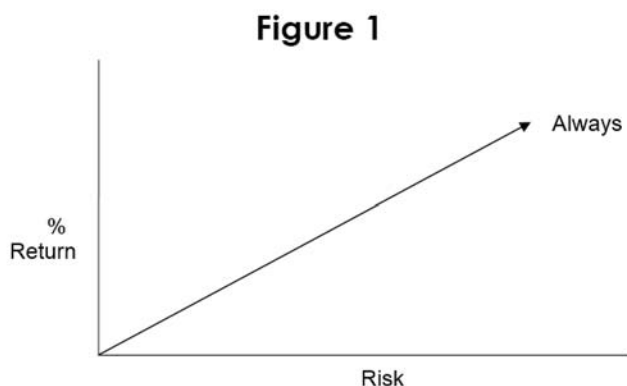
Lesson 22

Mix It Up

This lesson deals with the basics of investing, and the need to be diversified in your investments.

CAUTION: You are entering a slow read zone. **Take your time reading both this lesson and Lesson 23 – you may want to read in sections, then go back and review before reading the next section.** It may be more than some of you want to know, but these lessons will provide valuable information that will help you ask informed questions to your financial planner, 401K administrator, or yourself.

There are basic rules to remember as we approach the investment milestone. First, if a higher return is offered, there is a corresponding higher risk - see **Figure 1.**



Please note, however: the increased risk does not guarantee the higher return. **Don't fall for the "sure thing" investment. There is no sure thing in investing.**

The second fundamental rule is that your asset allocation (the mix of stocks and bonds and types within each) will have a greater impact on your investment returns than the performance of the individual investments. To quote Austin Pryor (SMI), **"Studies have shown that 80% or more of your investment return is determined by how much of your portfolio is invested in stocks versus bonds, and only about 20% is determined by how good a job you did at making the individual selections."**

To help understand the previous paragraph, let's explore the different asset types. For this study, we will limit our discussion to what can be purchased through the US stock market – stocks, bonds and mutual funds. Yes, you can purchase real estate or buy precious metals etc., but as a small investor, it is much simpler to be adequately diversified by investing in the US stock market. Plus, you actually can be invested in real estate and precious metals by investing in mutual funds that specialize in those type assets.

The following discussion is an oversimplification and is designed to provide you enough information to develop a general understanding of basic investing terminology. For more detailed information refer to the resources listed on Pages A-6 and A-9.

When you purchase a STOCK, you are an OWNER

- You can purchase shares of different size companies ("capitalization" describes size).
- Capitalization (cap) = number of shares outstanding x share price.
- Large cap (more than $5 billion in value, generally speaking); Bank of America, for example.
- Mid cap ($1 to $5 billion)
- Small cap (less than $1 billion) – could be riskier investment, but may have larger growth potential.
- Brokerage fees (buy/sell transactions) can be costly, especially with full service broker.

Two major styles of investing; Value and Growth.
- Value stock - share price compared to the overall company value appears favorable.
- Growth stock - company viewed as having potential for considerable upward growth.

When you purchase a BOND, you are a LENDER

- Bonds can be offered by a corporation, municipality, federal government etc.
- When a bond is acquired, you lend that entity money for a specified period at a specified rate of return.
- Bonds are basically IOUs –a promise to pay the bond holder the amount borrowed plus interest.
- Typically lower risk than stocks, but there are risks.
- Bonds are issued with set interest rates with different maturity dates.

  Short term (2-3 years approximately)
  Mid-term (3-10 years)
  Long term (over 10 years)

Fundamental fact: bonds are directly influenced by interest rates
- When interest rates increase, bond prices decrease.
- When interest rates decrease, bond prices increase.

For example, if you purchased a long term bond that paid 3% interest, and the overall market interest rates increased to 6%, you would continue to receive 3% on your investment. Also, the value of the bond would decrease, since it offers a lower interest rate than market rates. If you could sell the bond, it would sell for less than you paid for it. The reverse is true if you purchased at a higher interest rate and markets rates dropped. Your bond value would increase, and you would be earning a higher rate of interest than the current market rates.

Market conditions, the national economy, interest rates, and overall investor sentiment are constantly changing. If we add to that the individual investor's risk tolerance, it is clear that the small investor is best served by having funds spread over different asset types and allocated within those asset types in a variety of ways. **Figures 2 and 3 on the next page will hopefully clarify the discussion of the last few paragraphs.**

As we begin our investment career, we may have more risk tolerance and want to be more aggressive. As we approach retirement age, our stock/ bond allocation may become more conservative to reduce risk (fewer stocks and more bonds). The left hand column of **Figure 2** indicates starting with a 100% stock allocation.

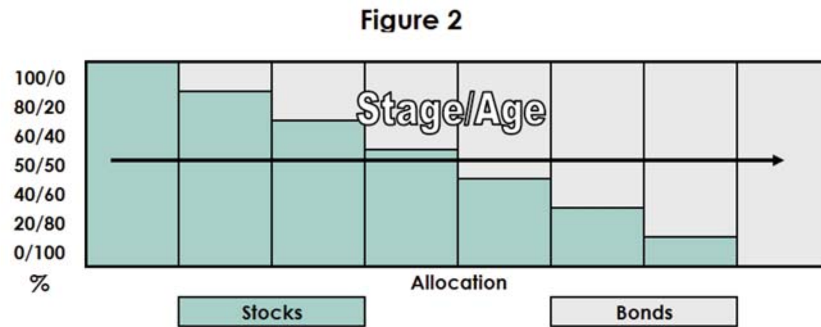


Figure 2

As time goes on, the stock percentage of our portfolio decreases and the bond allocation increases. As we mentioned earlier, bonds generally are lower risk than stocks. When we are early in our investment career, we have more time to recover from a downturn in stock prices. As we move into our retirement years, we may want to be 100% invested in bonds (right hand column), both for the security aspect as well as the fact that bonds pay interest on a regular basis, which provides an income source.

Look at **Figure 3**. If we had our investments spread over the asset types listed, we would be well diversified. For example, if the US stocks grew in value over a six month period, they would offset any potential decline in the foreign stock value and vice versa. Likewise, part of our portfolio includes bonds, which would help offset a decline in stock values.

Figure 3

Diversified Portfolio Holdings
Small Cap Growth Stocks
Small Cap Value Stocks
Large Cap Growth Stocks
Large Cap Value Stocks
Foreign/International Stocks
Bonds (short, mid, and long-term)

Figure 4 represents the portfolio of an aggressive, higher risk investor. This may be appropriate early in your investing career. You are diversified, but diversified in stocks that have more potential for growth, and carry with that potential the stronger possibility of a temporary downturn.

Figure 4

Aggressive/Higher risk Portfolio
Small Cap Growth Stocks
Large Cap Growth Stocks
Foreign/International Stocks

On the other hand, **Figure 5** represents the holdings of a conservative investor. The stocks owned are probably larger, stable companies. The stocks combined with the lower risk bonds maintains diversity, but at a much lower risk than what was represented in **Figure 4**.

Figure 5

Conservative/Lower risk Portfolio
Small Cap Value Stocks
Large Cap Value Stocks
Bonds

Now that you have a general sense of the differences between stocks and bonds and an overview of the different types of each, let me put your mind at rest for all of you whose eyes are beginning to cross. For the average person who wants to wisely invest, but doesn't have the need or desire to become a financial analyst, your investment life has been made much simpler with mutual funds.

MUTUAL FUNDS

A traditional mutual fund is a large pool of money.

- Accumulated as a result of a lot of contributions from small investors.
  - If 1 million people deposited $50 per month, the fund would have $50 million to invest.
- Managed by professional investors guided by rules developed when the fund was created.
  - Example, XYZ fund created to specialize in small companies in energy sector.
  - Manager would evaluate hundreds of companies that fit the criteria.
  - Buys shares in 80 companies, for example, and monitors performance.
    - 75 do well, 5 do not, for example.
    - Manager sells 5 non performers and invests in 5 different companies.

This is an oversimplification of the process, but provides a general understanding of how a mutual fund works.

A mutual fund's share price is computed at end of trading day.

- Price is termed Net Asset Value (NAV).
  - Price per share that you and I pay if we purchase shares in fund.
  - An NAV of $20 would allow us to purchase 5 shares for $100.
  - Using previous example of XYZ fund – We would own 5 shares of the XYZ fund.
    - But the risk for our $100 would essentially be spread across 80 companies!
  - No other way for the small investor to be so diversified!

There is a cost for owning mutual funds, but the cost is minimal.

- Some funds (called "no-load") can be bought and sold without a commission.
- Annual administrative costs, however – typically about 1% annually.
- Fund's gain should well exceed costs in a good year.
- Be aware of a possible short term redemption fee if the fund is sold shortly after acquiring.
  - A 1% or 2% short-term redemption fee is not uncommon for a fund held less than 60 days.
  - Mutual funds are not designed to be traded frequently like individual stocks.
- Fees are listed in each fund's "Prospectus" (governing and performance document).
- Prospectus also lists the minimum investment required to make an initial purchase.
  - Minimum investments range from $50 to several thousand.
  - Amount depends on the fund and if the fund is maintained within a retirement account.

Overall, there are numerous advantages for investing in mutual funds. Here are a few:

1. Reduces the anxiety of investing by being well diversified and managed by professionals.
2. Can be purchased in small amounts within a retirement account – easy to get started.
3. Can be purchased on a recurring basis – monthly contributions, for example.
4. Funds are less volatile in price swings than individual stocks.
5. Performance is public record. Each fund is required to publish a prospectus outlining guidelines.
6. Dividends can be easily reinvested.
7. Can be used in your retirement plans (individual accounts and employer accounts).
8. Can be sold when necessary – fairly liquid asset.
9. Relatively low administrative cost, and generally, no cost to buy and sell for certain funds.
10. Mutual funds are regulated by the federal government.
11. While not FDIC insured, they provide a safe place for your investment money.
12. Administrative paperwork is handled for you.

INDEX FUNDS

A special kind of mutual fund is called an "index fund".

- Only one objective: to mirror the performance of a particular market index.
    - Example, Standard and Poor (S&P) is a financial company which monitors performance of companies around the world.
    - One index is made up of 500 large companies – called the S&P 500.
    - Portfolio manager for the S&P 500 index fund invests in the same securities (stocks) used in calculating the index, i.e., the same 500 companies.
    - If S&P 500 increases (or decreases) by 10%, the S&P 500 index fund price will do the same.
    - Your investment dollars are even more diversified (500 companies, in this case).
    - By using index funds, you keep pace with overall markets with little effort.

Exchange Traded Funds (ETF)

An Exchange Traded Fund (ETF) is a different type of index fund.

- Trades like an individual stock - share value fluctuates throughout the market day.
- Advantage in that it can be purchased in very small quantities (a single share).
- Can be sold as quickly as it was purchased without short-term redemption fees.
- Tremendous variety of ETFs from which to choose.
- Management requires less research and labor, so administrative fees are less.
- However, brokerage commissions can be costly if bought in small quantities.
- Share price can be influenced by the overall market conditions.
    - Could over or under inflate price compared to overall value of represented companies.

In the next lesson, we will discuss the different options you have to manage your overall investment portfolio. **For now, realize that traditional Mutual Funds, Index Funds and Exchange Traded Funds will likely be the primary vehicles to help you meet your investment goals.**

REFLECTION: Based on your risk tolerance assessment, where do you see yourself on the graph in Figure 1? How about Figure 2. Does the topic of investing create confusion for you? Would you be more comfortable having someone else manage your investments? Your answers will help you consider options discussed in the next lesson. **Record your thoughts:**

ACTION STEP: If you are participating in an employer sponsored retirement plan, determine the different types of investments represented in your account. In light of this lesson, assess how your account is being managed (diversified, low risk, high risk, conservative, aggressive). Discuss with your account administrator to ensure your investment portfolio is in line with your temperament and stage of life.

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