Chapter 11
Investing for the Future

11.1 Basic Investing Concepts

11.2 Making Investment Choices

Consider THIS

Pavel has saved some money that he will use for college expenses in a few years. Right now, it’s in a regular savings account, earning 3 percent a year.

“My parents say I can do better,” Pavel told his best friend. “If I invest the money, I could get 6 to 8 percent, or maybe even better. So I’ve been checking my options. You know what I’ve found so far? That investing is filled with risk, and there are many types of risk. If I’m willing to take a lot of risk, then I may be able to earn more money. But I also stand a chance of losing part or all of my money. So I have to decide what my goals are, weigh the tradeoffs, and make the best choice to meet my goals. This is interesting stuff, but it isn’t as easy as it sounds.”
Basic Investing Concepts

GOALS
- Explain why you should consider investing.
- Discuss the stages of investing.
- Explain the concept of risk.
- Describe investment strategies and options.

TERMS
- investing, p. 240
- inflation, p. 240
- Rule of 72, p. 240
- portfolio, p. 243
- investing risk, p. 243
- diversification, p. 243
- temporary investments, p. 246
- permanent investments, p. 246

WHY INVEST?
Investing is the use of long-term savings to earn a financial return. Investing is a proven and powerful way to strengthen your financial position over time. It is an essential part of providing for future needs. It provides a source of income in addition to a paycheck, allowing you to make money on money.

INVESTING HELPS BEAT INFLATION
Inflation is a rise in the general level of prices. Inflation reduces purchasing power over time. As prices rise, it takes more money to buy the same goods and services. Thus, investors seek investments that will grow faster than the inflation rate. For example, if the annual inflation rate is 4 percent, you will want your investments to yield a rate of return higher than 4 percent.

Thus, investing will help protect your purchasing power. As prices rise, your investments will keep your net worth rising. Investments allow your net worth to grow at a faster rate than general price levels.

A quick way to evaluate an investment’s rate of return is to use the Rule of 72. The Rule of 72 is a technique for estimating the number of years required to double your money at a given rate of return. Simply divide the percentage rate of return into 72. For example, if an investment is yielding an average of 6 percent, it will take 12 years to double your money (72 ÷ 6). As shown in the Math Minute feature, you can also use the Rule of 72 to estimate the rate of return needed to double your money in a given number of years.
INVESTING INCREASES WEALTH

Financial success grows from the assets that you build up over time. Investing helps you accumulate wealth faster than if you simply saved your excess cash in a savings account. When you invest in stocks and bonds, you are participating in helping businesses make and sell new products and services. You will be rewarded with dividends and interest.

INVESTING IS FUN AND CHALLENGING

Investors make choices and hope to pick winners. Once you gain experience, you can have fun choosing investments, buying and selling when the time is right, and using your knowledge to plan for your financial security.

STAGES OF INVESTING

Before you begin investing, you must consider your budget, including your income, expenses, and savings. Typically, as your income grows and exceed your expenses, you can progress through stages from temporary savings into different kinds of investing and greater amounts of risk.

STAGE 1. PUT-AND-TAKE ACCOUNT

When you first begin to earn a paycheck, you will put it into an account and take money out as needed to pay your bills. This money is your emergency fund, or your “put-and-take” account. (See Figure 11.1.) The purpose of this money is to pay for your short-term needs with enough left over to cover unexpected expenses. Thus, you want to put your money in an account that offers security, or safety of principal.

MATH Minute

THE RULE OF 72

The Rule of 72 is a rule of thumb or approximation technique. You can use it to estimate either the number of years or rate of return needed to double your money.

If you want to find the number of years, divide 72 by the rate of return.

Example: You are earning 10% on your money. How long will it take to double your money?

Solution: 72 ÷ 10 = 7.2 years

If you want to find the rate of return, divide 72 by the number of years in which you want your money to double.

Example: You have $5,000 and want to double it in 6 years. What rate must your investment earn to achieve $10,000 in 6 years?

Solution: 72 ÷ 6 = 12%. At 12% your money will double in 6 years.
Many financial advisers recommend that you have three to six months’ net pay set aside in this type of fund. Then, should a need arise, you won’t dip into permanent, long-term investments to pay for temporary, short-term needs. Your main concerns should be safety and liquidity.

**STAGE 2. INITIAL INVESTING**

Investing really begins when you have “excess” savings beyond what you need for daily expenses and emergencies. Your *initial investing* should be conservative with low risk. At this stage, you don’t have a lot of money to invest, so you don’t want to risk losing it. Once you have established a safe cushion of investment, you can afford to make riskier (and potentially more profitable) investments. Typically, young workers in their 20s and early 30s begin investing when their spending is stable and their excess cash is increasing.
STAGE 3. SYSTEMATIC INVESTING

Once you are comfortable with your initial investments, you can then enter a stage called systematic investing. Systematic investing is making investments on a regular and planned basis. Money is set aside regularly for investing each month. As income grows, the amount invested also grows. At this stage, your goals are long-range. You are investing for a financially secure future. This ability to contribute regular sums of money usually happens in your 30s and 40s, when earning potential is highest.

STAGE 4. STRATEGIC INVESTING

Strategic investing is the careful management of investment alternatives to maximize growth of your portfolio (collection of investments) over the next five to ten years. For example, when the growth prospects for one investment seem to be declining, you would move your money into another investment where the prospects for growth seem greater. You would invest in different types of securities (stocks and bonds) to try to maximize your returns.

STAGE 5. SPECULATIVE INVESTING

When you are investing regularly in a broad collection of investments but you still have money available to take bigger risks, then you can choose to move into the final stage, called speculation. Speculative investing happens when you make bold and high-risk investment choices. In this stage, you can make—or lose—a great deal of money in a short period of time. You must be aware of the risks and be prepared to lose. Typically, odds are small that you will make a profit in a speculative investment, but when it does pay off, the profit is enormous. Beginning investors should avoid speculative investments because they cannot afford the loss that is likely to occur. High-risk investing is not for everyone; some people prefer to avoid it altogether.

RISK AND RETURN

Investing risk is the chance that an investment’s value will decrease. All types of investing involve some degree of risk. The greater the risk you are willing to take, the greater the potential returns. A safe investment has little risk of loss. Some people are willing to take more risks than others. Those who are willing to accept a reasonable amount of risk will likely make considerably more in the long run than investors who are risk averse (afraid to make investments in which they might lose some or all of their investment). However, risk-takers (investors who like to take on a great deal of risk) could make a lot or lose a lot. The best plan for most investors is to plot a moderate course, somewhere between no risk and extreme risk, where they feel comfortable.

DIVERSIFICATION

One way to minimize risk is through diversification, which is the spreading of risk among many types of investments. Rather than buying only one kind of investment, you should choose several types of investments, such as stocks, bonds, and real estate. Also, you should diversify among types of stocks. For example, you might select some low-risk stocks to balance others with greater
risk. Diversification reduces overall risk because not all of your choices will perform poorly at the same time. If one choice does not do well, the others will likely make up some or all of the loss.

**TYPES OF RISK**

Short-term investments are generally less risky than long-term investments. You can predict much more accurately what will happen in a week, a month, or a year than you can in 10–20 years.

**Interest-Rate Risk**

Interest-rate risk is the chance that inflation will rise faster than the return on your investments. Inflation makes your fixed-rate investments worth less because they are “locked in” at lower rates. The value of a fixed-rate investment decreases when overall interest rates increase. Their value increases when overall interest rates decrease. For example, if you own a security paying a fixed interest rate (say, 5 percent) and interest rates are increasing (to a level greater than 5 percent), your investment will be worth less over time.

**Political Risk**

Political risk refers to actions the government might take that would reduce the value of your investment. Increased taxes and certain regulations, such as costly environmental controls that businesses are required to apply, can make some investments less attractive.

**Market Risk**

Market risk is caused by the business cycle—periods of economic growth or decline. When the economy is doing well, the financial markets usually follow (and vice versa).

**Nonmarket Risk**

Nonmarket risk is unrelated to market trends. Nonmarket risk is entirely unpredictable and uncontrollable. For example, terrorism threats affect all investments in the short term. Because of the violent and unpredictable nature of such events, people change their behavior and seek ways to protect themselves. This causes markets to suffer as people sell their investments to hold more cash for personal security.

**Company and Industry Risk**

Company risk is associated with owning one company’s stock. If that company fails, you lose your investment. Industry risk affects groups of businesses. For example, if you invest in the candy industry, a nationwide trend toward dieting or the avoidance of sugar may adversely affect the value of your investment.
INVESTMENT STRATEGIES

Many individuals never start an investment program because they think they don’t have enough money. But even small sums of money grow over time. To achieve financial security, start investing as soon as you can and continue to invest over your lifetime. The suggestions that follow will help you make wise investment decisions.

CRITERIA FOR CHOOSING AN INVESTMENT

Some investments increase in value at a rate higher than the rate of inflation. Some do not. Some investments provide for increases in value that do not show up as taxable income for many years. Evaluate your investment choices based on these factors:

- Degree of safety (risk of loss)
- Degree of liquidity (ability to get your money quickly)
- Expected dividends or interest
- Expected growth in value, preferably exceeding the inflation rate
- Reasonable purchase price and fees
- Tax benefits (saving or postponing tax liability)

No investment offers a high degree of all of these. Each investment choice represents a tradeoff. For example, in exchange for tax benefits, you would likely have to give up a high return and liquidity. However, you should choose investments that offer, for example, the highest degree of safety you can get for the expected return. A diversified portfolio of investments achieves a balance among these factors. It would include some safe but low-yield investments as well as some riskier, higher-growth choices plus some tax-deferred investments. These factors will be examined in the discussion of specific types of investments in Chapters 12–15.

WISE INVESTMENT PRACTICES

People commonly make investment mistakes. Some mistakes are minor and can be corrected easily. Others cause serious financial damage. To avoid investment mistakes and maximize your investing returns, follow the investment practices described on the next page.
Define Your Financial Goals

Clearly defined financial goals will help you to identify which investments to purchase. To be useful, investment goals must be specific and measurable. Set specific monetary targets. Identify how you plan to use the money and how soon you need to accomplish each goal.

Go Slowly

Before making investments, gather the information you need to make a wise decision. Make temporary investments until you are certain they will meet your needs. Temporary investments are investment choices that will be reevaluated within a year or less. If they aren’t performing as expected, they will be sold and other choices selected. Avoid get-rich-quick schemes—if they sound too good to be true, they probably are!

Follow Through

A common mistake is keeping temporary investments too long and not reevaluating them regularly to determine how well they are performing. Permanent investments are investment choices that will be held for the long run—five or ten years, or longer. These securities will become the “critical mass” of your investment portfolio. They will sustain good solid returns over long periods of time and will grow substantially in principal as well.

Keep Good Records

To keep a clear view of your progress toward future needs and goals, keep good financial records. Pay attention to how your investments are doing. Every year, compare your investments’ current balances with their previous years’ balances. Keep statements to verify your account balances and make transfers when needed. Unless you know where you have been and where you are now, it is difficult to plan where you are going.

Seek Good Investment Advice

Don’t be afraid to ask questions. Seek competent advice from a trained professional as you make investment decisions. To get this advice at low cost and without a commitment, consider attending an investment seminar. Here you can learn about products, costs, and risks. Then you can decide what to do in your own home without pressure.

Keep Investment Knowledge Current

Be aware of what is new in the financial market, what kinds of investments are currently good prospects, when to sell, and when to buy. It is your responsibility to know when to ask questions and to make the final decisions about your investments. Understanding the economy and how it works will help you make better investment choices.

Know Your Limits

Understand your risk tolerance and the amount of money you can afford to risk, so you can maximize returns within your risk comfort zone. If you are uncomfortable taking large risks, then avoid them. The chance of making huge profits is not worth being stressed out by the risk.
Wherever people are successfully meeting the needs of a large quantity of customers, there is a computer program that keeps the records and processes the accounts. Computer programmers design all types of software, including the financial planning tools that are available to consumers.

Computer programmers write, test, and maintain detailed instructions, called programs, so that computers can operate as needed. Programmers also conceive and design software. Programmers know a variety of programming languages, and they tend to work on databases, mainframe, or Web programs. Most programmers are either applications programmers or systems programmers.

**Employment Outlook**
- Employment in this field is expected to decline slowly.

**Job Titles**
- Software engineer
- Systems analyst
- Computer programmer
- Systems programmer
- Applications programmer

**Needed Skills**
- A bachelor’s degree is commonly required, although a two-year degree may be adequate.
- Relevant programming skills and experience are highly valued.

**What's it like to work in... Computer Programming**

Janeec works a typical 40-hour workweek. This week, she and the entire systems engineering department have been hard at work creating a new investment software package for a major client. They must meet the deadline and have the program up and running within two months.

Today, Janeece is writing program code so that the client can perform needed tasks. The company has many requirements for the software package. Janeece must incorporate a calculator that will perform various functions, which the company’s financial advisers will use to compute asset growth and payout for their clients. The program must also have the capability to access live data from various stock exchange web sites to obtain current stock prices.

Janeece will be responsible for testing the program upon its completion to ensure it produces the desired result for the client. If problems occur, she will make the appropriate changes to the code and recheck it again until the program is functioning properly. Janeece will continue to offer product support for as long as the program is in use.

**What About You?**

Do you have an aptitude for writing detailed instructions that are logical and systematic? Do you enjoy working with the computer for most of the day? Is a career in computer programming right for you?
11.1

Assessment

KEY TERMS REVIEW

Match the terms with the definitions.

1. The spreading of risk among many types of investments
2. Investment choices held for the long run
3. The use of long-term saving to generate a financial return
4. The chance that an investment’s value will decrease
5. A technique for estimating the number of years required to double your money at a given rate of return
6. Investment choices that will be reevaluated in the short term
7. A rise in the general level of prices
8. A collection of investments

CHECK YOUR UNDERSTANDING

9. Why do you need to establish an emergency fund before you start investing?
10. How does investing help you beat inflation?
11. What is diversification and what is its purpose?

APPLY YOUR KNOWLEDGE

12. Why is it important to start with temporary investments that lead to permanent investments?

THINK CRITICALLY

13. Why is risk an important consideration when investing? Write a paragraph explaining your comfort level with risk and how it will affect your investment decisions.
14. Explain the connection between keeping good records and making good investment choices.
15. Financial advice is only as good as its source. Explain why you should seek several sources of information before making investment decisions. Is it a good idea to use relatives and friends for advice? Why or why not?
11.2 Making Investment Choices

**Goals**
- List and describe sources of investment information.
- Describe basic investment choices and rate them by risk.

**Terms**
- annual report, p. 251
- bonds, p. 252
- discount bond, p. 252
- stock, p. 253
- mutual fund, p. 254
- annuity, p. 254
- futures, p. 255
- option, p. 255
- penny stocks, p. 255

**Sources of Financial Information**

To make good investment choices, you must have good information. Investment information can be found in print, online, and through other sources to help you evaluate investment options.

**Newspapers**

Found in your local newspaper, financial pages list all types of securities, including stocks and bonds, as well as other information related to investing. Reading these pages daily will help you keep track of financial markets and obtain information needed to make wise investment decisions.

*The Wall Street Journal* is a daily paper that provides detailed coverage of the business and financial world. *Barron’s* is a weekly paper that also provides charts of trends, financial news, and technical analysis of financial data. Both of these publications offer online subscriptions as well as free articles and data available at their web sites.

**Investor Services and Newsletters**

Companies called investor services provide extensive financial data to clients. Major services include the following:
- Moody’s Investors Service
- Standard and Poor’s Reports
- Value Line

These publications are found in public libraries and brokerage firms, as well as online. They contain precise current and historical financial data. Many investors subscribe to weekly or monthly investment newsletters, which give them the latest financial data and information.

**Financial Magazines**

A number of weekly and monthly magazines specialize in business and financial information. Most of them interpret financial data and give opinions and recommendations. Choices include the following:
These magazines will keep you current, so you can determine when it is time to buy, hold, or sell securities. All of these publications offer financial news and stock market performance data at their web sites.

**BROKERS**

*Full-service brokers* provide clients with analysis and opinions based on their judgments and the opinions of experts at the company they represent. However, you cannot expect a broker to pick winners for you every time. Almost all full-service brokerage firms provide monthly market letters giving advice on the purchase and sale of certain securities. Some well-known full-service brokerage companies include the following:

- Merrill Lynch
- Fidelity Investments
- American Express

Some people are well informed and know what they want to buy and sell. For these investors, a discount broker is adequate. *Discount brokers* buy and sell securities for clients at a reduced commission. A discount broker usually provides little or no investment advice to a client. Examples include the following:

- Charles Schwab
- TD Ameritrade
- E*TRADE

Because of the increasing popularity of inexpensive trading, many full-service brokers also offer discount trading at their web sites. Some banks, credit unions, and other financial institutions also assist their customers with buying and selling securities. Money can be transferred out of your checking or savings account to pay for securities purchased or transferred into your account for securities sold. You will receive statements showing the current value of your securities.
With most types of brokerage accounts, you can manage your account online. You can give buy and sell orders, transfer money among investment accounts, and track the progress of your investments, either with your own software or with a platform supplied by the broker or bank.

**FINANCIAL ADVISERS**

Professional investment planners are called financial advisers or certified financial planners (CFPs). They are trained to give investment advice based on your goals, age, lifestyle, and other factors. The adviser will ask you to supply confidential information about your assets, liabilities, net worth, income, and budget, as well as your financial goals. The adviser usually receives a fee for consulting services, although some also receive a commission when they sell you investment products (such as stocks, bonds, or life insurance policies). Generally, you will get better overall advice when the adviser does not stand to make a profit on the investments you choose to buy.

**ANNUAL REPORTS**

An annual report is a summary of a corporation’s financial results for the year and its prospects for the future. The Securities and Exchange Commission (SEC) requires all public corporations to prepare this report each year and send it to their stockholders. Investors can use the information contained in the report to evaluate the corporation as an investment prospect.

You can find annual reports online at the SEC web site (www.sec.gov). Corporations often publish their financial performance data in the investor section of their web sites. If you are interested in investing in a corporation, you can receive a copy of the annual report by writing to the company or submitting a request at the company’s web site. Also, some large libraries keep copies of annual reports of major corporations.

**ONLINE INVESTOR EDUCATION**

In addition to the web sites of print publications and brokers, the Internet offers many educational sites for new investors. Teenvestor is a web site dedicated to helping teens learn how to invest and manage their money. The Motley Fool web site offers money management tips in its personal finance section. Its “fool’s school” presents investment basics in reader-friendly language. The National Association of Investors Corporation is a nonprofit site dedicated to investor education. This organization also helps investment clubs get started. These are just a few of the many educational sites available to investors online. A web search using a search engine or a directory from a popular home page, such as Yahoo!, will produce many more.
INVESTMENT CHOICES

Once you are ready to make permanent investments, it’s time to consider all of your investment choices. Investments can be categorized by their degree of risk and expected return. In Chapters 12 through 15, you will explore each type of investment more thoroughly.

LOW RISK/LOW RETURN

For your first investments, you will likely want to consider fairly safe investments, even though their returns will be relatively low. Even as you grow as a sophisticated investor, however, you should continue to include some low-risk investments as part of your diversified portfolio.

Corporate and Municipal Bonds

Bonds are debt obligations of corporations (corporate bonds) or state or local governments (municipal bonds). When a corporation or government body sells a bond, it is borrowing from an investor. When you invest in a corporate bond, the corporation pays you a fixed amount of money (called interest) at a fixed interval (usually every six months). The corporation also must repay the principal (amount borrowed) at maturity. The maturity date of a bond is the date on which the borrowed money must be repaid.

When you loan money to a state or local government unit, such as a city, county, community college district, or utility district, you are also paid interest on your investment. Your principal is repaid when the bond matures. Typically, interest earned on municipal bonds is tax-free, giving the investor a tax advantage. Bonds are explained in detail in Chapter 13.

U.S. Government Savings Bonds

When you buy a savings bond, you are lending money to the United States government. U.S. savings bonds are available in two forms as follows:

- **Series EE Savings Bonds.** These bonds are known as discount bonds. A discount bond is purchased for less than the maturity value. The purchase price of a Series EE bond is one half of its maturity value. For example, you could buy a $50 bond for $25 and a $100 bond for $50. At maturity, you receive the full value of the bond. If you don’t cash the bond at maturity, it continues to earn interest for up to 30 years.

- **Series I Savings Bonds.** These bonds are designed for investors wanting to protect against inflation and earn a guaranteed rate of return. With I bonds, interest is added to the bond monthly and is paid when the bond is cashed. I bonds are sold at face value (you pay $50 for a $50 bond), and they grow with inflation-indexed earnings for up to 30 years. In other words, the I bond pays a fixed rate combined with a semiannual inflation adjustment to help protect purchasing power.

You can buy savings bonds from commercial banks, through payroll deduction plans, or online. Savings bond certificates should be stored in a safe deposit box. If you are seeking safety, savings bonds are a good choice. You can hold them to maturity or cash them in at a bank for their current value after holding them for at least one year. Their interest is not subject to state or local taxes, only federal. Some savings bonds used to finance a college education.
Treasury Securities

For those with cash to invest, there are three types of U.S. Treasury securities. All of these are taxed by the federal government but are exempt from state and local income taxes. You can learn more about these securities at the TreasuryDirect web site (www.treasurydirect.gov).

- **U.S. Treasury Bills.** These bills (called T-bills) are available for a minimum purchase of $100. The maturity date for these bills ranges from a few days to 52 weeks (one year).
- **U.S. Treasury Notes.** These notes (called T-notes) are available for a minimum purchase of $100. Maturities are 2, 5, or 10 years. Interest rates for Treasury notes are slightly higher than for Treasury bills.
- **U.S. Treasury Bonds.** These bonds are issued for a minimum of $100 with a 30-year maturity. Interest rates are generally higher than rates for either T-bills or T-notes because of the longer maturity. Interest is paid every six months.

MEDIUM RISK/MEDIUM RETURN

When you feel secure enough to take more risk and you have additional money to invest, you are ready to step up to the medium-risk range to increase your return. Some of these medium-risk options involve investing with companies that manage the investment.

**Stocks**

Stock is a unit of ownership in a corporation. The owner of stock is called a stockholder. A stockholder receives a stock certificate, which is evidence of the ownership. When you are a stockholder, you will share in a corporation’s profits, which are paid to you as dividends. If the company does well, you earn returns in two ways: in dividends and in the increased value of the stock you own.

Stocks generally carry more risk than choices with fixed interest, such as savings bonds, because a stockholder’s earnings can go up or down, depending on the company’s profits. Stocks in well-established companies are reasonably safe, while stocks in less-stable companies can be quite risky. However, a diversified portfolio of stocks of various risk levels can achieve a medium overall risk. You will learn more about investing in stocks in Chapter 12.
**Mutual Funds**

Suppose you have $500, which is not enough to buy a diversified portfolio of stocks. You can buy shares in a large, professionally managed group of investments called a mutual fund. A **mutual fund** is the pooling of money from many investors to buy a large selection of securities. Security funds are grouped to meet the fund’s stated investment goals. Two major advantages of a mutual fund for investors are professional management and diversification. Since the fund invests in a wide variety of securities, it provides diversification that small investors could not otherwise achieve with their limited resources.

Although some mutual funds fall in the speculative category and others fall in the low-risk category, such as those that specialize in money market securities, most mutual funds fall somewhere in the broad medium range in terms of risk and return. You can further diversify your portfolio by investing in mutual funds with different objectives. For example, some funds buy securities in riskier small companies, hoping to earn a higher return. Others stick to well-established, safe companies to earn a lower but stable return. By investing money in both funds, you are diversifying your investments. If your riskier fund does not do well, your stable fund will limit your losses.

Mutual funds are the fastest-growing segment of the American financial services industry. You will learn more about mutual funds in Chapter 14.

**Annuities**

An **annuity** is a contract that provides the investor with a series of regular payments, usually after retirement. Generally, you receive income monthly, with payments to continue as long as you live. You usually buy an annuity directly from a life insurance company. The interest on the principal, as well as the interest compounded on that interest, builds up free of current income tax. Taxes are **deferred** until you receive payments from your annuity (these are called tax-deferred annuities). The payments from an annuity are normally used to supplement retirement income. The annuity is often described as the opposite of life insurance. It pays while you are alive; life insurance pays when you die.

**Real Estate**

Many people like to invest in real estate—houses and land. While this type of investment usually represents a large and often nonliquid investment of cash, it has proven to be protection against inflation in most parts of the United States. In
some areas, market values of homes have increased faster than the inflation rate. Real estate investments also have tax benefits. Certain costs associated with home ownership are deductible from gross income, and thus lower taxable income. While investing in your own home carries little risk, investment in other types of real estate can be very risky. Investing in real estate is covered in greater depth in Chapter 14.

**HIGH RISK/HIGH RETURN**

High-risk/high-return choices involve considerable uncertainty. Returns can be high, but they can also be low or even negative, resulting in a loss of principal (the amount of the original investment). If you are willing to take the risks involved with these choices, you stand to make high returns over time. But you also risk high losses if your investments prove to be poor performers.

**Futures**

Futures are contracts to buy and sell commodities (products that are mined or grown) or stocks for a specified price on a specified date in the future. The investor is betting that the price of the commodity or stock will be higher on that future date than it is at the time of the contract. Thus, trading in futures is very risky speculation. If prices fall, the investor loses. If prices rise, the investor stands to make a lot of money. This type of investment is not for beginners or for individuals who cannot afford to lose their investment.

**Options**

An option is the right, but not the obligation, to buy or sell a commodity or stock for a specified price within a specified time period. As with futures, the investor is betting that, during the option period, the price of the stock will rise. If it does, the investor can choose to buy it at the lower option price, resulting in an instant profit. Typically, options are short-term investment devices used by speculators to make a quick profit. They are risky and not for inexperienced investors.

**Penny Stocks**

Penny stocks are low-priced stocks of small companies that have no track record. The stock usually sells for under $5 per share. The small companies often have low revenues and few assets to assure future growth. Dot-com (Internet) companies typically begin this way. Many of them fail, and the stock is worthless. Occasionally, a penny stock will be successful, and the investor will make a large windfall. Generally, penny stocks are highly risky.

**Collectibles**

Many people like to collect items such as coins, art, memorabilia, ceramics, or other items that are popular from time to time, such as Beanie Babies or baseball cards. If you collect an item that goes up in value rapidly, you can reap large rewards. If, however, you don’t sell when your items are a hot commodity, they are likely to lose their value just as quickly, making them a risky investment. Collectors must be aware of the market and realize that their collections are subject to changing public tastes and can be difficult to resell.
ISSUES IN YOUR WORLD

CHOOSING THE RIGHT FINANCIAL ADVISER

Selecting the right financial adviser can be tricky. The most important factor is trust. You must feel comfortable with your adviser, be willing to give him or her a complete picture of your finances and financial goals, and then follow his or her advice. Many people begin their investing with a trusted family friend who is in the business of giving financial advice at a bank, brokerage firm, or other financial institution. Or, you may know someone who has worked with a particular adviser for many years and can recommend that adviser to you. If so, your choice will be somewhat easier. Some people consult with financial advisers at credit unions or through employee assistance plans. Others participate in group seminars offered by employers or professional organizations. In many cases, these choices provide good general advice about investment strategies that are effective for people with investment goals similar to yours.

The trick to finding and building a relationship of trust with a financial adviser involves taking the time to ask questions and thoroughly discuss your income, assets, liabilities, risk comfort level, and financial goals. Be sure to ask potential financial advisers about their training, background, and experience. Ask about their philosophy of investing, fees (how they earn money), and investment strategies. You also should know how clients have done in the past with their investment recommendations. Ask for references. Good advisers will tell you about their past successes. You can also check up on the past performance of stockbrokers through the Financial Industry Regulatory Authority. It monitors complaints and takes actions against its members when they are in violation of its rules. Remember: If you don’t feel comfortable with a prospective financial adviser, keep looking until you find one who you feel can help you achieve your investment goals.

THINK CRITICALLY

1. If you needed financial advice, whom would you ask? Why?
2. What are the characteristics you would look for in a successful financial adviser? What would it take to build your trust?
3. Locate the names and addresses of three or more financial advisers in your area.
KEY TERMS REVIEW

Match the terms with the definitions. Some terms may not be used.

1. A savings bond that is purchased for less than its maturity value
2. Low-priced stocks of small companies that have no track record
3. A summary of a corporation’s financial results for the year and future prospects
4. A contract that provides the investor with a series of regular payments
5. Debt obligations of corporations or state or local governments
6. Unit of ownership in a corporation
7. Pooling of money from many investors to buy securities

a. annual report  
b. annuity  
c. bonds  
d. discount bond  
e. futures  
f. mutual fund  
g. option  
h. penny stocks  
i. stock

CHECK YOUR UNDERSTANDING

8. What are some sources of financial information useful for making investment decisions?
9. Why should beginning investors choose low-risk investments?
10. Why is investing in stock considered more risky than investing in bonds?

APPLY YOUR KNOWLEDGE

11. Visit a library or go online to obtain a copy of a current annual report of a major corporation that does business in your state. Outline the contents of the report and decide whether or not this corporation would be a good investment choice. Explain why or why not.

THINK CRITICALLY

12. What are advantages and disadvantages of investing through a discount broker rather than a full-service broker?
13. Explain why it is not possible for one investment to offer both low risk and a high return. Which is most important to you?
14. Compare U.S. government savings bonds to mutual funds and collectibles in terms of risk and potential return. Explain why these investments are categorized as they are.
Chapter 11

Assessment

SUMMARY

11.1

- Investing helps you beat inflation when your investments give you a return that is higher than the inflation rate.
- As your income grows beyond current needs, you can progress through investment stages involving greater amounts of risk.
- All investments involve some risk that your investment will lose value. Diversification helps minimize overall risk.
- Types of investment risk include interest-rate risk, political risk, market risk, nonmarket risk, company risk, and industry risk.
- Evaluate investment options for their degree of safety, liquidity, dividends or interest, growth, cost, and tax benefits. All investments involve trade-offs among these criteria.
- To make wise investments, define your goals, go slowly, keep good records, get good advice, keep your investment knowledge current, and know your limits.

11.2

- You can get investment information from newspapers, investor newsletters, financial magazines, annual reports, and brokers and financial advisers as well as from online sources.
- Full-service brokers give you advice in buying and selling securities; discount brokers do not give advice, but their cost is lower.
- Generally, the more risk you are willing to take, the more you stand to gain or lose from an investment.
- Investment choices can be low risk, medium risk, or high risk—depending on the investor’s ability and willingness to take risks.
- Medium-risk/medium-return investments include stocks, mutual funds, annuities, and real estate.
- Futures, options, penny stocks, and collectibles carry a high risk of loss but also offer large gains if they are successful.
APPLY WHAT YOU KNOW

1. Read the financial section of your local newspaper. Write a few paragraphs summarizing the type of information covered and its usefulness to you as an investor.

2. Visit a discount brokerage firm online to find out how to open an account. Summarize their requirements in a paragraph.

3. Using keywords such as “investment,” “stock,” or some others you can think of, search the Internet for resources to help you make investing choices. List the names and URLs of three sites that you think would help you most. Briefly describe the types of investment information available at those sites.

4. Consult a financial newspaper or magazine or search the Internet to find the current rate for each of the following securities:
   - Series EE savings bonds
   - one-year Treasury bills
   - two-year Treasury notes
   - thirty-year Treasury bonds

5. Describe the five stages of investing. Which stage do you think is most important? Explain why.

6. Identify criteria you can use to evaluate an investment. Which criteria is most important to you? Why?

MAKE ACADEMIC CONNECTIONS

7. **Math** Using the Rule of 72, compute how long it would take to double your money at 1%, 3%, 5%, 7%, 9%, 11%, and 13% annual rates of return. Assuming the inflation rate is 5.5% in a given year, how do these rates of return meet your needs?

8. **Research** Conduct research on a famous person (past or present) who has invested wisely over his or her life, resulting in substantial wealth. Consult their biography (if available) and other sources and explain their investment strategies. Write a report on your findings.

9. **Economics** Explain the concept of a business cycle. If the economy is growing, how would that affect your choices of investment? If the economy is slowing, how would that affect your choices? Consult The Economist magazine and find an article about the business cycle. Where are we at this point in time (recession, recovery, peak, or trough)? Explain what those terms mean in terms of investing.

10. **Careers** Assume you would like to work as a broker some day. Research the qualifications and skills required. What are the educational requirements? Describe the work environment and characteristics of this occupation. What is the average salary? Compile your research into a “career profile” of a broker.
**SOLVE PROBLEMS AND EXPLORE ISSUES**

11. Ryan, who is 19 and in college, has just inherited $1,000. He does not need the money for his put-and-take account. What would you tell him to do with it? If Ryan invested the money in a stock that earned, on average, a 10 percent return, how much would his investment be worth in five years? Using the Internet, locate a savings planner tool for help.

12. If Ryan invested his $1,000 at a 5 percent average return, how many years would it take for his investment to be worth $2,000?

13. Allison is considering investing $500. Explain to her what factors she should consider when choosing investment alternatives.

14. Karmyn would like to invest in XYZ Corporation. You’ve never heard of it. What kinds of information should she have before she invests in this company? Where can she get that information?

15. Diane plans to invest $10,000 that she inherited from her uncle. She would like to have the money for her daughter’s college education. Her daughter is now 10 years old and will start college in eight years. She does not want to take a lot of risk because she cannot afford to lose the $10,000. What course of action would you suggest for Diane?

16. Assume that Diane (in number 15) invested her $10,000 in a way that earned, on average, a 6 percent annual return. On the Internet, locate a college planner tool to find out how much more she would have to invest each year to cover her daughter’s college costs. Assume that college will cost $10,000 a year for four years.

17. Choose six of the investment alternatives presented in this chapter. Rank the choices from high to low on the factors of safety, risk, and liquidity. Assume that 3 is the highest score and 1 is the lowest score for each factor. Based on the results of your review of possible investments, which three alternatives would you select as permanent investments? Why?

**EXTEND YOUR LEARNING**

18. **Legal Issues** Insider trading occurs when someone who has inside information about a company makes stock market transactions that create wealth for that individual. Why is insider trading illegal? What are the consequences or penalties? What is the Security and Exchange Commission’s (SEC) role in enforcing laws against insider trading?

For related activities and links, go to [www.cengage.com/schoolipfinance/mypf](http://www.cengage.com/schoolipfinance/mypf)