Investor Education *Series*

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In the investment world, you can place your money in many different types of investment vehicles. Which vehicle you choose for your investment journey depends on where you're going, how fast you want to get there, and what risks you're willing to take along the way.

This little booklet is designed to explain, in simple terms, some of the different options that are available for you, as an investor, on the road to financial success.

Types of Investments

- *Money Market Accounts*
- *Stocks*
- *Bonds*
- *Mutual Funds*
- *Annuities*

Investment Concepts & Strategies

- *Portfolio*
- *Risk*
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Understand the Basics of Investing

Types of Investments:

What is a Money Market Account?

Accounts opened at financial institutions where the money is invested into safe, short-term debt instruments, such as CDs and US Treasury bills. They usually pay a higher return than regular savings accounts. Many money market deposits are not FDIC insured.

What is a Stock?

Stock represents **ownership** in a corporation. It may be represented by a certificate and can be either common or preferred, voting or non-voting, redeemable, convertible, etc..
A blue chip stock is the description of the stock of well-established companies having stable earnings and no extensive liabilities. Most blue chip stocks pay regular dividends, even when business is faring worse than usual. They are valued by investors seeking relative safety and stability, though prices per share are usually high. Typically, such stocks are perceived to offer reliable returns, low-yield, and low-risk.

- **Common stock**

Common stockholders are on the bottom of the priority ladder within ownership structure. In the event of liquidation common shareholders have rights to a company's assets only after the bond holders, preferred shareholders, and other debt holders have been paid in full.

- **Preferred stock**

A class of ownership in a corporation with a stated dividend that must be paid before dividends to common stockholders are paid out. Preferred stock does not usually hold voting rights. Preferred shareholders have priority over common shareholders on earnings and assets in the event of liquidation.

- **Dividends**

Distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. The amount of a dividend is quoted in the amount each share receives, or in other words, dividends per share.
Dividends may be in the form of cash, stock, or property. Most secure and stable companies offer dividends to their stockholders. Their share prices might not move much, but the dividend attempts to make up for this. High-growth companies don't offer dividends because of all their profits are reinvested to help sustain higher-than-average growth.

What is a Bond?

A debt investment with which the **investor loans money** to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate. The indebted entity issues investors a certificate, or bond, that states the interest rate (coupon rate) that will be paid and when the loaned funds are to be returned (maturity date). Interest on bonds is usually paid every six months (semiannually). The main types of bonds are the corporate bond, municipal bonds, treasury bonds, treasury notes, treasury bills, and zero-coupon bonds. The higher rate of return the bond offers, the more risky the investment. There have been instances of companies failing to pay back the bond (default), so, to entice investors, most corporate bonds will offer a higher return than a government bond. It is important for investors to research a bond just as they would a stock or mutual fund. The bond rating will help in deciphering the default risk.

Municipal Bonds
A debt security issued by a state, municipality, or county, in order to finance its capital expenditures. Municipal bonds are exempt from federal taxes and from most state and local taxes, especially if you live in the state that the bond is issued.
Such expenditures might include the construction of highways, bridges, or schools. "Munis" are bought for their favorable tax implications, and are popular with people in high income tax brackets.

Treasury Bill (T-bill)
A U.S. government debt security with a maturity that is less than one year. Treasury bills are issued through a competitive bidding process at a discount from par. This means they do not pay fixed interest payments like most bonds do.

Treasury Bond
A marketable, fixed-interest U.S. Government debt security with a maturity over 10 years.

Treasury Note (T-note)
A marketable, U.S. government debt security with a fixed interest rate and a maturity between one and 10 years. T-notes can be bought either directly from the U.S. government or through a bank.
When buying from the government you can either put in a competitive or noncompetitive bid. With a competitive bid you specify the yield you want; however, this does not mean your bid will be approved. With a noncompetitive bid, you accept whatever yield is determined at auction.
T-notes are extremely popular investments as there is a large secondary market that adds to their liquidity. Interest payments on the notes are made every six months until maturity. The income for interest payments are not taxable on a municipal or state level but are federally taxed.
We will discuss the mechanics of bonds later.

What is a Mutual Fund?

An investment company that acquires funds by selling shares to investors, and then invests the money in a diversified portfolio of investment securities. Some key advantages of investing in a mutual fund are that investors are able to diversify their holdings, and also investment decisions are made by professional money managers. There are two different kinds of mutual fund companies, closed end and open end.

- **Closed end funds**

When an investment company issues a fixed number of shares in an actively managed portfolio of securities. The shares are traded in the market just like common stock.
Most mutual funds are open-end funds, not closed-end. The main difference concerning closed-end funds is that the market price of the shares is determined by supply and demand and not by net-asset value (NAV).

- **Open end funds**

Open-end funds have no limit to the number of shares they can issue. The majority of mutual funds are open end.

Stock Funds are mutual funds which predominately hold stocks and are designed for growth, or capital appreciation. While stocks funds have greater price volatility than more conservative investments, they offer the potential for higher returns.

Bond Funds are mutual funds that invest primarily in Bonds. They provide diversification by investing in a variety of bonds according to guidelines set in the funds' Prospectuses. Bond Funds are usually categorized by the types of Bonds they invest in, for example: government Bond Funds, corporate Bond Funds, international Bond Funds, and municipal funds.

Balanced Funds are mutual funds that invest its assets into the money market, bonds, preferred stock, and common stock with the intention to provide both growth and income. Also known as an asset allocation fund.

Index Funds seek to mirror the performance of a market index (eg, S&P 500 or S&P MidCap 400). While most growth funds seek to outperform major indexes by stock selection, an Index Fund essentially seeks to replicate the performance of an Index.

Specialty Funds are mutual funds that concentrate in some specific area of the market such as real estate and/or commodities.

International and global funds are mutual funds that can invest in companies located anywhere in the world, including your own country. Many people confuse a global fund with an international fund. The difference between the two is that a global fund includes the entire world, whereas an international fund includes the entire world, except for your home country.

What is a Annuity?

A tax-deferred product that combines features of an investment and features of an insurance policy. There are generally two types- fixed annuities (pay a fixed rate of interest) and variable annuities (your return is not guaranteed but you have freedom to choose how your money is invested). Among the advantages: unlike a 401(k) or IRA, there's no dollar limit on how much you can invest with an annuity. Also, some variable annuities offer income or withdraw guarantees, which may be beneficial to a retiree. Among the disadvantages: annuities typically carry relatively higher fees and penalties than mutual funds, and annual internal costs can exceed 4%, not allowing much room fro growth.

Basic Investment Concepts & Strategies:

What is a Portfolio ?

A portfolio is the group of assets - such as stocks, bonds and mutual funds - held by an investor. To reduce their risk, investors tend to hold more than just a single stock or other asset. Think of the portfolio as a pie: each pie is divided up into specific assets such as bonds, equities, real estate, gold etc. This is called asset allocation and the diversification gained by good allocation is possibly the greatest way to reduce risk.

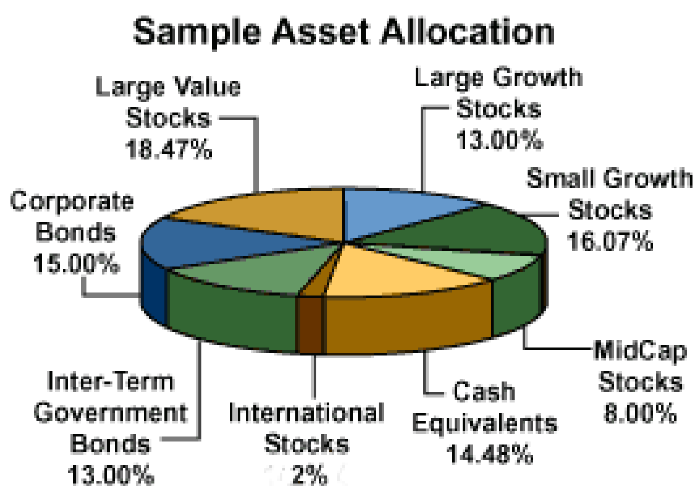
The two main investment approaches that a stock fund manager takes to reach his/her objectives are:

Growth Investing

A strategy whereby an investor seeks out stocks with what they deem good growth potential. In most cases a growth stock is defined as a company whose earnings are expected to grow at an above-average rate than its industry, or the overall market.

Value Investing

The strategy of selecting stocks that trade for less than their intrinsic value. Value investors actively seek stocks of companies with sound financial statements that they believe the market has undervalued. They believe the market always overreacts to good and bad news, causing stock price movements that do not correspond with their long-term fundamentals. The result is an opportunity for value investors to profit by taking a position on an inflated/deflated price and getting out when the price is later corrected by the market. Typically, these investors select stocks with lower-than-average price-to-book or price-to-earning ratios and/or high dividend yields.



What is Risk?

Risk is the chance that an investment's actual return will be different than the expected return. This includes the possibility of losing some or all of the original investment. It is usually measured using the historical returns or average returns for a specific investment.

Risk-Return Tradeoff

The principle that potential return rises with an increase in risk. Low levels of uncertainty (low risk) are associated with low potential returns, whereas high levels of uncertainty (high risk) are associated with high potential returns. In other words, the risk-return trade-off says that invested money can render higher profits only if it is subject to the possibility of being lost.

Because of the risk-return tradeoff, you must be aware of your personal risk tolerance when choosing investments for your portfolio. But, taking on some risk is the price for achieving returns, so, to make money, you can't cut out all risk. The goal instead is to find an appropriate balance, one that lets you sleep at night but still generates some profit. Furthermore, you want to maximize your potential return for the risk you take on, and a good asset allocation is one means of doing so.

What is Market Capitalization?

A **measure of a public company's size**. Market capitalization is the total dollar value of all outstanding shares. It's calculated by multiplying the number of shares times the current market price. This term is often referred to as market cap.

Keep in mind that classifications such as "large cap" or "small cap" are only approximations that change over time. Also, the exact definition can vary between brokerage houses.

Small Cap Funds

Mutual funds that primarily invest in small, start-up or very specialized companies. Small cap funds typically invest in companies with a market capitalization greater than $300 million but less than $2 billion.

Mid Cap Funds
Short for "Middle Cap," mid cap refers to stocks with a market capitalization of between $2 billion to $10 billion.
As the name implies, a mid-cap is in the middle of the pack. A mid-cap isn't too big, but at the same time has a relatively decent market cap.

Large Cap Funds
Mutual funds that primarily invest in stocks of large corporations such as those found in the S&P 500 like General Electric, Wal-Mart, or Microsoft. Large-Cap funds typically invest in companies with a market capitalization greater than $10 billion.

What is an Index?

Indexes are benchmarks that are used to compare the performance of funds by comparing them to an appropriate index category.

S&P 500
An index consisting of 500 stocks chosen for market size, liquidity, and industry group representation, along with other factors. The S&P 500 is designed to be a leading indicator of U.S. equities, and it is meant to reflect the risk/return characteristics of the large-cap universe.
Companies included in the index are selected by the S&P Index Committee, which is a team comprised of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value.

Dow Jones Composite

Combination of the Dow Jones Industrial Average (DJIA), Dow Jones Transportation Average (DJTA) and the Dow Jones Utility Average (DJUA).

Dow Jones Industrial

the average consists of 30 of the largest and most widely held public companies in the United States. The "industrial" portion of the name is largely historical—many of the 30 modern components have little to do with heavy industry.

MSCI EAFE Index

An index of foreign stocks which includes selections of stocks from all the developed markets in the works, minus the US and Canada. It is probably the most commonly used benchmark for “foreign” stock funds.

Russell 1000 Index

An index that measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. The average market capitalization is approximately $12.1 billion.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States

Russell 3000 Index

This index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 8% of the total market capitalization of the Russell 3000 Index. The market cap of these companies range from about $100 million to $1.2 billion.

The 'MECHANICS' of BONDS (FIXED INCOME)

When trying to understand bonds and their valuation there a couple of key concepts and terms about which we need to have a clear idea about. The basic concepts are as follows:

Nominal, principal, par or face amount — the amount on which the issuer pays interest, and which has to be repaid at the end of the term, usually set by issue price, typically $1000.

Issue Price -- — the price at which investors buy the bonds when they are first issued, and to which the coupon is fixed. This will be equal to the nominal amount. (usually $1000)

Maturity Date — the date on which the issuer has to pay back the nominal amount and make the final interest payment, ending the contract.

Coupon rate — the interest rate the issuer pays to the bond holders. Usually this rate is fixed but some bonds have floating or adjustable rates based on some measure. This will often be different from the bonds current yield, or yield to maturity based on fluctuations on the bonds current price as described below.

The main idea behind bonds is that the price of a bond remains fixed at the time of issuance and maturity; in between the price fluctuates according to the market. The coupon price does not change though. As mentioned earlier, they are normally fixed rate. Because of this, THE OVERALL LEVEL OF INTEREST RATES HAS A DIRECT BEARING ON A BOND'S PRICE. It is born at $1000, it matures at a $1000, but what happens to its price in between is set by the overall level of interest rates and any changes in the credit quality of the issuer.

THE PRICES OF BONDS ARE INVERSELY RELATED TO THE OVERALL INTEREST RATES. If rates go down, the prices of bonds will go up all else being equal. Conversely, if rates go up, the prices of bonds fall in response to higher overall interest rates. The length to maturity of a bond also has a direct impact on its price change due to interest rates. Long maturity bonds are more sensitive to this than short maturity bonds. Why? As a bond nears it maturity date and its final redemption value of $1000, it will stop responding to changes in intermediate or long term interest rate changes and start trading very close to its par value.

PRICE QUOTES: A bond is normally issued no less than $1000.00 (except for zero coupon bonds or Tbills) but it may be marked as $100.00: No need to get confused, it's a pricing convention followed on Wall St. A bond price of $1000.00 is expressed as 100.00. A premium price of 102.50, means the bond is priced at $1025.00, a discount price of 98.00 gives a bond price of $980.00 and so forth.

PREMIUMS and YTM: When you pay a premium for a bond, you will lose that premium upon the bonds maturity. Nevertheless, we call this "the devil we know versus the devil we don't know". The yield to maturity of the bond (published on the transaction notice) will account for this loss of premium. Yet, in order to preserve capital, you must be able to calculate yield to maturity on fixed income holdings. In investments such as bond mutual funds and ETF's, there is no yield to maturity given, only a current yield. What you will eventually earn on the investment is anyone's guess, as you have no maturity date or value with which to calculate your investment return, or yield to maturity—YTM. Bond funds may still be advisable for certain unique types of bonds, such as high yield or global, but then they cannot be considered fixed income by strict standards. Investors ought hold the majority of their fixed income in maturing securities where your investment results are known ahead of time. This insulates the investor against shifts in interest rates; which have been traveling lower in the U.S. for over thirty years.

What will the next ten , twenty or thirty years bring?

A commonly used, and quite effective portfolio strategy which insulates the portfolio against changes in interest rates is called LADDERING.

LADDERING is the construction of a bond portfolio with bonds maturing in consecutive time frames. For example, a laddered portfolio would include 1, 2, 5, 7 and 10 year bonds. (and possible longer). This partially insulates the portfolio against shifts in interest rates, by having both some longer term bonds, as well as bonds maturity soon after the portfolio is created.

ETF's Exchange Traded Funds

A security that tracks an index, a commodity or a basket of assets like an index fund but trades over an exchange like stocks. Most ETF's track an index like the SP 500 or MSCI EAFE (Morgan Stanley Capital International Europe Asia and Far East). ETF's are attracting more and more investors these days because of their low cost, tax efficiency and stock-like features. ETF's have historically been traded as index funds but starting 2008 the SEC (Securities and Exchange Commission) began to authorize the creation of actively managed ETF's.

ETFs generally provide the easy diversification, low expense ratios, and tax efficiency of index funds, while still maintaining all the features of ordinary stock, such as limit orders, short selling, and options. Because ETFs can be economically acquired, held, and disposed of, some investors invest in ETF shares as a long-term investment for asset allocation purposes, while other investors trade ETF shares frequently to implement market timing investment strategies.

The main reasons ETF's attract the eyes of an investor, especially in this post-crisis period are:

Lower costs – ETFs generally have lower costs than other investment products because most ETFs are not actively managed and are also insulated from the costs of having to buy and sell securities to accommodate shareholder purchases and redemptions. ETFs typically have lower marketing, distribution and accounting expenses.

Buying and selling flexibility – ETFs can be bought and sold at current market prices at any time during the trading day, unlike mutual funds and unit investment trusts, which can only be traded at the end of the trading day. As publicly traded securities, their shares can be purchased on margin and sold short, enabling the use of hedging strategies, and traded using stop orders and limit orders, which allow investors to specify the price points at which they are willing to trade.

Tax efficiency – ETFs generally generate relatively low current capital gains distributions, because they typically have low turnover of their portfolio securities. While this is an advantage they share with other index funds, their tax efficiency is further enhanced because they do not have to sell securities to meet investor redemptions.
Market exposure and diversification – ETFs provide an economical way to rebalance portfolio allocations and to "equitize" cash by investing it quickly. An index ETF inherently provides diversification across an entire index. ETFs offer exposure to a diverse variety of markets, including broad-based indices, broad-based international and country-specific indices, industry sector-specific indices, bond indices, and commodities.

Transparency – ETFs, whether index funds or actively managed, have transparent portfolios and are priced at frequent intervals throughout the trading day.

Types of ETF's:

Index ETF's: Most ETFs are index funds that hold securities and attempt to replicate the performance of a stock market index. An index fund seeks to track the performance of an index by holding in its portfolio either the contents of the index or a representative sample of the securities in the index.

Commodity ETF's: Commodity ETFs (ETCs or CETFs) invest in commodities, such as precious metals and futures.

Bond ETF's: Exchange-traded funds that invest in bonds are known as bond ETFs. They thrive during economic recessions because investors pull their money out of the stock market and into bonds (for example, government treasury bonds or those issues by companies regarded as financially stable). Because of this cause and effect relationship, the performance of bond ETFs may be indicative of broader economic conditions.

Currency ETF's: ETFs invested in a single currency or basket of currencies. Currency ETFs aim to replicate movements in currency in the foreign exchange market by holding currencies either directly or through currency-denominated short-term debt instruments. In 2005, Rydex Investments launched the first ever currency ETF called the Euro Currency Trust in New York. Since then Rydex has launched a series of funds tracking all major currencies under their brand CurrencyShares-   www.currencyshares.com

In 2007 Deutsche Bank launched EONIA Total Return Index ETF in Frankfurt tracking the euro, and later in 2008 the Sterling Money and US Dollar Money Market ETF in London.

Equity ETFs – likely the fastest growing category of ETFs and include sector strategies, investment method strategies, industry strategies, thematic strategies, and more. This is a category where the distinction between active and passive management begins to blur, and the higher associated costs related to these strategies can effect long term results and current taxation, i.e, many of these ETFs look and feel a lot like mutual funds.

Generally speaking, we observe that passive index investments often perform better than active investments in strong bull markets, while sideways or bear markets give active strategies a chance to shine.

Risk and its types:

Most investors would define "risk" as the chance of losing money. In Finance we define risk as dispersion or lack of predictability. Both are indeed correct definitions of risk, albiet from two different perspectives.

In finance, risk can be broadly classified into two categories:
Systematic risk
Unsystematic risk
Systematic risk: Risks that are related to the overall economy or markets. Basically difficult to diversify.
Systematic risk now can be categorized as follows:
Purchasing Power Risk: Risk that inflation would vary (rise).
Interest Rate Risk: Risk that interest rates will vary (go up and down).
Interest rate risks can me sub-classified into two more groups:
Price Risk: Price risk arises due to the possibility that the price of the shares, commodity, investment, etc. may decline or fall in the future.
Reinvestment rate risk: Risk that arises from the fact that dividend/interest earned from one investment cannot be reinvested with the same rate of return as it was acquiring earlier.
Business Cycle Risk: Risk that the economy might collapse around us and people might lose their jobs.
Market Risk/Psychological Risk: Market risk is associated with consistent fluctuations seen in the trading price of any particular shares or securities.

Unsystematic risk: Risk related to an individual person or market. These types of risk are normally diversifiable. The types of risk that are grouped under unsystematic risk are as follows:
Management Risk: Risk with the management of the company/firm (bad management).
Default Risk: Risk of non-payment of interest, principle or both.
Liquidity Risk: Risk that securities become more liquid.

Further Reading/Reference:
http://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm
http://www.newyorkfed.org/newsevents/speeches/2008/gei080403.html

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