WEALTH CARE KIT℠




Investment Planning

SmartAboutMoney.org

A website built by the National Endowment for Financial Education dedicated to your financial well-being.

Do you have long-term goals you're uncertain how to finance?

Are you a saver or an investor? Have you been reluctant to invest money because you think the stock market is too risky? Do you want to know more about the fundamentals of developing a sound investment program?

This section contains information that will help you answer some of these questions. It will explain:
- the difference between saving and investing
- investment risks and how to control them
- the different types of investments available
- how to match investments with your goals
- ten keys to successful investing

THE IMPORTANCE OF INVESTING

While people commonly use the words "saving" and "investing" interchangeably, there are important distinctions. Saving typically means putting aside money in "low-risk" passbook savings accounts, money market funds, or certificates of deposit (CDs) for short-term goals, such as buying a new car, taking a family vacation, or establishing an emergency fund. It's money you want to be able to get to quickly, easily, and with little or no risk that you'll lose what you set aside.

Investing, on the other hand, means putting money into assets, such as stocks, bonds, mutual funds, and real estate, that historically have earned a higher rate of return than common savings products. If you deposited $2,000 in a savings account at 3 percent annual interest, it would grow to $3,612 in 20 years (before taxes). The same $2,000 invested in a stock mutual fund earning an average 10 percent a year would grow to $13,455 in 20 years (before taxes)! Investments are usually selected to achieve long-term goals, such as paying for college education or funding retirement.

INVESTMENT RISKS

"But what about the risks?" you may ask.

Yes, every investment involves risk. Anyone who claims otherwise is either naive or trying to sell a lie. Even so-called low-risk or no-risk savings alternatives involve risk. Let's look at two of the most important types of risk.

Market risk. The prices of stocks, bonds, mutual funds, real estate, gold, and other investment assets rise and fall due to the economy, investor sentiment, political events, changing interest rates, changes in the fortunes of companies or industries, and other factors. All investment assets fluctuate to some extent. This is the type of risk people most associate with investing.

Inflation risk. Inflation basically means that receipt of a dollar tomorrow is worth less than receipt of a dollar today. Inflation is a silent thief that, over time, can rob your savings of significant buying power. For example, even at a modest 3 percent annual inflation rate, $1,000 today will buy only $554 worth of goods 20 years from now! Looked at another way, a $12,000 new car today will cost $21,673 in 20 years. Under these circumstances, a savings account earning 3 percent will only break even in terms of purchasing power. Subtract taxes on the earnings, and the savings account will actually lose ground.

In addition to understanding the different types of risks, it's important to understand that the willingness and ability to withstand short-term price fluctuations generates greater long-term rewards. This relationship is illustrated in the investment pyramid on page 5. Stocks fluctuate more than CDs, for example. With stocks, you can lose part or even all of your investment in a short period of time. Yet, over the long term, stocks on average have consistently and substantially outperformed cash and the thief of cash: inflation.

HOW TO CONTROL INVESTMENT RISK

If accepting greater risk is one of the necessities of investing, then one of the keys to investing is controlling risk. Three controls on investment risk are diversification, consistent investing, and time.

Diversifying your investments means never putting all of your eggs into one basket. A well-balanced investment portfolio involves spreading investment funds among different types of assets, which might include stocks, bonds, real estate, cash or cash equivalents, and international investments, and investing in different securities within each type of asset. This reduces risk, because even though one or more investments might falter, others will gain.

For example, if you have all of your investment money in a single asset, such as your company stock purchased through a retirement plan, and the value of that asset plunges 50 percent, you've lost half of your total investment. However, if the company stock makes up only 10 percent of your portfolio, the total value of the portfolio would decline by only 5 percent. Meanwhile, other investments in the portfolio may be rising, so that overall the portfolio grows in value.

Another way to control risk is to invest consistently. One popular method is known as dollar-cost averaging. Each month, for example, you invest a specific amount of money, regardless of whether the market is up or down. You'll buy some shares when it's high, and some shares when it's low, but since markets generally rise over time, you'll come out ahead. This is a good strategy because predicting the best time for making an investment is so difficult.

Research also has shown that time reduces the risk of investing. The price of a given investment—particularly one in a more volatile category such as stocks—may rise and fall within a short period of time. But over the long run, many investments gain back any losses in value...and then some. That's why investing is a long-term strategy for long-term goals (typically five years or longer) and why many investment experts recommend that investors buy and hold investments instead of trying to guess whether to buy or sell based on current market indicators (known as market timing).

> "DIVERSIFYING YOUR INVESTMENTS MEANS NEVER PUTTING ALL OF YOUR EGGS INTO ONE BASKET."

TYPES OF INVESTMENTS

There are many types of investments, but the most common are stocks, bonds, mutual funds and cash equivalents.

If you buy stock, you are buying a share of ownership in a company.
Advantages include:
• Capital appreciation. If you sell an asset for more than you paid for it, you make what's called a capital gain. The gain, potentially, could be many times your investment and there may be tax advantages.

• Dividends. Many stock investments provide a quarterly stream of dividends, or income, from the company's profits. Research has shown that unless you need current income, it's best to reinvest any dividends to grow your investments.

Capital appreciation plus dividends equals the total return on your investment in common stocks. Studies indicate that, over longer periods of time, common stocks provide significantly higher total returns than bonds or cash equivalents.

Owning stocks has disadvantages, as well:
• Capital loss. As an owner, you're not guaranteed that you'll get back all or part of your investment.

• Volatility. In the short term, stocks tend to fluctuate in value much more than do bonds and cash equivalents.

When you invest in a bond, you are lending money to a company, or the government, that promises (though not necessarily guarantees) that it will pay back your principal with interest. Bonds include Treasury bonds, municipal bonds, and corporate bonds.

Advantages include:
• You receive a fixed stream of income.

• Government and high-grade corporate bonds have relatively little risk of default.

• Yields usually are higher than with CDs and money market accounts.

• Some types of bonds, called municipal bonds, pay interest that is free from federal (and, in some cases, state and local) tax.

Disadvantages include:
• Bond holders cannot share in the growth of the company.

• Bonds can lose purchasing power if interest payments are lower than the combination of the inflation rate and your tax rate.

• You can lose money on your investment if you sell the bond before it reaches its maturity date (when principal is repaid) and interest rates have risen since you bought the bond. (When interest rates go up, bond prices fall.)

Cash equivalents are short-term, interest-bearing securities such as CDs, money market accounts, and Treasury bills. They fluctuate little, if at all, and you can convert them to cash quickly and easily. However, their interest rates generally are close to the inflation rate, so cash equivalents serve best for short-term needs or as a temporary "parking place" until you move the money into more attractive investments.

Other types of investments include real estate (your home, commercial property, etc.), precious metals (such as gold and silver), and energy (oil and gas).

INVESTMENT PRODUCTS

You can invest in a variety of ways. Stocks and bonds, for example, can be bought and sold individually or through mutual funds. Real estate can be bought directly or through limited partnerships, which are groups of individuals who gather for the purpose of investing, or through real estate investment trusts, which invest in real estate properties or mortgages and whose shares are traded like stocks.

A popular way for many people to invest is through mutual funds. Mutual funds pool money from many shareholders to buy securities. Mutual funds have different objectives: some buy the stocks of new or emerging companies that may offer no dividends, but have strong potential for capital appreciation; some funds invest in bonds and dividend-paying stocks to provide current income for their shareholders; other funds focus on overseas investments or on certain industries or sectors of the economy. There are countless variations, and it's important that you learn through a fund's prospectus exactly what objectives and strategies the fund uses.

"A POPULAR WAY FOR MANY PEOPLE TO INVEST IS THROUGH MUTUAL FUNDS."

For the small investor with limited capital to invest, mutual funds offer the advantages of diversification (each fund may hold from 25 to over 100 different securities), small initial investment (typically $2,000), and professional management. Trying to diversify by buying individual stocks, bonds, or other securities usually requires more money, time, expertise and risk tolerance, but the potential reward can be greater.

Another popular way to invest is through Exchange Traded Funds (ETFs). ETFs are similar to mutual funds with a few key differences. An ETF mirrors the performance and diversification of a stock or bond index. Just as mutual funds pool money from many investors to buy securities, ETFs do the same. But while most mutual funds can only be bought or sold once a day at market closings, ETFs can be bought and sold any time the markets are open, just like individual stocks or bonds. ETFs tend to have lower operating costs than mutual funds, and they are usually more tax efficient.

Many people invest through their company retirement or savings plan, such as a 401(k) or profit-sharing plan. In these "qualified plans," the investment earnings are tax deferred. Each plan typically offers a choice of investments, such as mutual funds, guaranteed investment contracts, money market funds, and so on. Similar investment options can be found in individual retirement accounts, annuities, and cash-value life insurance.

A GAME PLAN

Once you understand the fundamentals of investing, you can develop an investment plan or strategy. This involves first clarifying your goals, such as early retirement, current income, or saving for college education. How much money will you need to achieve these goals and how much time do you have? Be as specific as possible.

Next, define your investment objectives. What types of investments and what investment products will help you reach your goals? If you have 30 years to retirement, you may want to consider investing the majority of your funds in aggressive growth mutual funds through your 401(k) plan because they offer capital appreciation and you'll have time to ride out the ups and downs of the market. If you're approaching retirement, you may want to consider less volatile investments that will provide high current income; but you'll still need some growth funds in your portfolio to stay ahead of inflation during your retirement years.

Whether you're trying to reach one goal or several, the combination of investments you make is called a portfolio. Your plan should state what percentage of the total portfolio will consist of stocks, bonds, cash or cash equivalents, international investments, precious metals, real estate, or other types of investments you choose. How much you allocate to each category will depend on your goals, risk tolerance, time horizon, age, and amount of funds to invest. A diversified portfolio is more likely to reduce risk and stabilize return.

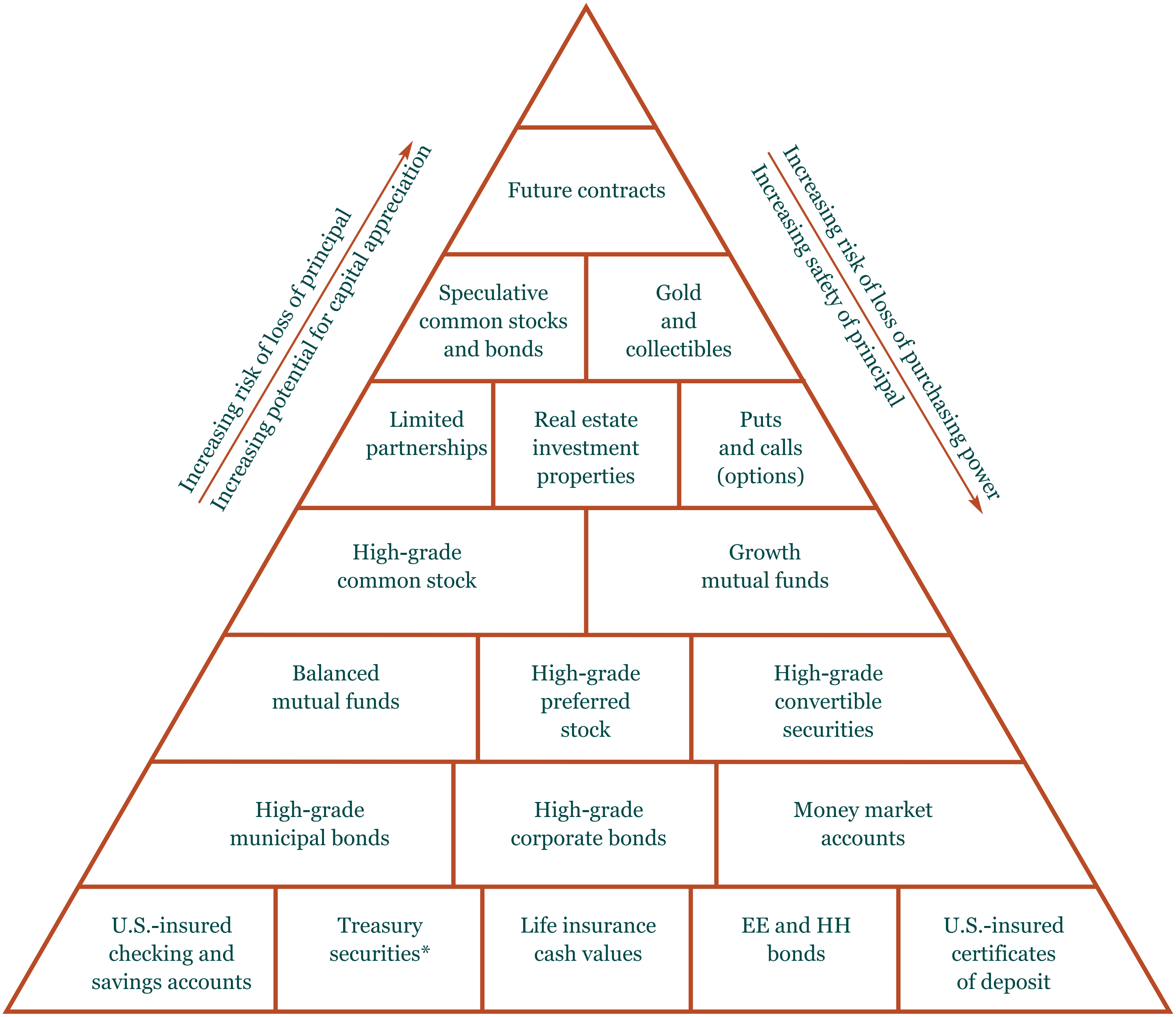
A well-thought-out investment plan is critical, because you will use it to monitor your progress. It also keeps you steady through good times and bad and helps you avoid those tempting "hot" investments that really don't fit your needs.

Finally, if you work with an investment adviser, make sure the adviser helps you develop a written investment policy statement. It specifies your investment goals, risk tolerance, acceptable asset classes, and investment performance measurement criteria.

Ten Keys to Investment Success

1. Develop a plan and link it to your financial goals.
2. Diversify by owning different types of assets and securities.
3. Invest for the long term.
4. Have realistic expectations. It's rare to increase return without increasing risk, or vice versa.
5. Never invest in anything you can't "sleep on."
6. Monitor the performance of your investment portfolio at least annually.
7. Take full advantage of tax-deferred retirement programs.
8. Avoid buying any investment that claims you can earn a great return for little risk. If an investment looks too good to be true, it probably is.
9. Take control of your investments. Stay informed. Even if you work with financial professionals, you must be the one ultimately responsible for your decisions.
10. Don't invest in something you don't understand.

INVESTMENT VEHICLE PYRAMID: RISK/RETURN TRADE-OFF



* If held to maturity. Otherwise, they are subject to volatility due to interest rate risk as with any other type of bond.

- Investment products at the top of the pyramid tend to be non-liquid and speculative in nature.
- Investment products at the top of the pyramid offer a greater potential reward through capital appreciation, but also have a greater potential for the loss of principal.
- Investment products at the bottom of the pyramid tend to be liquid (easily converted to cash with little principal fluctuation) and offer a stable, but lower rate of return. While investment products at the bottom of the pyramid pose little risk of loss of principal, there is little or no potential for capital appreciation. Because of this, if the rate of return is less than the rate of inflation, there is a risk that purchasing power may be lost over time.
- Investment products in the middle of the pyramid offer a combination of moderate risk and return.

Growth in the U.S Stock Market

A $100 INVESTMENT IN STOCKS IN 1979, WOULD TODAY BE WORTH OVER $2,300.

Source: Lipper, as of June 30, 2005. Hypothetical gains (or profits) on stocks are based on returns of the S&P 500. It is important to remember that there are many ways to invest, and diversifying your investments can reduce risk.

Ranking Your Investment Objectives

Before you can select an appropriate investment portfolio, you must first identify and rank your investment objectives. Several investment objectives are listed below. Rank these objectives from 1 (most important) to 10 (least important). After completing this ranking exercise, you will have a clearer idea of your investment priorities. Use this information when choosing investment products or when working with a financial professional.

________ Minimize the risk of loss of principal.

________ Maximize the potential for large short-term gains.

________ Ensure slow, stable growth to fund long-term future needs, such as retirement or a child's education.

________ Maximize liquidity in the event funds are needed in a hurry.

________ Maximize current income to provide for current needs.

________ Reduce income taxes.

________ Build savings toward short- or mid-term major purchases, such as a down payment on the purchase of a home.

________ Maximize the value of your estate for your heirs.

________ Minimize the amount of estate taxes owed upon your death.

________ Protect assets from the claims of creditors or others.