Investment Basics: What You Should Know

Table of Contents

The world of investing can seem mind-boggling for a beginning investor. How do you decide what type of security to invest in? Should you choose stocks, bonds or a combination of investments? What about mutual funds? How do you choose a particular fund, stock or bond? How do you assess the risk to your money?

This Financial Guide provides a starting point for inexperienced investors. It describes how securities markets work, what protections are afforded, the general types of securities available, the interaction of risk and reward and how to select the investments appropriate for your risk tolerance.

go to top

How Securities Are Bought and Sold

The term "securities" encompasses a broad range of investments, including stocks, corporate bonds, government bonds, mutual funds, options, and municipal bonds. Investment contracts, through which investors pool money into a common enterprise managed for profit by a third party, are also securities. Securities may be traded on an organized exchange or traded "over the counter" between investors.

Exchanges

Securities are bought and sold in a number of different markets. The best known are the New York Stock Exchange and the American Stock Exchange, both located in New York City. In addition, six regional exchanges are located in cities throughout the country.

A corporation's securities may be traded on an exchange only after the issuing company has applied to the exchange and met any listing standards relating, for example, to the company's assets, number of shares publicly held, and number of stockholders. Organized markets for other instruments, including standardized options, impose similar restrictions. The exchanges facilitate a liquid market for securities where buyers and sellers are brought together. Listing on an exchange, however, does not constitute approval of the securities or provide any assurance as to risk and return.

Over-The-Counter

Many securities are not traded on an exchange but are traded over the counter (OTC) through a large network of securities brokers and dealers. In the National Association of Securities Dealers' Automated Quotation System (NASDAQ), which is run by the National Association of Securities Dealers (NASD), trading in OTC stocks is done via on-line computer listings of bid, which asks prices and completes transactions.

Like the exchanges, NASDAQ has listing standards that must be met for securities to be traded in that market. Similar to an exchange it provides a "meeting place" for buyers and sellers. The typical investor generally will not know whether their security is bought or sold through an exchange or over the counter. The investor engages a broker who arranges the transaction in the appropriate market at the desired price.

Brokers

If you buy or sell securities on an exchange or over the counter, you will probably use a broker, and your direct contact will be with a registered representative. The registered representative, often called an account executive or financial consultant, must be registered with the National Association of Security Dealers (NASD), a self-regulatory organization whose operations are overseen by the Securities and Exchange Commission (SEC), and with the states in which the broker is conducting business. The registered representative is the link between the investor and the traders and dealers who actually buy and sell securities on the floor of the exchange or elsewhere.

go to top

How Prices are Established

How are the stock prices that appear in the financial section of the newspaper arrived at? Market prices for stocks traded over the counter and for those traded on exchanges are established in somewhat different ways.

Exchange Prices

The exchanges centralize trading in each security at one location, on the floor of the exchange. There, auction principles of trading set the market price of a security according to current buying and selling interests. If such interests do not balance, designated floor members known as specialists are expected to step in to buy or sell for their own account, to a reasonable degree, as necessary to maintain an orderly market.

Over the Counter (OTC)

In the OTC market, brokers acting on behalf of their customers (the investors) contact a brokerage firm which holds itself out as a market-maker in the specific security, and negotiate the most favorable purchase or sale price. Commissions received by brokers are then added to the purchase price or deducted from the sale price to arrive at the net price to the customer.

In some cases, a customer's brokerage firm may itself act as a dealer, either selling a security to a customer from its own inventory or buying it from the customer. In such cases, the broker hopes to make a profit on the purchase and sale of the security, but no commission is charged. Instead, a retail "mark up" is added to the price charged by the firm when a customer buys securities and a "mark down" is deducted from the price paid by the firm when a customer sells securities.

Bid and Ask Prices

In both cases, a stock is quoted in terms of bid and ask. The bid is the price at which the market or market maker is willing to buy the security from you. Similarly, the ask is the price at which the market or market maker is willing to sell the security to you. Not surprising, the ask price is higher than the bid price. The difference between the two is called the spread. For example, if a stock is quoted 18-18 ¼, this means that the investor could sell the stock for $18 a share or purchase the stock for $18.25. The higher the spread the more the market maker profits and the higher the cost is to investors. Heavily traded securities typically have narrow spreads while infrequently traded securities can have wide spreads.

go to top

How Your Securities are Protected

Investors' money is protected in three ways: by federal laws and regulations that are enforced by the SEC (Securities and Exchange Commission); by self-policing in the industry; and by state law.

Under federal securities laws, those engaged in the business of buying and selling securities have a great deal of responsibility for regulating their own behavior through SROs (self-regulatory organizations) operating under the oversight of the SEC. These SROs include all of the exchanges; the NASD; the Municipal Securities Rulemaking Board (MSRB), which establishes rules that govern the buying and selling of securities offered by state and local governments; and other organizations concerned with somewhat less visible activities such as the processing of transactions.

The SROs are responsible for establishing rules governing trading and other activities, setting qualifications for securities industry professionals, regulating the conduct of their members, and disciplining those who fail to abide by their rules.

In addition, the federal securities laws provide investors with certain protections, including the ability to sue if they have been harmed as a result of certain violations of those laws.

Many brokerage firms require that their customers sign an agreement containing an arbitration clause when they open a brokerage account. If you sign an agreement with an arbitration clause, you are agreeing to settle any future disputes with the broker through binding arbitration, instead of through the courts.

Arbitration proceedings are administered by the SROs, and the rules that apply in arbitration proceedings are specified by each SRO. Although the SEC oversees the arbitration process, it cannot intervene on behalf of, or directly represent individual investors. Nor can the SEC modify or vacate an arbitration decision. The grounds for judicial review are very limited.

Further protection for investors is provided by state laws designed to regulate the sale of securities within state boundaries.

The Function of the SEC

The SEC, an independent agency of the U.S. Government, was established by Congress in 1934 to administer the federal securities laws. It is headed by five Commissioners, appointed by the President, who direct a staff of lawyers, accountants, financial analysts, and other professionals. The staff operates from its headquarters in Washington, D.C. and from five regional offices and six district offices in major financial centers throughout the country.

The SEC's principal objectives are to ensure that the securities markets operate in a fair and orderly manner, that securities industry professionals deal fairly with their customers, and that corporations make public all material information about themselves so that investors can make informed investment decisions. The SEC accomplishes these goals by:

- Mandating that companies disclose material business and financial information;
- Overseeing the operations of the SROs;
- Adopting rules with which those involved in the purchase and sale of securities must comply; and
- Filing lawsuits or taking other enforcement action in cases where the law has been violated.

Despite the many protections provided by federal and state securities laws and SRO rules, it is important for investors to remember that they have the ultimate responsibility for their own protection. In particular, the SEC cannot guarantee the worth of any security. Investors must make their own judgments about the merits of an investment.

What Companies Must Disclose

Before any company offers its securities for sale to the general public (with certain exceptions), it must file with the SEC a registration statement and provide a "prospectus" to investors. In its registration statement, the company must provide all material information on the nature of its business, the company's management, the type of security being offered and its relation to other securities the company may have on the market, and the company's financial statements as audited by independent public accountants. A copy of a prospectus containing information about the company and the securities offered must be provided to investors upon or before their purchase. In addition, most companies must continue to update, in filings made with the SEC, this disclosure information quarterly and annually to ensure an informed trading market.

The SEC reviews registration statements and periodic reports for completeness, but the SEC does not review every detail and verification of each statement of fact would be impossible. However, the securities laws do authorize the SEC to seek injunctive and other relief for registration statements containing materially false and misleading statements.

Persons who willfully violate the securities laws may also be subject to criminal action brought by the Department of Justice leading to imprisonment or criminal fines. The laws also provide that investors may be able to sue to recover losses in the purchase of a registered security if materially false or misleading statements were made in the prospectus or through oral solicitation. Investors must seek such recovery through the appropriate courts, since the SEC has no power to collect or award damages or to represent individuals.

How the SEC Supervises Industry Professionals

Another important part of the SEC's role is supervision of the securities markets and the conduct of securities professionals. The SEC serves as a watchdog to protect against fraud in the sale of securities, illegal sale practices, market manipulation, and other violations of investors' trust by broker-dealers, investment advisers, and other securities professionals.

In general, individuals who buy and sell securities professionally must register with the appropriate SRO, meet certain qualification requirements, and comply with rules of conduct adopted by that SRO. The broker-dealer firms for which they work must, in turn, register with the SEC and comply with the agency's rules relating to such matters as financial condition and supervision of individual account executives. In addition, broker-dealer firms must also comply with the rules of any exchange of which they are a member and, usually, with the rules of the NASD.

The SEC can deny registration to securities firms and, in some cases, may impose sanctions against a firm and/or individuals in a firm for violation of federal securities laws (such as, manipulation of the market price of a stock, misappropriation of customer funds or securities, or other violations). The SEC polices the securities industry by conducting inspections and working in conjunction with the securities exchanges, the NASD, and state securities commissions.

go to top

Protecting Yourself

You should be as careful about buying securities as you would be about any other costly purchase. The vast majority of securities professionals are honest, but misrepresentation and fraud do take place. Observe the following basic safeguards when "shopping" for investments:

- *Never* buy securities offered in unsolicited telephone calls or through "cold calls". Ask for information in writing before you decide. Check on the credentials of anyone who tries to sell you securities.

Tip: Beware of salespeople who try to pressure you into acting immediately.

- Don't buy on tips or rumors. Not only is it safer to get the facts first, but also it is illegal to buy or sell securities based on "inside information" which is not generally available to other investors.
- Get advice if you don't understand something in a prospectus or a piece of sales literature.

Tip: Be sure you understand the risks involved in trading securities, especially options and those purchased on margin. Be skeptical of guarantees or promises of quick profits. There is no such thing, at least not without an accompanying increase in risk.

- Remember that prior success is no guarantee of future success in an investment arrangement.
- With tax-sheltered investments, partnerships, and other "liquid" investments, be sure to ask about the liquidity and understand that there may not be a ready market when you want to sell.
- Don't speculate. Speculation can be a useful investment tool for those who can understand and manage the risks involved and those who can afford to lose money, but it is dangerous for most people.

Tip: For the average investor, more conservative investment strategies are generally appropriate.

Professional guidance can be very helpful in developing a sound investment program.

go to top

Types of Investments

Two broad categories of securities are available to investors: equity securities, which represent ownership of a part of a company and debt securities, which represent a loan from the investor to a company or government entity. Within each of these types, there are a wide variety of specific investments. In addition, different types can be combined (e.g., through mutual funds) or even split apart to form derivative securities.

Each type has distinct characteristics plus advantages and disadvantages, depending on an investor's needs and investment objectives. In this section, we provide an overview of the most common classes of investment securities.

Stocks

The type of equity securities with which most people are familiar is stock. When investors buy stock, they become owners of a "share" of a company's assets. If a company is successful, the price that investors are willing to pay for its stock will often go up and shareholders who bought stock at a lower price then stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. The rise in the price of a stock is termed appreciation or "capital gain." The stockholder is also entitled to dividends, which may be paid out from the company. Investors, therefore, have two sources of profit from stock investments, dividends and appreciation. Some stocks pay out most of their earnings as dividends and may have little appreciation. These stocks are sometimes referred to as income stocks. Other stocks may pay out little or no dividend, preferring to reinvest earnings within the company. Since all of an investors potential earnings comes from appreciation these stocks are sometimes referred to as growth stocks. Stock prices are also subject to both general economic and industry-specific market factors. There is no guarantee of a return from investing in stocks and hence there is risk incurred in investing in this type of security.

As owners, shareholders generally have the right to vote on electing the board of directors and on certain other matters of particular significance to the company. Under the federal securities laws, most companies must send to shareholders a proxy statement providing information on the business experience and compensation of nominees to the board of directors and on any other matter submitted for shareholder vote. This information is required so that stockholders can make an informed decision on whether to elect the nominees or on how to vote on matters submitted for their consideration.

Stock investments are typically common stock, which is the basic ownership share of a company. Some companies also offer preferred stock, which is another class of stock. Preferred stock typically offers some set rate of return (although it is still not guaranteed), and pays dividends before dividends are paid for common stock. Preferred stock may not, however, participate in as much upside as common stock. If a company does really well, preferred stockholders may receive the same dividend as any other year, while common stockholders reap the rewards of a great year.

Corporate Bonds

The most common form of corporate debt security is the bond. A bond is a certificate promising to repay, no later than a specified date, a sum of money which the investor or bondholder has loaned to the company. In return for the use of the money, the company also agrees to pay bondholders a certain amount of "interest" each year, which is usually a percentage of the amount loaned.

Since bondholders are not owners of the company, they do not share in dividend payments or vote on company matters. The return on their investment is not usually dependent upon how successful the company is. Bondholders are entitled to receive the amount of interest originally agreed upon, as well as a return of the principal amount of the bond, if they hold the bond for the time period specified.

Companies offering bonds to the public must file with the SEC a registration statement, including a prospectus containing information about the company and the security.

Government Bonds

The U.S. Government also issues a variety of debt securities, including Treasury bills (commonly called T-bills), Treasury notes, and U.S. Government agency bonds. T-bills are sold to selected securities dealers by the Treasury at auctions.

Government securities can also be purchased from banks, government securities dealers, and other broker-dealers.

Similar to corporate bonds, these bonds pay interest and the amount of principal at maturity. Some bonds, such as Treasury Bills, may not pay cash interest. Instead the bond is purchased at a discount and the interest is built into the amount the investor receives at maturity. Contrary to popular belief investors must pay income tax on U.S. government bond interest.

Municipal Bonds

Bonds issued by states, cities, or certain agencies of local governments such as school districts are called municipal bonds. An important feature of these bonds is that the interest a bondholder receives is not subject to federal income tax. In addition, the interest is also exempt from state and local tax if the bondholder lives in the jurisdiction of the issuing authority. Because of the tax advantages, however, the interest rate paid on municipal bonds is generally lower than that paid on corporate bonds.

Municipal bonds are exempt from registration with the SEC; however, the MSRB establishes rules that govern the buying and selling of these securities.

Stock Options

A stock option is a type of derivative security and refers to the right to buy or sell something at some point in the future. There are a wide variety of these specialized instruments such as futures, options and swaps. Most are not appropriate for the average investors. The type of options with which we are concerned here are standardized, exchange-traded options to buy or sell corporate stock.

These options fall into two categories:

- "Calls", which give the investor the right to buy 100 shares of a specified stock at a fixed price within a specified time period, and
- "Puts", which give the investor the right to sell 100 shares of a specified stock at a fixed price within a specified time period.

While options are considered by many to be very risky securities, if used properly they can actually reduce the risk of a portfolio. Generally, if you are bullish on a stock (i.e. you expect the price to go up), you buy a call option. The price you pay is called the premium. You would purchase a put option if you are bearish on a stock (i.e. you expect the price to go down). If the stock moves in the right direction you can profit handsomely. If it doesn't you lose the premium that you paid. Buying puts and calls is not a risky strategy, but selling puts and calls is. One exception is selling a call option on a stock you already own. This is known as a "covered call." This actually reduces the overall risk of your portfolio in exchange for you giving up some of your upside.

Mutual Funds

Companies or trusts that principally invest their capital in securities are known as investment companies or mutual funds. Investment companies often diversify their investments in different types of equity and debt securities in hope of obtaining specific investment goals. When you invest in a mutual fund, the fund invests in individual equity and debt securities. There's no need to make individual purchase and sale decisions. Mutual funds also provide an easy way to diversify a portfolio. Rather than purchasing 50 stocks yourself, you can purchase a single mutual fund.

Related Guide: For more detailed information, please see the Financial Guide INVESTING IN MUTUAL FUNDS: Time-Tested Guidelines.

go to top

Investment Contracts and Limited Partnerships

Investors sometimes pool money into a common enterprise managed for profit by a third party. This is called an investment contract. Such enterprises may involve anything from cattle breeding programs to movie productions. This is often done through the establishment of a limited partnership in which investors, as limited partners, own an interest in a venture but do not take an active management role. Some of these securities have been issued in the past primarily for purposes of reducing income tax liability. Such opportunities are limited today. Care should be taken in investing in these securities since they can be illiquid and require a great deal of expertise. Consult with your financial advisor before investing in these types of investments.

Real Estate Investment Trust (REIT)

Real estate investment trusts are set up in a fashion similar to mutual funds. Instead of investing in stocks or bonds, however, REIT investors pool their funds to buy and manage real estate or to finance real estate construction or purchases. Real estate limited partnerships are also common. This is a way to get diversification from real estate investment without the headaches of property ownership and management.

Asset Allocation

Asset allocation is the process of allocating your investments among several broad categories, including stocks, corporate bonds, and government bonds and is **extremely**important in investment success. In fact, portfolio selection should generally be based on asset allocation, whether formal or informal. This process can be complicated, but computer programs are available to assist in performing the allocation.

Related Guide: For a discussion of this very important concept, please see the Financial Guide ASSET ALLOCATION: How To Diversify Your Assets For Maximum Return

go to top

Risk vs. Return

One of the more basic relationships in investing is that between risk and reward. Investments that offer potentially high returns are accompanied by higher risk factors. It is up to you to decide how much risk you can assume. Always keep in mind your current and future needs.

Risk

There are many types of risk. The one most people think of is **market risk**, which is the risk that market prices can fluctuate. If you have a short investment horizon, generally something less than five years, this risk is important since the market could be down at the time you most need the money. On the other hand, if you have a long time horizon, for example when saving for retirement, you may be unconcerned with market risk. The investment has the opportunity to come back prior to the time you need the funds.

Another risk, which many people don't think about, is **purchasing power risk**. This is the risk that your investment will not keep up with inflation and you will not be able to maintain your desired standard of living. A bank CD for example might pay interest of 3% and have no market risk. Your principal does not fluctuate in value and you are insured against loss. However, if inflation exceeds 3% you will lose purchasing power.

Tip: In general, prospective investors should avoid "risky" investments unless they have a steady income, adequate insurance, and an emergency fund of readily accessible cash.

Tip: U.S. Treasury bills, notes, and bonds are the safest possible investments.

You need to assess how much risk you can tolerate. In general the longer your investment horizon the greater the amount of risk you can afford to take. Your financial advisor can assist you in measuring your risk tolerance.

Risk can also be reduced through diversification. Rather than buying one stock, buy a basket of 20 to 30 stocks. This reduces your overall risk. You can also reduce risk by combining different investment types such as stocks, corporate bonds and government bonds. These securities are not highly correlated, in other words, they tend not to go up or down at the same time.

Return

Why would one want to take on more risk? Because it generally comes with a higher expected return. While stocks may have the greatest market risk, they have also had the highest market return over the long haul. Stock returns have averaged between 10 and 11% since the early part of this century. Corporate bonds on the other hand have averaged between 6 and 7%, and government bonds closer to 5%. As you can see the lower the risk the lower the expected return. You must balance the amount of risk you are willing to tolerate with the amount of return you expect to achieve. There is no such thing as a high return/low risk investment.

go to top

Planning Techniques

You should first assess your current resources and future goals because this will assist you and your advisors in determining what rate of return is necessary to achieve your goals, and how much risk you can tolerate. Here is a suggested checklist:

- Assess your current financial resources. How much do you have to invest?
- Assess your future financial resources. Do you have an excess of income over expenses that can be invested?
- Determine your financial goals. How much money do you need and when do you need it?
- Determine the rate of return you need to achieve your goals.
- Determine how much risk you can tolerate based upon your time horizon and personal preferences.
- Choose an appropriate asset allocation to achieve the desired risk/return relationship. How should you allocate your investment among the various classes of investments?
- Choose the individual securities within each asset class. Which securities should you buy?

go to top

Security Selection

Once you have decided what percentage of your assets should go in each asset class, you need to select the appropriate individual securities. For each security you must evaluate its unique risk and its expected return. There are a number of sources of information about specific securities that you can explore, but generally, the most important of these for mutual funds and new stock issues is the prospectus. The prospectus is the security's selling document, containing information about costs, risks, past performance (if any) and the investment goals. The prospectus is obtained from the company or mutual fund or from your financial advisor. Read it and exercise your judgment carefully, before you invest.

In the case of a mutual fund, there is also a Statement of Additional Information (SAI). An SAI is sometimes referred to as Part B of the prospectus, and explains a fund's operations in greater detail than the prospectus. It's also possible to get a clearer picture of a fund's investment goals and policies by reading its annual and semi-annual reports to shareholders. If you ask, the fund must send you an SAI and/or its periodic reports; however, this process is time-consuming and requires a great deal of time and expertise.

go to top

Six Investing Pitfalls to Avoid

Here are the top mistakes that cause investors to lose money unnecessarily.

1. Using a Cookie-Cutter Approach

> Most investors, along with many of the people who advise the, are satisfied with a one-size-fits-all investment plan. The "model portfolio" is useless to most investors. Your individual needs as an investor must govern any plans you make for investment. For instance, how much of your investment can you risk losing? What is your investment timetable...are you retired, a young professional, or middle-aged? The allocation of your portfolio's assets among various types of investments, including Treasuries, blue-chip stocks, equity mutual funds, and other, should match your needs perfectly.

2. Taking Unnecessary Risks

> You do not have to risk your capital to make a decent return on your money. There are many investments that offer a return that beats inflation-and more-without unduly jeopardizing your hard-earned money. For instance, Treasuries, the safest possible investment, offer a decent return with virtually no risk. Blue-chip preferred stocks, common stocks, and mutual funds offer high returns with a fairly low level of risk.

3. Allowing Fees and Commissions to Eat Up Profits

Many investors allow brokers' commissions and other return-eating costs to cut into their returns. Professionals need to be compensated for their time; however, you should make certain that the fees you are paying are appropriate for the services performed.

4. Not Starting Early Enough

Many investors are not cognizant of the power of interest compounding. By starting out early enough with your investment plan, you can invest less, and still come out with double or even quadruple the amount you would have had if you started later. Another way to look at it is that by investing as much as possible earlier on, you'll be able to meet your goals and have more current cash on hand to spend.

5. Ignoring the Cost of Taxes

Every time you or your mutual fund sells stocks, there is a capital gains tax to pay. Unless you are in a tax-deferred retirement account, taxes will eat into your profits, therefore you should invest in funds that have low turnover (i.e., funds in which shares are bought and sold less frequently). Your portfolio, overall, should have a turnover of 10% or less per year.

6. Letting Emotion Govern Your Investing

Never give in to pressure from a broker to invest in a "hot" security or to sell a fund and get into another one. The key to a successful portfolio lies in planning, discipline, and reason. Emotion and impulse have no role to play in investing. Similarly, do not be too quick to unload a stock or fund just because it slips a few points. Try to stay in a security or fund for the long haul. On the other hand, when it's time to unload a loser, then let go of it.

Finally, do not fall prey to the myth of "market timing." This is the belief that by getting into or out of a security at exactly the right moment, we can retire rich. Market timing does not work. Instead, use the investment strategies that do work: a balanced allocation of your portfolio's assets among securities that suit your individual needs, the use of dividend-reinvestment programs and other cost-saving strategies, and a well-disciplined, long-haul approach to saving and investment.

go to top

Government and Non-Profit Agencies

- The SEC

Most companies whose stock is traded over the counter or on a stock exchange must file "full disclosure" reports on a regular basis with the SEC. The annual report (Form 10-K) is the most comprehensive of these. It contains a narrative description and statistical information on the company's business, operations, properties, parents, and subsidiaries; its management, including their compensation and ownership of company securities: and significant legal proceedings which involve the company. Form 10-K also contains the audited financial statements of the company (including a balance sheet, an income statement, and a statement of cash flow) and provides management's discussion of business operations and prospects for the future.

Companies file regular reports with the SEC in a computer database known as EDGAR. For example, a company declaring bankruptcy will file a form 8-K that tells where the case is pending and which chapter of bankruptcy was filed. You can access EDGAR through your computer at: www.sec.govIf you don't have access to a computer, your public library may have a computer you can use. You can also request a copy of Form 8-K, or any other reports that the company files with the SEC, see "How to Request Public Documents". Or, you can visit the SEC's Public Reference Room, 100 F Street NE, Washington, DC 20549. You might also be able to get copies of SEC filings from your full-service stockbroker, or the company itself.

Other sources of information filed with the SEC include public or law libraries, securities firms, financial service bureaus, computerized on-line services, and the companies themselves.

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625 N. Michigan Avenue
Chicago, IL 60611
Tel: 800-428-2244

Investment Company Institute (an organization promoting public understanding of mutual funds)

1401 H Street NW, Suite 1100
Washington, DC 20005
Tel: 202-326-5800

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