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Investment Alternatives...For The Beginner

This publication discusses risks associated with investing, and then gives a brief introduction to 21 investment alternatives. The alternatives are classified into seven types of investments.

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Risks Associated With Investing

There are many types of risk involved with investments. Let's consider two types: investment risk and purchasing power risk.

Investment risk is the probability that the actual return on an investment will be different from what you expect. This is the type of risk one usually thinks of when considering investments. For example, CD's and EE savings bonds are considered safe investments because the probability that the actual return on your investment will be what you expect is 100 percent. They are guaranteed. On the other hand, stocks are considered more risky because you have no guarantee about the actual return.

Of equal importance is a second type of risk associated with investments which is also important to consider. **Purchasing power risk** is the risk that the value of the money you invest will not keep up with inflation. In general, this risk is greatest with those investment alternatives with a set, guaranteed rate of return. So while CD's have a low investment risk, they have a high purchasing power risk.

Investment Alternatives

Type 1 investments have the lowest investment risk but the highest purchasing power risk. These include insured savings accounts, certificates of deposit, FE and HH savings bonds, treasury securities, and government agency securities.

Type 1 Investments:

Insured Savings Accounts
Certificates of Deposit
EE and NH Bonds
Treasury Certificates
Government Agency Securities

- ***Insured Savings Accounts***. Passbook savings accounts, credit union shares, and interest-bearing checking accounts generally are insured savings accounts. Some advantages of these accounts are that your money is instantly available; funds can be used as collateral for a personal loan; and funds are extremely safe if kept in a federally insured institution. However, any interest earned is subject to federal and state income tax law.

- ***Certificates of Deposit (CD's)***. Money in a CD is tied up from a few months to six years or more depending on the terms of the specific CD you buy. A notice of withdrawal is required and a penalty imposed if you withdraw money before the CD matures. Interest earned is higher than paid on insured savings accounts. The longer you tie up money in a CD, the higher the interest rate earned. Interest is paid either at time of purchase or at maturity, depending on the policy of the financial institution. In most cases, the more money you invest, the higher the rate of interest earned. All earnings are subject to income tax. CD's are available from banks, savings and loans and credit unions. No purchase fees are charged.

- ***EE and NH Savings Bonds***. Ten-year series EE bonds are issued at a discount and earn a variable rate of interest. The smallest denomination is the $50 bond sold for $25. Tax on interest is not paid until the bond is redeemed unless the owner opts to pay taxes each year. Series NH bonds are sold at par (face value) and pay a fixed rate of interest if held to maturity (10 years). Interest is paid each year and taxes must be paid on earned interest. $500 is the smallest HH bond.

- ***Treasury Securities***. Treasury **bills** represent short-term debt of the U.S. government and are sold in denominations of $10,000 to $1,000,000 for 3 to 12 months. Treasury **notes**, intermediate debt, are sold in denominations of $1,000 to $1,000,000 for 2 to 10 years. Treasury **bonds**, long term debt of the government, are sold in denominations of $1,000 to $1,000,000 for 10 years or more. These securities can be purchased from a broker or financial institution or directly from the Federal Reserve. Yields are usually higher than that paid for savings bonds. Interest earned is not subject to state or local taxes, but federal income tax must be paid. Treasury securities can be sold at any time in a secondary market, but their value rises and falls throughout the time before they mature.

- ***Government Agency Securities***. Government agencies also issue notes and bonds. These are usually sold in amounts ranging from $1,000 to $25,000. Interest paid is generally higher than that paid for treasury securities. Bought from a financial institution or broker, these securities are issued by agencies such as Tennessee Valley Authority, Federal Home Loan Banks, Federal Land Banks, and the Federal National Mortgage Association.

  The second type of investment alternatives include money markets and tax-exempt bonds. They have slightly more investment risk and slightly less purchasing power risk than the first group.

Type 2 Investments

Money Markets
Tax-Exempt Bonds

- ***Money Markets***. Available from financial institutions, money markets give the smaller investor the opportunity to get in on treasury securities. The institution buys a variety of treasury securities with the money you invest. The rate of return changes daily, and services such as check-writing may be offered.
- ***Tax-Exempt Bonds***. Often referred to as municipal bonds, tax-exempt bonds represent state and

local government debt. A city, town, or a village and also states, territories, and U.S. possessions, housing authorities, port authorities, and local government agencies may issue these bonds. Interest earned is exempt from federal income taxes and from state and local income taxes if bonds issued are from your state or city. Interest rates are determined by the general level of interest rates and by the credit rating of the issuer. The seller of these bonds has tables showing you what the tax-exempt yields of these bonds are equivalent to in taxable yield for your tax bracket. As little as $1,000 may be invested in these bonds, available from a broker or a financial institution.

Type 3 investments include corporate bonds and corporate stocks. Higher investment risk and lower purchasing power risk are represented by these investment alternatives.

Type 3 Investments

Corporate Bonds
Corporate Stocks

- ***Corporate Bonds***. Corporate bonds return their face value when they mature; in the meantime, their value fluctuates daily. Bonds are graded; high quality corporate bonds may actually belong in group two while speculative bonds would belong in group five. Bond ratings can be checked in these publications: *Moody's Industrial Manual or Standard and Poors Register of Corporations*. Both are available at most libraries. The highest quality bonds are graded AAA or Aaa on down to C, D, and even non-rated issues.

  When you buy a bond you are lending money to the business issuing the bond. In return for use of your money, you are promised a specified rate of interest called the coupon rate. In general, bonds are safer than stock since bond holders are paid their interest first before stockholders are paid profits. Some bonds are convertible; that is, they can be changed into common stock of the issuing firm. Some bonds also have callable features; this means that a company has the right to have you redeem your bonds before the maturity date. Bonds are issued in denominations of $1,000, but some sell at a premium. This is a price higher than $1,000. Others sell at a discount which is a price lower than $1,000. Bond prices are affected by such factors as current interest rates, maturity date, and the bond's rating.

- ***Corporate Stock***. Like bonds, there are different classes of stock. High grade preferred and blue chip stock would be in Type 3 while speculative stock would be in Type S.

  When you own stock, you own a part of the issuing corporation. The value of stock can rise or fall depending on such factors as the growth of the company, general economic conditions and market conditions. When you sell stock, the difference between what you paid for the stock and what you sell the stock for (minus any sales commission) represents your gain or loss. If the corporation is earning profits, shareholders will get a portion of the profits in the form of dividends, usually paid quarterly.

  Blue chip stock is the stock of well known companies that have a long and consistent record of making profits while preferred stocks are those that provide an income in the form of dividends. Dividends are paid to preferred stockholders before they are distributed to common stockholders. Some preferred stock is convertible; the owner can convert preferred stock into common stock of the same company.

Type 4 Investments

Stock Options
Limited Partnerships

Type 4 investments include stock options and limited partnerships. More investment risk and less purchasing power risk are involved with these alternatives than with those of the previous groups.

- ***Stock Options***. A stock option gives the owner the right to buy or sell a certain stock within a specified time period. A call option is the right to buy while a put option is the right to sell. If you buy a **call option**, you are betting that the price of the stock will rise; if you buy a **put option**, you are betting that the price of the stock will fall. When you buy options, you do not purchase the stock itself. Potential for gain, and for loss, can be quite high; this is definitely not an investment alternative for beginners.

- ***Limited Partnerships***. Investing in limited partnerships means you own part of whatever the partnership owns. Your liability is also limited to the percentage of the partnership you own. Limited partnerships require time and knowledge, and, like stock options, are not for beginners.

Type 5 represents investment alternatives with the least amount of purchasing power risk but with the greatest amount of investment risk. The chance of gain or loss with these alternatives is usually great. Definitely not for beginners, investors in group five alternatives must have a great deal of knowledge about the alternatives in which they are investing, and must be willing to spend time with their investments.

Type 5 Investments

Collectibles
Futures
Precious Metals, Gemstones

- ***Collectibles***. Antiques, coins, stamps, art objects, Coca Cola memorabilia, and baseball cards represent the thousands of items which might be classified as collectibles. Their value depends on whether there is a market at a given time as well as the condition of the particular item. Unless you are an expert, collectibles are a very risky investment. Even if you are an expert, you will still be dealing with considerable risk. For middle-income people, investment experts say to buy collectibles mainly for the enjoyment you get from owning them, not as an investment.

- ***Futures***. A future is an agreement for the future delivery of a commodity at a specified date. Commodities traded in the futures market include such agricultural products such as wheat, soybeans and livestock, and stock index futures. While futures are used by businesses as a hedge against unfavorable price changes and by speculators who take the risk of such contracts in the hopes of high returns, they are not for beginning investors.

- ***Precious Metals, Gemstones***. With a high investment risk and low purchasing power risk, precious metals like gold and silver, and gemstones such as diamonds take a great deal of knowledge as an investment alternative. While they may be considered a hedge against inflation, precious metals and gemstones are another investment alternative which is definitely not for beginners.

The first five types of investment alternatives have been presented in the order of increasing investment risk and decreasing purchasing power risk. Now let's look at two special types of investment alternatives.

Type 6 Investments

Real Estate
One's Own Business

- ***Real Estate, One's Own Business***. These two investment alternatives make up Type 6. They probably could fit somewhere in the last three groups described, but their exact placement is impossible because the relative amounts of investment risk and purchasing power risk depend on the exact piece of real estate or business being considered. Both alternatives usually require a great deal of time and knowledge to be successful investments. Again, they are not for most beginners.

Type 7 is a special group of investment alternatives including life insurance; annuities; mutual funds; and IRA's, Keogh's, and similar retirement investments.

Type 7 Investments

Life Insurance
Annuities
Mutual Funds
IRA's, Keogh's

- ***Life Insurance***. The traditional purpose of life insurance is income protection for dependents in the event of death of a breadwinner. The newer forms of life insurance combine this traditional purpose with various investment programs. The actual place of a particular life insurance policy in one of the first five types of investment alternatives depends on how the life insurance company invests the money you pay in premiums and the stability of the life insurance company itself.

In some newer forms of life insurance, you have the right and responsibility to choose where your money will be invested. Again, the relative value of investment risk and purchasing power risk depends on the particular investment alternatives chosen by either the company or by you, and the stability of the particular life insurance company. Commissions and management fees also are part of the newer forms of life insurance which include an investment component. For more information about life insurance as an investment, the study packet Insurance Insights is available at cost from the Cooperative Extension Service.

- ***Annuities***. Annuities are usually sold by life insurance companies, but should not be confused with life insurance. While life insurance is bought to provide a source of income for dependents, annuities are bought to provide you (and possibly your spouse) a source of income when you retire. An annuity program makes money management decisions easier, but should never be considered as your sole source of retirement income. You are guaranteed a fixed amount of income monthly, and assured that you will receive this amount for as long as you live. Purchasing power risk can be fairly high since the benefits of annuities are fixed. Investment risk depends on the stability of the company. Annuities also have more than one form. Some of the newer forms have additional advantages as investments under the Tax Reform Act of 1986.

- ***Mutual Funds***. Mutual funds are investment companies that use the funds from investors to invest in other companies or investment alternatives. They have the advantage of professional management, diversification, convenience and special services such as check writing and telephone account service. It is generally easy to sell mutual fund shares although you run the risk of needing to sell and being forced to take the price offered. Mutual funds come in various types, allowing you to choose those funds with objectives which most closely match your own personal investment objectives. A load mutual fund is one that has sales charge or commission attached. The fee is a percentage of the initial investment. Generally, mutual funds sold through brokers are load funds while funds sold directly to the public are no-load or low-load. As an investor, you need to decide whether you want to take the time to research prospective mutual funds yourself or pay the commission and have a broker who will do that for you. All funds have annual management fees attached.

- ***IRA's, Keogh's, and Similar Retirement Investments***. Individual Retirement Accounts (IRA's) are a way of setting up an investment which will provide income for retirement. For those people who are not covered by qualifying pension plans, taxes on the investment earnings are deferred until the money is taken out. Almost any investment alternative already identified in this publication can be used for this purpose. Further information on IRA's is available in the study packet, *IRA'S -- Individual Retirement Account*, available at cost from the Cooperative Extension Service.

Choosing an Investment Advisor

Before you start to look for an investment advisor, know what your investment goals are. The clearer your goals are to you, the easier you will be able to explain them to someone else.

If you do not have an investment advisor, ask friends, relatives, and business associates for recommendations. Check for suggested names from other financial advisors also. Then schedule an initial interview with at least three of the names recommended to you. This initial interview should be at no cost to you.

During the interview explain in general what your investment goals are, approximately what your present asset situation is and approximately what your annual income is. Then ask what general recommendations that person would make for someone in your situation. Ask what their personal philosophy of investing is -- you are trying to find an investment advisor whose philosophy matches your own.

Ask for references from past clients and follow up on those names. While you know the person will only name references which will reflect favorably, checking with references can give you additional insight into how a certain person operates. Ask references these questions:

- How often are clients contacted?
- How easy is he or she to get a hold of when you need to talk to your investment advisor?
- How have they handled past mistakes? What has their performance record been? Are you comfortable with the person? Do you feel you can ask questions and have confidence in the answers?
- Check the fee schedule of the person's firm as well as the firm's performance record. How have actual accounts performed in the past five to ten years?
- Check for special services such as check writing.
- What provisions are there if you need to get part of all of what you have invested in case of an emergency?

Immediately cross off any person or firm who pushes you to "sign up now."

Don't expect an investment advisor to be right all of the time. They are human and will make mistakes. What is more important than always being right is that your investment advisor is honest and straightforward; provides good service; understands your investment goals; and works for, and with, you.

Investment Tips For Beginners

1. Know your investment goals and their priority.
2. Diversify to spread risk.
3. Establish a solid financial base before starting to invest.
4. Gear investments to your situation, both financial and personal.
5. Match investments with your risk tolerance level.
6. Adopt an investment strategy.
7. Stay flexible and adapt to change in your situation and in the economy.

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