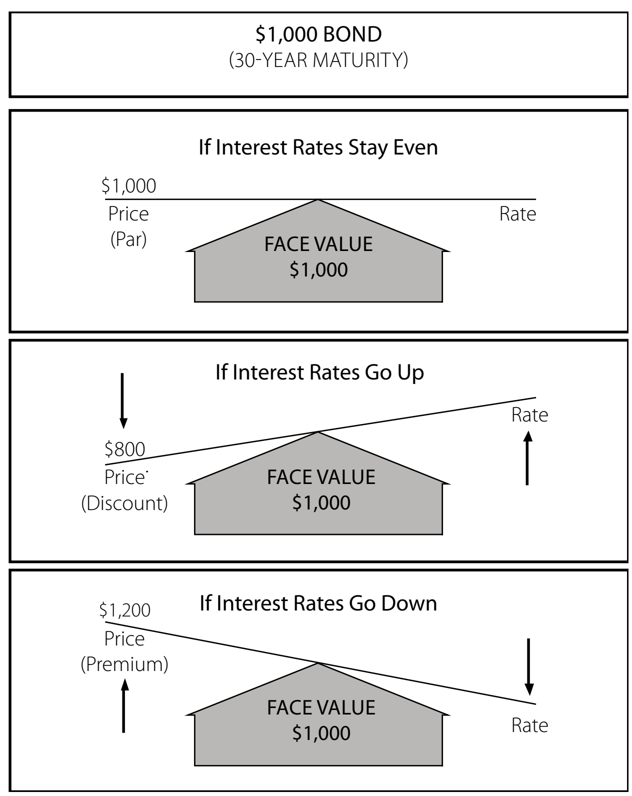
Adapted with permission from: Thau, A. (2000). *The Bond Book*. McGraw-Hill Trade.
Additional source: www.InvestinginBonds.com.

ing bond until maturity when new ones are paying a higher interest rate.

Example: If interest rates rise 1%, a 2-year Treasury note (or short-term bond) loses nearly 2% in value. On the other hand, a 30-year Treasury loses about 12% in value.

Reinvestment risk, which can be experienced since bond issuers have the right to call back their bonds and return the bondholder's principal. The risk is that you generally have to reinvest your principal at lower rates than you were receiving and counting on.

Exercise III-5, ***Comparing Fixed-Income Investments*** (page 90), will help you compare three bond investment vehicles and choose the one best suited to your needs.



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EXERCISE III-5

Comparing Fixed-Income Investments

Characteristic	Fixed-income investment #1	Fixed-income investment #2	Fixed-income investment #3
Name			
Return			
Maturity date, if any			
Minimum investment amount			
Subsequent investment amount			
Tax advantages, if any			
Frequency of interest payments			
Quality rating			
Other features			

Your Minimum "Need to Knows" about Bonds

- A bond is an interest-bearing security with a maturity date.
- A bond is a loan to a corporation, the federal government, or a state or local government or government agency.
- Compared to stocks, bonds offer higher current income with less volatility, but don't grow in value.
- Bonds are given ratings from AAA to C or D (depending on the rating firm), denoting their issuers' ability to repay principal and interest owed to holders.
- Low expenses are critical to bond fund returns.
- Mutual funds that invest in bonds are generally more risky than individual bonds, all things being equal (for the same quality of bonds).
- Bonds and bond funds are frequently recommended as a low-risk way to balance or stabilize a portfolio and for short-term goals.
- It can be wise to limit bond maturities to 5 years to reduce interest rate risk.
- It is best not to sacrifice quality. Investing in lower-rated junk bonds (or junk bond funds) can be high risk.

What Are Mutual Funds and Why Should You Own Them?

Every mutual fund has specific investment criteria that are spelled out in its prospectus, the official booklet that describes a mutual fund. Investors then know what they are getting and can match their investment objective to that of a fund.

> ***Mutual fund.*** A portfolio of stocks, bonds, or other securities that is collectively owned by thousands of investors and managed by a professional investment company. The shareholders are people who have similar investment goals.

In a nutshell, this is how mutual funds work . . .

- A large number of people with a common objective put money in a pot (a mutual fund) with other people's money.
- They pool their money for more buying power.
- The fund manager invests all of the money in a collection of stocks, bonds, or other securities.
- In exchange, investors are given shares in the fund. The number they own is proportionate to the amount they invest.
- Investors receive or reinvest dividends and capital gains distributed by the fund.

What Are the Advantages of Mutual Funds?

- You get full-time professional money management. Most people do not have the time or skill to select and monitor individual stocks and bonds.
- You get reduced risk through diversification because a mutual fund owns many stocks or bonds. You can also pick your level of market risk by choosing particular types of funds.
- You don't need a lot of money to get started. Many funds require only $1,000 to open an account, and some funds require minimum initial investments as low as $500. Subsequent deposits can be as small as $25–100 if an automatic investment plan (AIP) is adopted.
- You retain ready access to your money. A mutual fund is required to buy back your shares, which makes withdrawals easy. The management company will mail your check within 7 days of the request at the closing price (the net asset value, or NAV) on the day it is received. The NAV is calculated as follows:

$$\frac{\text{value of fund securities} - \text{expenses}}{\text{number of shares outstanding}}$$

> ***Automatic investment plan.*** An arrangement in which you agree to have money automatically withdrawn from your bank account on a regular basis (e.g., once a month or every quarter) and used to purchase individual stock or mutual fund shares.

- Mutual funds are often a less expensive way to invest than individual stocks because the thousands of shareholders share research and operating costs. The most efficiently run funds have an expense ratio of less than 1% per year. Some well-established funds charge annual fees as low as 0.10–0.50%. Also, many funds are sold directly through their sponsors with no sales charge; these are known as no-load funds.
- Mutual funds are convenient. They can be purchased (and sold) directly from a mutual fund company by mail, by telephone, and from full-service brokers, financial planners, banks, or insurance companies.
- Automatic withdrawal plans are available, making it possible to have a steady stream of income for retirement (e.g., withdrawals of $250 per month).

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> ***Expense ratio.*** The percentage of fund assets deducted for management and operating expenses.
> ***"No-load" funds.*** Require no up-front fees to purchase shares and have no marketing fees.
> ***"Low-load" funds.*** Carry a sales commission of 1–3% of the amount invested.
> ***"Load" funds.*** Carry a sales commission of up to 8.5% of the amount invested.

- Monitoring mutual funds and stocks is simple. Prices are reported daily in the financial section of many newspapers.

Now for the Downside . . .

- If there is a broad market drop, your fund's value will dip with it. The diversification of most mutual funds protects you when one or several securities fall, but not when the whole market takes a downturn.
- Mutual funds have no guaranteed rate of return, as there is with CDs and Treasury securities.

> ***Taxable distributions.*** Payments to investors of profits (capital gains) realized upon the sale of securities within a mutual fund.

- Unwanted taxable distributions could also be a disadvantage. Funds are required to pay out 98% of their dividends, interest, and capital gains annually. Taxes must be paid on these distributions, even if you never received them but instead reinvested them in additional shares. Unfortunately, sometimes you can also owe taxes even if your fund lost money for the year. This is a non-issue if funds are held in a tax-deferred account such as a 401(k) or IRA.

Where to Buy and Sell Mutual Funds

The issue isn't whether you can find someone to sell you a mutual fund, but the best way for you to buy. The decision will depend mainly on how much of the research you are willing to do, whether it bothers you to see some of your investment dollars go into sales commissions, rather than into the funds themselves, and how high a premium you place on convenience.

The four main avenues by which to own or redeem funds are:

- directly from the mutual fund company
- financial planners and full-service brokers
- banks with associated investment firms
- discount brokers including mutual fund supermarkets such as Charles Schwab, Fidelity, TD Ameritrade, and Vanguard.

Types of Mutual Funds

Mutual funds fall into three main categories:

- stock (or equity) funds
- bond funds
- money market funds.

Stock Funds

Stock funds invest primarily in stocks. But stock fund portfolios vary, depending on the fund's investment objective. The major distinction is that some stress growth, some income, and some a combination of the two. The profits on all stock fund distributions are taxable (if held in a taxable account), but there is no tax on the increase in value until shares are sold.

Bond Funds

Just like bonds, bond funds produce regular income. However, unlike bonds, bond funds have no maturity date and no guaranteed repayment of the amount you invest. Dividends can be reinvested in the fund to increase the principal. Buyers can invest a much smaller amount of money than would be needed to buy an individual bond and still get a diversified portfolio.

Bond funds come in many varieties with different investment strategies, goals, and maturities. They include investment-grade corporate bonds, Treasuries, junk bonds, long-term, short-term, taxable, and tax-free (municipals). Interest earned on corporate and

U.S. government funds is taxed. There is no federal tax on municipals and no state and local taxes for investors who live in the state and/or municipality that issued them.

Money Market Funds

These funds resemble savings accounts. For every dollar you put in, you get a dollar back, plus interest.

- Investors can write checks against their account, but there is usually a per-check minimum (e.g., $250 or $500).
- Money market funds come in taxable and tax-free varieties—taxables buy the best short-term corporate or government issues available. Tax-frees buy municipal debt.
- A money market fund usually pays a little more interest than a bank money market or CD, but always compare.
- Check yields and management fees.
- Use a money market fund as a place to stash money you'll need soon, as a parking place for cash you'll invest later, and as a place for your emergency fund.

Mutual Fund Objectives

A fund's objective should correspond with an investor's objective. Every mutual fund—stock, bond, or money market—is established with a specific investment objective that fits into one of these basic goals:

- future growth
- current income
- both income and growth
- preservation of capital.

Use the following worksheets (Exercises III-6 to III-11, pages 94–97) to help match your goals with the appropriate mutual funds. Examples for each category are provided. Any of the sample objectives could be met by any of the mutual fund types in each category. Write in your goals under "Your Objective" in each worksheet.

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EXERCISE III–6

Mutual Funds with a Growth Objective

Your objective	Mutual funds with a growth objective
Examples: Retirement in 25 years College fund for a newborn ____________________ ____________________ ____________________ ____________________ ____________________	Growth funds invest for the long term, and share prices can fluctuate considerably. They buy profitable, well-established companies that expect above-average earnings growth. Income is secondary; they pay very small dividends, if any. Aggressive growth funds (also called maximum capital appreciation funds) use riskier investment techniques and/or invest in stocks of smaller, less proven companies. They can be very volatile, but the trade-off is a high potential for capital appreciation. Small capitalization funds invest in stocks of small companies with assets less than $1 billion and are riskier than larger capitalization stock funds (more than $5 billion in assets). (Capitalization means number of shares outstanding multiplied by the price per share. See page 84 for details.) Specialty or sector funds limit investments to a specific industry (e.g., health care, biotechnology, financial services). International funds invest in securities of countries outside of the United States. Global funds invest in securities worldwide, including the United States. Index funds invest in stocks of one of the major broadly based market indexes such as the S&P 500 (large companies), Russell 2000 (small companies), or EAFE (Europe, Australia, Far East—an international index). Generally, these are passively managed funds with low expenses (meaning there is no manager deciding when to buy or sell securities).

EXERCISE III-7

Mutual Funds with an Income Objective

Your objective	Mutual funds with an income objective
Examples: Additional income for high tax-bracket retiree Supplement Social Security and pension for living expenses Lower risk in a stock-rich portfolio ________________ ________________ ________________ ________________	**Income funds** usually include a combination of bonds and utility stocks to produce steady income and lower investment risk. **Corporate bond funds** are available in short-, intermediate-, or long-term maturities. They invest in investment-grade bonds (debt) of seasoned companies. Investment-grade bonds have ratings of AAA, AA, A, or BBB by Moody's or Standard and Poor's. **Municipal bond funds** (short-, intermediate-, long-term) invest in tax-exempt municipal issues of state and local governments. They are generally sought by investors in the 25% and higher tax brackets. **High-yield (junk) bond funds** buy bonds with less than a BBB rating, thereby increasing risk to seek a higher return (not suitable for the risk-averse). **Government bond funds** invest in safe government-backed securities (e.g., Treasury notes and bonds). **GNMA funds** hold securities backed by a pool of government-insured mortgages. **Global bond funds** invest in bonds of overseas companies.

EXERCISE III-8

Mutual Funds with Both Growth and Income Objectives

Your objective	Mutual funds with both growth & income objectives
Examples: College tuition in 7 years Retirement in 10 years ________________ ________________	**Equity-income funds** aim for moderate income and some growth, investing primarily in blue-chip companies and utilities that pay current income and higher dividends. **Growth and income funds** aim for more long-term growth and a little less income than equity-income funds. They invest in large well-known firms that pay dividends. **Balanced funds** combine stocks and bonds in one portfolio to earn a reasonable income with reasonable growth. They usually contain a fixed ratio of 60% stocks to 40% bonds.

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EXERCISE III-9

Mutual Funds with a Preservation of Capital Objective

Your objective	Mutual funds with a preservation of capital objective
Example: Down payment on a house in 1 year ____________________ ____________________	**Taxable and tax-free money market funds** invest in very short-term debt securities such as Treasury bills and corporate IOUs known as commercial paper. **Tax-free money market funds** invest in very short-term securities issued by state and local governments.

EXERCISE III-10

Mutual Funds with All Four Objectives

Your Objective	Mutual funds with all four objectives
Examples: Invest for retirement in 5 years in one-fund portfolio (e.g., a fund with multiple objectives) New graduate starting from scratch ____________________ ____________________ ____________________ ____________________	**Lifestyle funds** typically offer three to four static portfolios from which to select. Different mixes of stocks, bonds, and cash are offered to fit people at different stages of life, with different tolerances for risk, or those getting started with a limited amount of money (e.g., T. Rowe Price Personal Strategy funds and Vanguard Life-Strategy funds). **Target Date Funds** (a.k.a., Target Retirement Funds and Life Cycle Funds) are a variation of lifestyle funds. Popular in 401(k) plans, they are one-decision funds for retirement investing. Investors simply pick a fund with a date close to their expected retirement (e.g., 2020, 2030) or other long-term goal and fund managers do the rest—allocate deposits around a broad spectrum of stocks, bonds, and cash and automatically adjust asset weightings over time so that the fund portfolio gets more conservative as the target date approaches. T. Rowe Price, Vanguard, and Fidelity are well-respected choices. **Asset allocation funds** aim for good returns with relatively low risk by combining changing amounts of the three asset classes—stocks, bonds, and cash. Managers of the fund shift the investments among the categories at their own discretion. F**unds of funds** are mutual funds that buy shares of their funds. In some instances these funds are run by a mutual fund family (e.g., Vanguard STAR and T. Rowe Price Spectrum-Income).

EXERCISE III-11

Comparing Mutual Fund Investments

Read the prospectus from three different mutual funds and complete the worksheet below.

		A	B	C
Name of fund				
Type of fund				
Your objective(s)				
Fund's investment objective(s)				
Performance	over 1 year			
	over 3 years			
	over 5 years			
(Optional)	over 10 years			
Minimum investment				
Maximum cost (fees)				
Commission/sales charge				
Redemption fee				
12b-1 fee*				
Expense ratio				
Manager tenure				
Portfolio turnover rate				
Other features				

* A fee charged by mutual funds for advertising and distribution costs.

EXERCISE III-12

Your Personal Investment Statement

Fill in the blanks to finalize your investment goals and plans.

1. I can best describe myself as a ______________________________ investor (conservative, moderate, or aggressive).
2. I feel most comfortable investing in (e.g., CDs, stocks, mutual funds)________________________________, ________________________________, ________________________________, and ________________________________.
3. Possible alternative investments might be (e.g., real estate) ________________________________.
4. I feel I will be able to get a real (after-inflation) return of _________% from my investments.
5. Within the next month I will do the following to learn more about investing:

   ____

   ____

6. Within the next year I will do the following to educate myself about investing:

   ____

   ____

   ____

7. By the year __________, I wish to have $____________ invested so I can

   ____

   ____

8. By the time I plan to retire at age _______ in ________ years, I want to have accumulated $______________________in assets.
9. I will accomplish these goals by: ____

   ____

   ____

10. The following circumstances might make me change my goals: ______________________________

    ____

    ____

Adapted with permission from: Dahl, B. (1996). *A Working Woman's Guide to Financial Security*. Urbana, Ill.: University of Illinois Cooperative Extension. ©Board of Trustees of the University of Illinois.

Your Minimum "Need to Knows" about Mutual Funds

- Mutual fund investing is simpler than investing in individual stocks and bonds.
- Mutual funds give you the benefit of instant broad diversification and professional management, usually at a low cost.
- Mutual funds vary greatly according to investment objective and what they invest in (e.g., stocks, bonds).
- Buying (and selling) mutual funds is an easy process, whether you do it directly through the fund company itself or through a broker/financial planner, bank, or mutual fund supermarket.
- All mutual funds are established with a specific investment objective that corresponds to one of these goals: growth, income, growth and income, preservation of capital, or a combination of all four.
- Funds can be purchased directly without a sales commission (no-load) or with a sales charge (load) through a broker/financial planner.
- All mutual funds charge management fees. Low-cost funds are critical to better returns.
- Look for mutual funds that have good performance records, not just for 1 year, but for 3, 5, and 10 years.
- With mutual funds and other investments, the higher the risk, the greater the potential return.
- Consider only no-load funds so that you'll have all your money working for you. There is no need to pay a commission for a fund or to pay high expenses.

Money Talk: A Financial Guide For Women

Action Steps

SESSION III: **Investing Basics**

- ☐ Identify your risk tolerance with the *What Kind of Investor Are You?* worksheet (page 76) and the *Finding Your Comfort Zone* worksheet (page 77).
- ☐ Review the list of Rung 1 investments (page 78) and select those appropriate for your goals.
- ☐ Review the list of Rung 2 investments (page 80) and select those appropriate for your goals.
- ☐ Review the list of Rung 3 investments (page 81) and select those appropriate for your goals.
- ☐ Review the list of Rung 4 investments (page 82) and select those appropriate for your goals.
- ☐ Automate your investments with payroll deductions and/or automated deposits.
- ☐ Use the *Comparing Stock Investments* worksheet (page 86) to compare several possible stock investments.
- ☐ Use the *Comparing Fixed-Income Investments* worksheet (page 90) to compare fixed-income securities.
- ☐ Determine the type(s) of mutual funds that best match your investment objective.
- ☐ Use the *Comparing Mutual Fund Investments* worksheet (page 97) to compare mutual funds.

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