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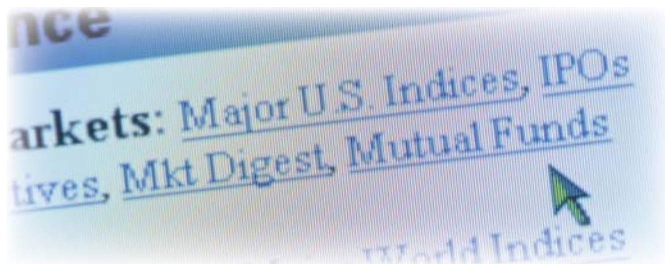

Investments

Investment Choices

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Investing is the act of placing one's money in something that has the potential to make money or increase in value. In other words, you are trying to "grow" money. There are several different types of investments. This fact sheet will focus on the common investment choices of stocks, bonds, and mutual funds.

Money market funds, certificates of deposit, and savings accounts are also investment choices. Because of their low risk level, these choices are not usually considered investments.

Additional investment choices are: real estate; limited partnerships; U.S. Treasury bills, bonds and notes; annuities, gold and silver; and jewelry and other collectibles.

The most common investment choices are stocks and bonds. Most people end up investing in these choices through a mutual fund. Investing in a stock or a bond means that you either purchase a portion of the company or you lend your money to a company.

If you purchase part of a company, you share in the profits of that company and the growth in the company's net worth. With a bond, the company (a corporation or government) promises to repay your original money and interest for the privilege of using your money. The risk level with stocks and bonds is higher than the risk level for certificates of deposit and savings accounts. But there is potential for a greater return on your money with stocks and bonds.

In recent years, mutual funds have become quite popular. A mutual fund is an investment choice where a fund manager picks the stocks and bonds in which your money is invested. You are pooling your money with other investors. The amount of money you make varies. Usually, you earn more money than with a savings account or a certificate of deposit. The risk is usually less than when you pick your own array of stocks and bonds.

Stocks

When you purchase stock in a company, you are purchasing a share of ownership in that company. The more shares you own, the more of the company you own. The value of each share of stock changes depending on how the company manages its finances and its overall value.

A company board of directors sells shares of stock to raise money (capital) for running the company. After the initial stock offering, some investors decide to sell their shares of stock, while others decide to purchase shares. All of this activity is done through a stock exchange.

There are two types of stock–common and preferred. Common stock is what you own when you purchase a portion of the company. In exchange for

return

your purchase, you receive a stock certificate that is your title of ownership. Usually, the stockbroker who makes the transaction for you keeps the stock certificate at his or her office. This makes it more convenient to surrender your certificate(s) when you sell the stock.

The company shares the profits of the company with shareholders in the form of a dividend. The amount your money grows depends on the increase in value of a share of stock and the dividends paid. The company board of directors decides when and how much of a dividend to pay to shareholders.

Preferred stock is also traded through a stock exchange. It has characteristics of both bonds and stocks. At times, preferred stock can be converted to common stock shares in the same company. Preferred stock usually has a fixed dividend rate. Therefore, investors in preferred stock usually know what extra money they will receive from this type of stock. The dividend income from preferred stock is usually higher than for common stock. Preferred stock rarely increases in value in any significant amount.

If a company is dissolved, preferred stock shareholders can claim money from their ownership before common stock shareholders. Thus, the risk is somewhat less with preferred stock over common stock.

risk

Bonds

When you purchase a bond, you are lending your money to a corporation or government entity. You do not have ownership in that company. Bonds have a fixed interest rate. When you purchase a bond, you know that you loaned your money to the bond issuer for a specified period of time for an agreed amount of interest.

Bonds come with various names. Corporate bonds are issued by corporations and backed by the assets of that corporation. Government bonds are backed by faith and the taxing power of the government agency issuing them. Other types of bonds are discount bonds, zero coupon bonds, convertible bonds, and warrant bonds.

Some government bonds are tax-exempt. This means that the interest you receive from the bond issuer does not have to be included in your taxable income. If this is a feature that appeals to you, be sure you know if the tax exemption is for both federal and state taxes or just for one of them. In some states, interest from bonds is also exempt from state taxes. Some bonds are tax exempt in the state where they are issued but not necessarily tax-exempt in the state where you reside. This varies from state to state. Be sure to check with your accountant or stockbroker if this is a consideration for you.

While bonds traditionally have been considered a safe investment, some investors do not want to have their investment money locked into a 20-year bond. When interest rates are declining, a lock-in is a good idea. However, when interest rates are rising, the market value of bonds declines. Interest rates fluctuated so much during the 1970s and 1980s that bonds became less attractive to some investors. Interest rates were more stable during the 1990s, so some investors once again began favoring bonds.

As with shares of stock, bonds can vary in degree of risk. The safety of investing in a bond depends on the ability of the issuing organization to repay the loan you made and to pay the interest periodically. Some bonds are risky and others are quite safe. Be sure to know the bond rating and the amount of risk before you purchase any bond.

A discount bond is a bond whose price has dropped since it was first issued. This may be caused by increasing interest rates since the initial issue. If you are considering investing in a discount bond, calculate the yield to maturity and any capital gains consequences when it matures. This will help you know the overall return for your money.

Zero-Coupon Bonds. Zero-coupon bonds do not pay interest. The purchase price is below face value. At maturity you receive the face value of the bond. If you are considering a zero-coupon bond, check with your stockbroker or accountant on the tax consequences. Some bonds of this type have annual tax consequences from "implied interest," even though you never receive any cash interest payment in hand.

Convertible bonds. Convertible bonds are purchased originally as a bond but have the option of being converted to common stock. The bond is exchanged for common stock. There can be an expiration date for converting the bond to common stock. In general, convertible bonds have an investment value greater than common stock. The value tends to vary at the same rate as the common stock for the same company. Interest is usually paid more frequently than the dividends on the common stock.

Warrant Bonds. Warrant bonds are similar to convertible bonds. A warrant entitles you to purchase shares of common stock in the company. However, you must pay additional cash and surrender your warrant certificate for the common stock. Warrants have a specified time period. Once they expire, the warrant has no value.

Mutual Funds

Mutual funds come in many varieties. Basically, they are pooled money funds that are invested in a variety of common stocks, corporate bonds, tax-free bonds, and even in money market funds, and they are managed professionally. As with stocks and bonds, they have different risk levels.

If you are considering a mutual fund, determine the focus of the mutual fund. The mix of investments will vary depending on the objective of the fund. Mutual funds can be stock funds, taxable bond funds, tax-exempt bond funds, or stock and bond combined funds.

Mutual stock funds have different objectives. Here are the terms that are used to group this category of mutual funds: capital appreciation, growth, growth and income, equity income, small capital, medium capital, sector, global stock, international stock, European Region, Latin America, Pacific Region, emerging markets, science and technology, health and biotechnology, natural resources, gold, and utility.

Bond mutual funds categories include: short-term, intermediate, long-term, general, high yield, mortgage, and world.

The combined stock and bond mutual funds are categorized as balanced and stock/bond blend.

The big advantage of mutual funds is that the investor does not have to pay as much attention to the daily activities of the stock market and bond funds. The actual transactions are done by the fund manager. However, the investor needs to keep track of how the mutual fund is performing.

Know your investment goals before you invest. Determine if you want growth, income, tax-exempt income, or a balance. Determine at what risk level you are comfortable. Never invest assets that you are not willing to lose.

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