**Day 22 Homework: Introduction to Investments**

Read and take notes on the section titled “Investment Considerations: Liquidity, Risk, and Return” in your textbook, p. 112. Also read and take notes on the article below.

**Investment Basics**

**Stocks, Bonds and Cash Investments**
The three major asset classes of investing include [stocks](http://www.collegeadvantage.com/cms.aspx?SectionID=83#stocks), [bonds](http://www.collegeadvantage.com/cms.aspx?SectionID=83#bonds), and [cash investments](http://www.collegeadvantage.com/cms.aspx?SectionID=83#cash).

**Stocks**
Stocks, (also called equities) represent shares of ownership in a particular company, and have provided the highest long-term returns historically. They are also the most volatile, and you may experience sharp rises and falls throughout the years.

As with most things in life, the potential reward from owning stock in a growing business has some possible pitfalls. Shareholders also get a full share of the risk inherent in operating the business.

**Advantages** - Stocks have a long historical track record of outperforming other investments, such as bank deposits, money-market funds, CDs, bonds, real estate and commodities. Over the long run, stocks have typically gained an average of about 10% a year, helping them to stay well ahead of inflation, which has averaged more than 3% a year. To enjoy these long-term returns, investors have had to brace themselves against sharp declines from time to time. Plus, a stockholder or shareholder has voting rights that bondholders and bank depositors do not have.

**Disadvantages** - Stock prices often go up and down. They are never guaranteed. A shareholder may lose part or all of his money.

**Mutual funds**
Most people do not own individual stocks, but instead invest in the stock market through mutual funds. A mutual fund is simply a collection of stocks and/or bonds. On the whole, because of the administrative fees associated with running a mutual fund, the average mutual fund returns approximately 2% less per year to its shareholders than does the stock market in general.

**Mutual fund advantages** - Diversification. Buying a mutual fund provides instant holdings of several different companies. While this dilutes earnings of top-performing stocks, it also spreads the risk and shields investors from sub-par performance. A mutual fund also offers liquidity. Like individual stocks, a mutual fund investment can be converted into cash upon your request. Finally, accessibility. Investing in a mutual fund is much more readily accessible to the average investor than purchasing individual stocks.

**Mutual fund disadvantages** - No control. Unlike picking your own individual stocks, a mutual fund lets someone else pick them for you. Dilution of earnings can also be a disadvantage. Mutual funds generally have such small holdings of so many different stocks that insanely great performance by a fund's top holdings still doesn't make much of a difference in a mutual fund's total performance. Likewise, however, a mutual fund’s small holdings of individual stocks also shields investors from huge losses when an individual stock declines sharply or the issuer declares bankruptcy.

**Bonds**
Bonds are known as "fixed-income" securities because the amount of income the bond will generate each year is "fixed," or set, when the bond is sold. No matter what happens or who holds the bond, it will generate exactly the same amount of money.

Bonds are in essence loans to a government or a company, and have provided lower long-term returns—an average of about 6% a year—than stocks, but their returns usually have been less volatile than those of stocks. Investors typically invest in bonds for two reasons: for interest income and to help smooth the ups and downs of stock investing.

One of the most important things to know about investing in bonds is that bond prices and interest rates move in opposite directions. When interest rates rise, bond prices fall; when interest rates fall, bond prices rise.

**Advantages** - Bonds give higher interest rates compared to short-term investments. Bonds are generally less risky compared to stocks.

**Disadvantages** - Selling bonds before they’re due may result in a loss. If the issuer of the bond declares bankruptcy, you may lose money.

**Bond Rating**
One of the risks of investing in bonds is a default, which occurs when the issuer of the bond fails to make payments. To keep investors informed about the chance that a bond will default, companies such as Standard & Poors (S & P) and Moody’s give ratings to bonds. The higher the rating, the lower the chance that a bond will default. S & P grades bonds from AAA, AA, A ... to D. Moody’s rates bonds from Aaa ... to C. A strong company gets AAA or Aaa. AAA or Aaa means the chance of the entity defaulting on the bond is very small.

Low rated bonds are called junk bonds. A junk bond is issued by a weak company that may have trouble paying its bills. To compensate the risk an investor takes in purchasing a junk bond, it pays a higher interest rate.

**Cash investments (capital preservation)**Investing for the long term usually brings to mind stock and bond options. But did you know that having some of your portfolio invested in cash options, such as CDs and money market funds, plus good old-fashioned savings accounts, is also part of a smart college-saver’s strategy?

Capital preservation options include money market funds, bank certificates of deposit (CD's), U.S. Treasury bills and other accounts that hold ready money, and thus provide the lowest returns, but are relatively safe. They are appropriate when you know you'll need to cover a big expense in the next year or two.

**Certificates of Deposit (CDs)**
CDs have the highest earnings potential of cash options, but they do require you to let the bank hold the funds for a fixed period of time. CDs are issued with a variety of maturity dates, ranging from three months to 10 years or more. Traditional CDs require a minimum deposit of at least $1,000 or more, and are insured by the FDIC. If you cash in your CD before the maturity date, you’ll have to pay an early redemption penalty.

**Money market funds or accounts**
Banks and investment companies offer money market accounts or money market mutual funds. Money market mutual funds are a type of mutual fund that invests in short-term debt securities, and generally offer slightly higher rates of return than money market accounts found in banks. Investment company money market funds, like the CollegeAdvantage Vanguard Prime Money Market Option, are not FDIC-insured. However, these funds seek to maintain a net asset value of $1 per share.

**Savings accounts**
Savings accounts allow you to keep your money in a safe place, immediately accessible, while it earns interest each month. There is usually no minimum, or a very low minimum balance required. Funds are FDIC-insured.

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