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# Understanding Investment Terms and Concepts

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# Understanding Investment Terms and Concepts

Below are summaries of some basic principles you should understand when evaluating an investment opportunity or making an investment decision. Rest assured, this is not rocket science. In fact, you'll see that the most important principle on which to base your investment education is simply good common sense. You've decided to start investing. If you've had little or no experience, you're probably apprehensive about how to begin. It's always wise to understand what you're investing in. The better you understand the information you receive, the more comfortable you will be with the course you've chosen.

## Don't be intimidated by jargon

Don't worry if you can't understand the experts in the financial media right away. Much of what they say is jargon that is actually less complicated than it sounds. Don't hesitate to ask questions; when it comes to your money, the only dumb question is the one you don't ask. Don't wait to invest until you feel you know everything.

## Understand stocks and bonds

Almost every portfolio contains one or both of these kinds of assets.

If you buy stock in a company, you are literally buying a share of the company's earnings. You become an owner, or shareholder, of the company. As such, you take a stake in the company's future; you are said to have equity in the company. If the company prospers, there's no limit to how much your share can increase in value. If the company fails, you can lose every dollar of your investment.

If you buy bonds, you're lending money to the company (or governmental body) that issued the bonds. You become a creditor, not an owner, of the bond issuer. The bond is in effect the issuer's IOU. You can lose the amount of the loan (your investment) if the company or governmental body fails, but the risk of loss to creditors (bondholders) is generally less than the risk for owners (shareholders). This is because, to stay in business and continue to finance its growth, a company must maintain as good a credit rating as possible, so creditors will usually pay on time if there is any way at all to do so. In addition, the law favors a company's bondholders over its shareholders if it goes bankrupt. Bonds redeemed prior to maturity may be worth more or less than their original cost. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.

Stocks are often referred to as equity investments, while bonds are considered debt instruments or income investments. A mutual fund may invest in stocks, bonds, or a combination.

Don't confuse investments such as mutual funds with savings vehicles such as a 401(k) or other retirement savings plans. A 401(k) isn't an investment itself but simply a container that holds investments and has special tax advantages; the same is true of an individual retirement account (IRA).

**Note:** Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.

## Don't put all your eggs in one basket

This is one of the most important of all investment principles, as well as the most familiar and sensible.

Consider including several different types of investments in your portfolio. Examples of investment types (sometimes called asset classes) include stocks, bonds, commodities such as oil, and precious metals. Cash also is considered an asset class, and includes not only currency but cash alternatives such as money market instruments (for example, very short-term loans). Individual asset classes are often further broken down according to more precise investment characteristics (e.g., stocks of small companies, stocks of large companies, bonds issued by corporations, or bonds issued by the U.S. Treasury).

Investment classes often rise and fall at different rates and times. Ideally, in a diversified portfolio of investments, if some are losing value during a particular period, others will be gaining value at the same time. The gainers may help offset the losers, which can help minimize the impact of loss from a single type of investment. The goal is to find the appropriate balance of different assets for your portfolio given your investing goals, risk tolerance and time horizon. This process is called asset allocation.

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Within each class you choose, consider diversifying further among several individual investment options within that class. For example, if you've decided to invest in the drug industry, investing in several companies rather than just one can reduce the impact your portfolio might suffer from problems with any single company. A mutual fund offers automatic diversification among many individual investments, and sometimes even among multiple asset classes. Diversification and asset allocation alone can't guarantee a profit or ensure against the possibility of loss, but they can help you manage the types and level of risk you take.

## Recognize the tradeoff between an investment's risk and return

For present purposes, we define risk as the possibility that you might lose money, or that your investments will produce lower returns than expected. Return, of course, is your reward for making the investment. Return can be measured by an increase in the value of your initial investment principal, by cash payments directly to you during the life of the investment, or by a combination of the two.

There is a direct relationship between investment risk and return. The lowest-risk investments --for example, U.S. Treasury bills--typically offer the lowest return at any given time. The highest-risk investments will generally offer the chance for the highest returns (e.g., stock in an Internet start-up company that may go from \$12 per share to \$150, then down to \$3). A higher return is your potential reward for taking greater risk.

Remember that there can be no guarantee that any investment strategy will be successful and that all investing involves risk, including the possible loss of principal. Between the two extremes, every investor searches to find a level of risk--and corresponding expected return--that he or she feels comfortable with. When someone proposes an investment with a high return and suggests that it's risk-free, remember the old adage that "If something sounds too good to be true, it probably is."

## Understand the difference between investing for growth and investing for income

As you seek to increase your net worth, you face an immediate choice: Do you want growth in the value of your original investment over time, or is your goal to produce predictable, spendable current income--or a little of both?

Consistent with this investor choice, investments are frequently classified or marketed as either growth or income oriented. Bonds, for example, generally provide regular interest payments, but the value of your original investment will typically change less than an investment in, for example, a new software company, which will typically produce no immediate income. New companies generally reinvest any income in the business to make it grow. However, if a company is successful, the value of your stake in the company should likewise grow over time; this is known as capital appreciation.

There is no right or wrong answer to the "growth or income" question. Your decision should depend on your individual circumstances and needs (for example, your need, if any, for income today, or your need to accumulate retirement savings that you don't plan to tap for 15 years). Also, each type may have its own role to play in your portfolio, for different reasons.

Your decision about how much money to put into each type of investment is called your asset allocation, and it's one of the most important factors in determining your overall return on your money over time.

## Understand the power of compounding on your investment returns

Compounding occurs when you "let your money ride." When you reinvest your investment returns, you begin to earn a "return on the returns."

A simple example of compounding occurs when interest earned in one period becomes part of the investment itself during the next period, and earns interest in subsequent periods. In the early years of an investment, the benefit of compounding on overall return is not exciting. As the years go by, however, a "rolling snowball" effect kicks in, and compounding's long-term boost to the value of your investment becomes dramatic.

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