Introduction

The most common ways that people invest are by putting money into assets such as stocks, bonds, and mutual funds (collectively called securities).

Why People Invest

- To achieve financial goals, such as the purchase of a new car, a down payment on a home, or paying for a child's education.
- To increase current income.
- To gain wealth and a feeling of financial security.
- To have funds available during retirement years.

Prerequisites to Investing

- Balance your budget.
- Continue a savings program.
- Establish sufficient emergency fund and credit card maximum limits.
- Carry adequate insurance to protect against major catastrophes.
- Establish investment goals.

An Investment Plan

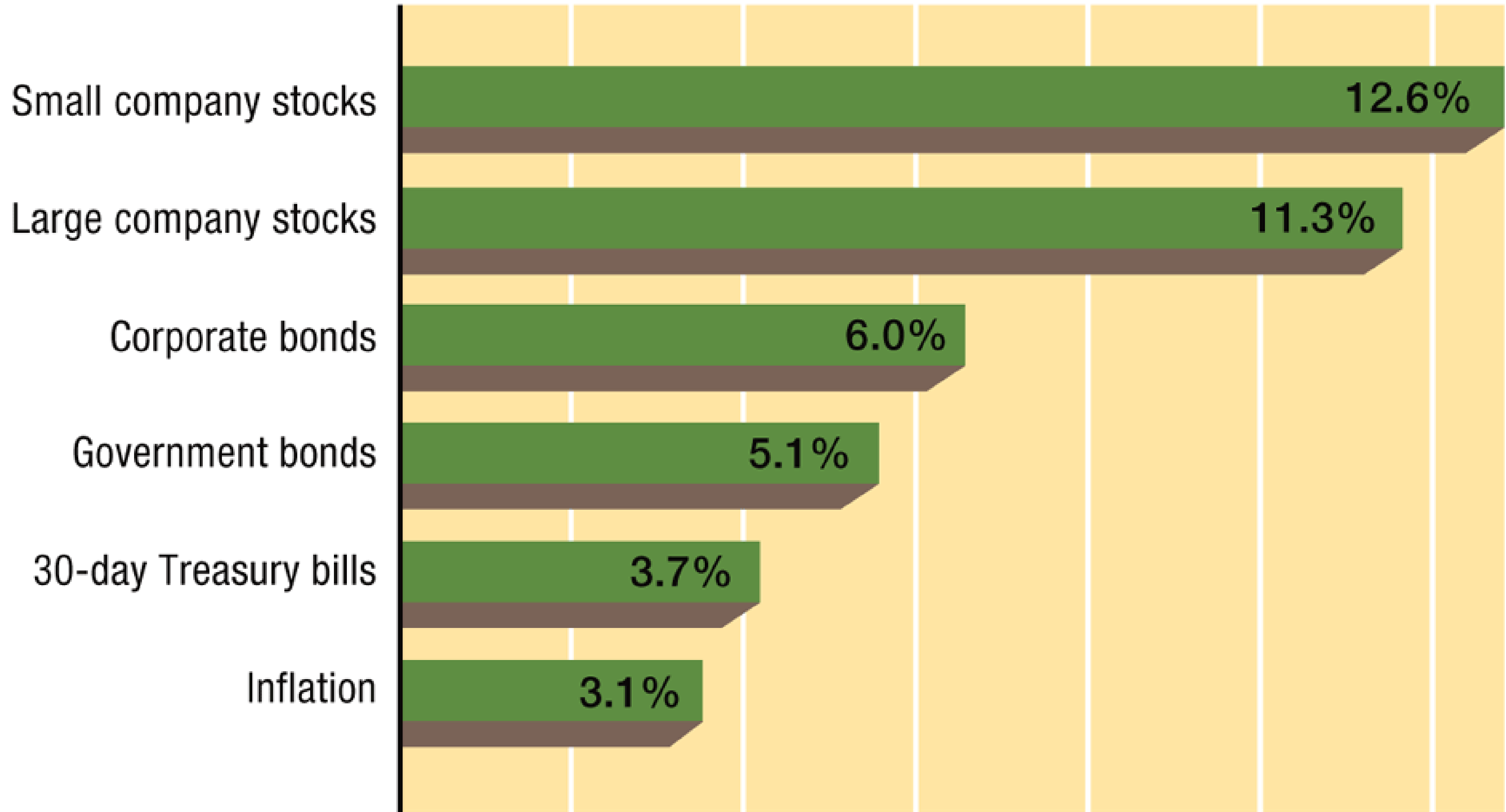
Investment Plan – explanation of how your funds will be invested for the purpose of reaching a specific goal.

- **Example:** Invest $5,000 per year for 5 years at 8% for house downpayment (reason for investing)

Investment Returns

- **Return** – income an investment generates from current income and capital gains.
- **Current Income** – money received while you own a investment (e.g., interest, rent).
- **Dividend** – portion of a company's earnings that a firm pays out to its shareholders.
- **Capital Gain** – occurs *only* when you actually sell the investment; it results from an increase in the value of the initial investment.

Figure 13.1: The Long-Term Rates of Return on Investments



How Do You Handle Investment Risk?

- **Investment Risk** – the uncertainty that the yield on an investment will deviate from what is expected.
- **Risk Premium** – the difference between a riskier investment's return and the totally safe return on the T-bill.
- The greater the investment risk, the higher the *potential* return

Ultraconservative "Investors" Are Really Just "Savers"

- People that invest very conservatively
- They do not get ahead financially over the long term because taxes and inflation offset most of their interest earnings

- Remember "The Rule of 72"?
  - 72/4% = 18 years
  - 72/8% = 9 years (money doubles much faster)

What Is Your Investment Philosophy?

- Conservative?
- Moderate?
- Aggressive?

Investment Risk Tolerance Quiz
available online at:
www.rce.rutgers.edu/money/riskquiz/

Should You Take an Active or Passive Investing Approach

- **Active Investor** – carefully studies the economy, market trends, and investment alternatives.
  - Buys individual stocks
- **Passive Investor** – does not actively engage in trading of securities or spend large amounts of time monitoring his or her investments.
  - Buys mutual funds

Identify the Types of Investments You Want to Make

Do You Want to Lend Your Money or Own an Asset?

- Debts – “**loanership**” (lending) investments.
  - **Fixed Maturity** – the borrower agrees to repay the principal to the investor on a specific date.
  - **Fixed Income** – the borrower agrees to pay the investor a specific rate of return for use of the principal.

- Equities – “**ownership**” investments.
  - Potential for a higher return by sharing in profits

Investment Risk

Speculative Risk – involves potential for either gain or loss.

Common Types of Investment Risk

- Inflation Risk
- Business-Cycle Risk
- Marketability Risk
- Reinvestment Risk
- Interest-Rate Risk
- Liquidity Risk

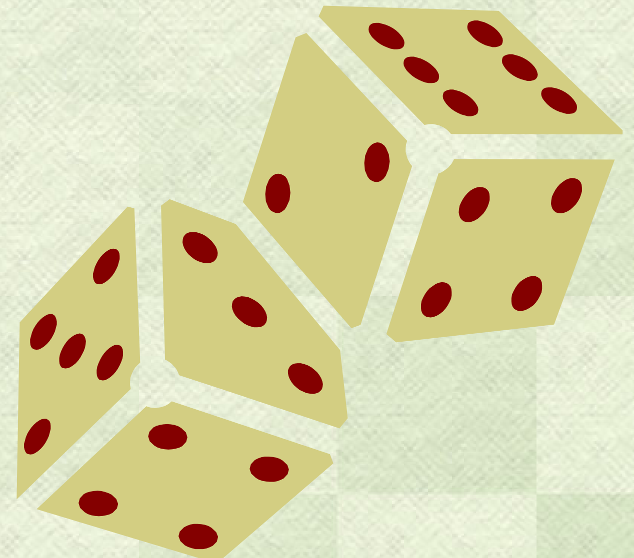
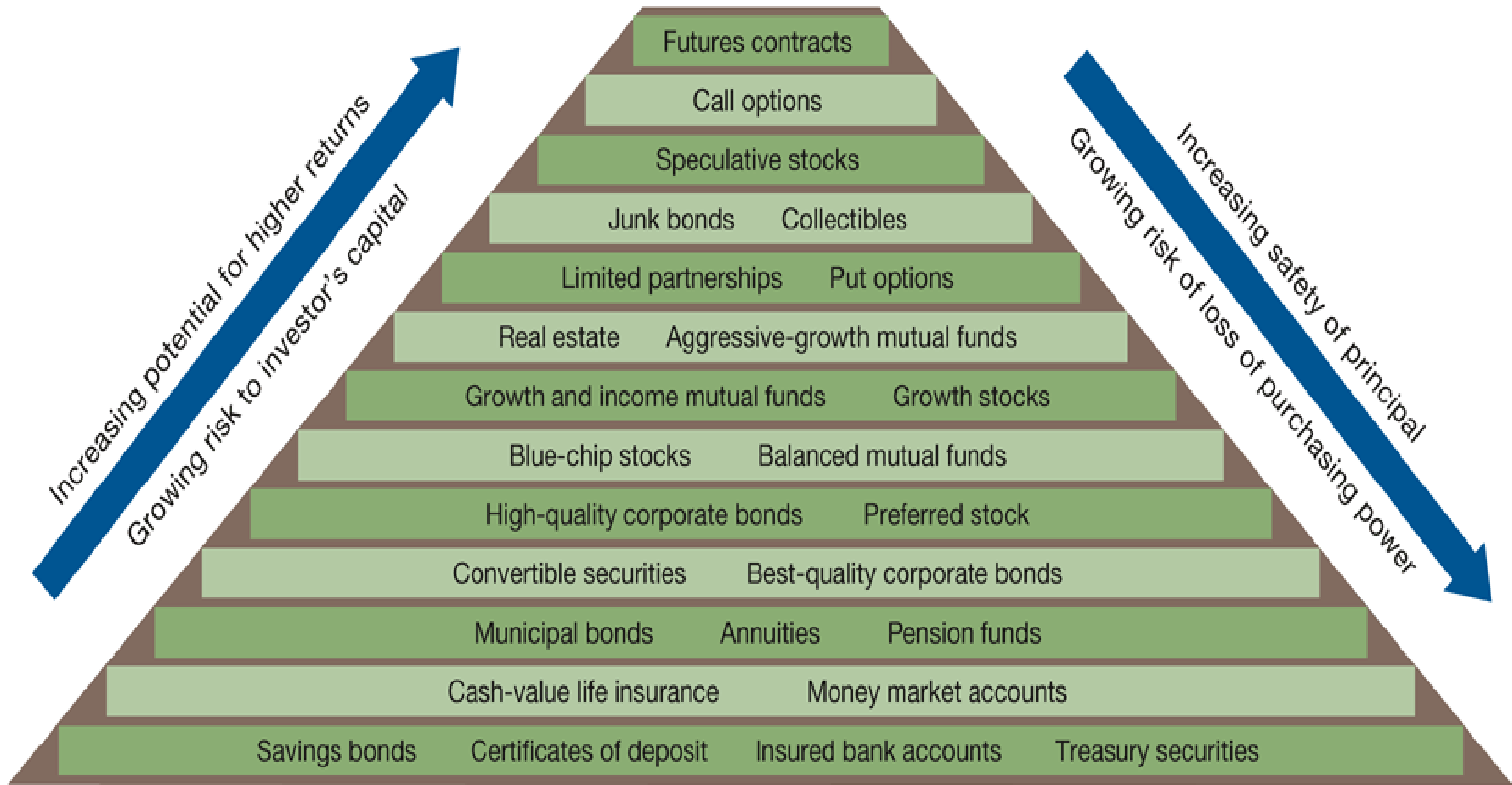
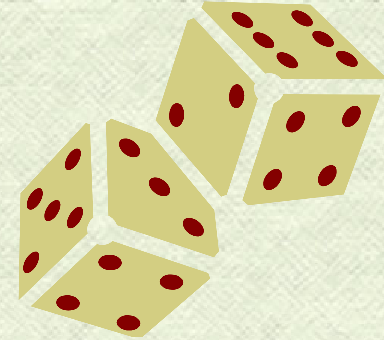


Figure 13.2: The Risk Pyramid Reveals the Trade-offs Between Investment Risk and Return



Random and Market Risk

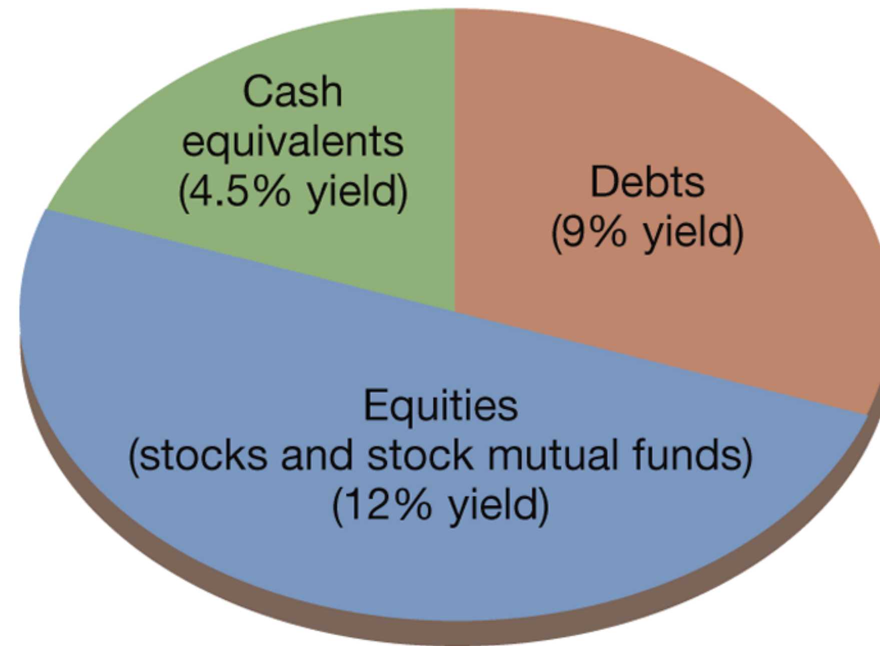


Market Risk (or Systematic Risk) – the value of an investment may drop due to events that affect all similar investments.

- To address market risk, an investor should diversify among stocks and bonds, while maintaining some funds in cash equivalents (savings).

Diversification – the process of reducing risk by spreading investment money among several investment opportunities.

Figure 13.3: One Effect of Diversification: A Lower Total Return



50%	of portfolio earning 12%	(50 x 0.12)	=	6.0%
30%	of portfolio earning 9%	(30 x 0.09)	=	2.7%
20%	of portfolio earning 4.5%	(20 x 0.045)	=	0.9%
100%	of portfolio earning		=	9.6%

Leverage

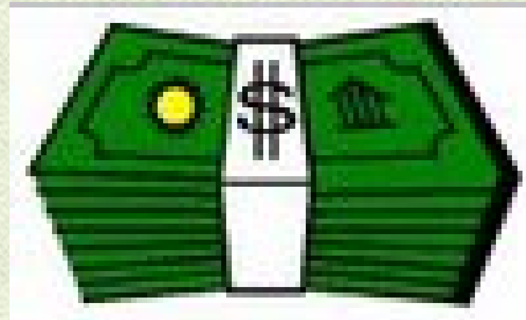
Leverage – borrowed funds are used to make an investment with the goal of earning a return in excess of the after-tax costs of borrowing.

- **Common example:** primary residences

Commissions and Transaction Costs

Commissions – fees or percentages of sales paid to salespersons, agents, and companies for their services – that is, to buy or sell an investment.

Buy "no load" investments, if possible.



Inflation

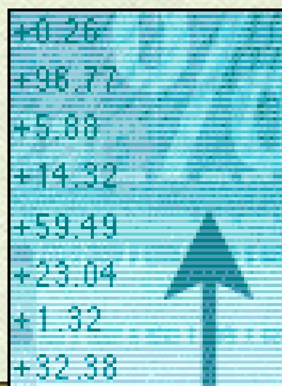
- To beat inflation, one must invest money so that it earns a higher return than the inflation rate
- **Real Rate of Return** – the return after subtracting the effects of both inflation and income taxes.

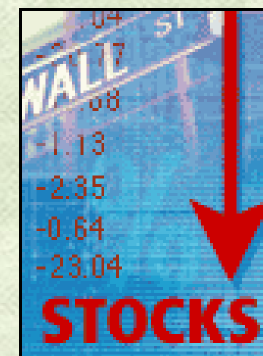
Example:

10% return, **7.5%** after taxes (25% tax bracket), **4%** inflation, real rate of return of **3.5%** after taxes and inflation

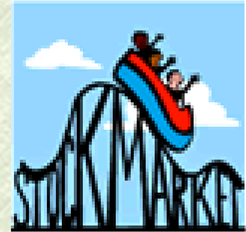
Other Important Terms

- Securities Markets – places where stocks and bonds are traded. **Examples?**
- **Bull Market** – when securities prices have risen 20 percent or more over time.
- **Bear Market**- – when securities prices have decreased 20 percent or more over time.





Strategy: Buy-and-Hold Anticipates Long-Term Economic Growth



- Most investors use this method.
- Hold diversified assets in good times and bad.
- Investor buys a widely diversified mix of stocks or mutual funds, reinvests the dividends by buying more stocks and mutual funds, and holds on almost indefinitely.
- The investor expects that the value of assets will increase over the long run with the growth of the American and world economies.

Strategy: Asset Allocation Keeps You in the Right Investment Categories at the Right Time

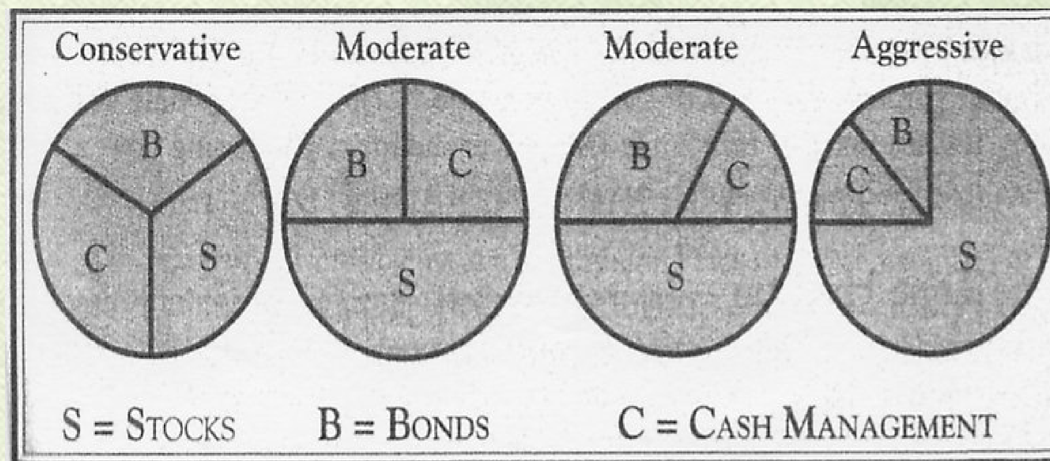
Asset Allocation – deciding the proportions of your investment portfolio that will be devoted to various categories of assets.

Example:

50% stock

30% bonds

20% cash assets



Strategy: Modern Portfolio Theory Evolves from Asset Allocation

- **Modern Portfolio Theory** – the goal is to identify investor's acceptable risk tolerance and find an optimal portfolio of assets that will have the highest expected returns for that level of risk.
- **Monte Carlo** – an analytical technique for solving a problem by performing a large number of trial runs, called simulations.
  - Commonly used for retirement planning projections

Strategy: Dollar-Cost Averaging

- **Dollar-Cost Averaging** – a systematic program of investing equal sums of money at regular intervals regardless of the price of the investment.
  - **Example:** investing $50 a month in XYZ mutual fund
- Invest automatically
- Buy more shares when stock price goes down
- Reduces average share costs

Figure 13.4: Illustrative Diversified Investment Portfolios

Conservative Investment Philosophy (aiming for a 5 or 6% annual return, accepts little risk, aims to preserve capital, needs current income to live on, appropriate for divorced mothers/retirees)

Blue-chip stock funds	Balanced mutual funds	Growth stock funds	Long-term bond funds	CDs and short-term bond funds	Money market funds
15%	10%	10%	15%	30%	20%

Moderate Investment Philosophy (aiming for an annual return of 8–10%, average risk tolerance, seeks steady growth, use funds for future goals, appropriate for anyone under 60 years of age)

Aggressive-growth stocks	Stock mutual funds	Blue-chip stock funds	Foreign mutual funds	Long-term bond funds	CDs and short-term bond funds	Money market funds
10%	25%	10%	10%	25%	10%	10%

Aggressive Investment Philosophy (aiming for a 15% or higher annual return, risk seeker, aiming for maximum capital gains, use funds for future goals, appropriate for anyone under 40

Aggressive-growth stocks or stock mutual funds	Growth mutual funds	Foreign growth mutual funds	Small-cap stocks	Long-term bond funds	Money market funds
30%	10%	20%	15%	15%	10%

Steps to Take for Effective Long-Term Investing

1. Identify your personal investment philosophy.
2. Keep an eye on local situations.
3. Set a time horizon for investing objectives.
4. Choose your preferred investment medium.
5. Invest in companies and industries that will outearn their competitors.
6. Develop a plan for investing and stick with it.
7. Maintain a diversified portfolio.
8. Invest regularly, reinvest your earnings, and relax

Golden Rules of Investment Fundamentals

1. Spend less than you earn and sacrifice some income to invest for your future lifestyle.
2. Diversify by assets – stocks, bonds, mutual funds, gold, and real estate.
3. Diversify by geography – Canada, U.S.A., International
4. Diversify by style and size – Value/Growth, Small/Mid/Large Cap
5. Look out for the “de-worsification trap”
6. It is okay to take profits
7. Start early in life to invest in a manner that is consistent with your investment philosophy.