INVESTING ESSENTIALS

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Basics of Investing

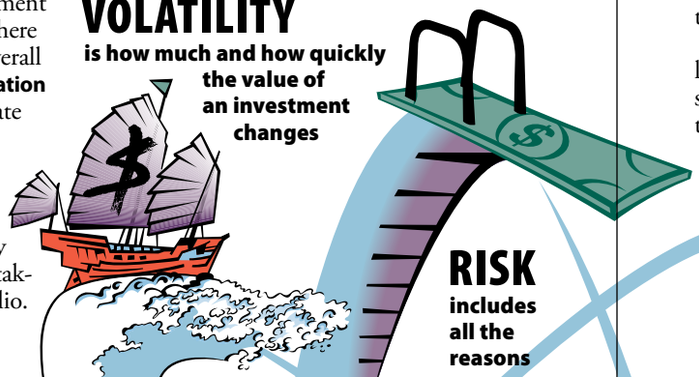
If you concentrate on the principles, you'll have the elements of an investment strategy.

As you make individual investment decisions, you'll want to ask where each investment fits in your overall **asset allocation** and **diversification** strategies. You'll want to evaluate the **yield** the investment may provide and the level of **return** it's reasonable to expect. And you'll want to assess how **volatile** the investment is likely to be and what **risks** you'll be taking in adding it to your portfolio.

Taking these steps doesn't guarantee that you'll achieve the results you want, but it should help protect you from avoidable mistakes.

VOLATILITY

is how much and how quickly the value of an investment changes

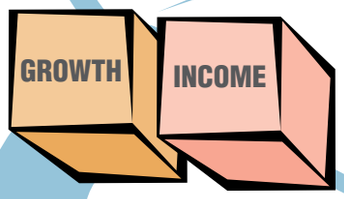


RISK

includes all the reasons you may have a loss or a week return

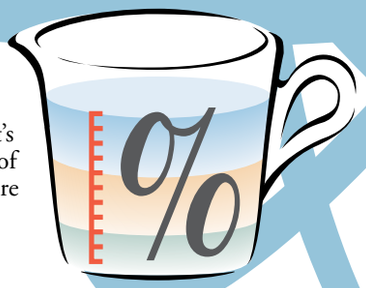
DIVERSIFICATION

is making several different types of investments rather than just one or two



ALLOCATION

is deciding what percentage of your portfolio goes into which categories of investment



TIME AND RISK

The range between an investment's high and low price over a period of time—such as a year—is a measure of its **volatility**. The smaller the percentage of change, the less volatile the investment is.

Volatilty poses the biggest risk to investment values in the short term. If you hold onto a stock when the price drops, the losses may be reversed and the value of your shares may reach or exceed their previous high, though that isn't guaranteed. Or, if you hold bonds until they mature, changing market values have no impact on what you earn.

Another way to deal with volatility is to capitalize on it. If an investment increases dramatically in value, you can sell it and make another purchase. If the price drops in the future, you might buy it again and wait for the cycle to repeat itself. In fact, some stock investors consider falling prices a buying opportunity that will let them take full advantage of future gains. The risk, of course, is that those gains can't be guaranteed even if your research shows the company to be a sound investment.

TWO STRATEGIC APPROACHES

You might decide that the way to meet your long-term goals is to put money into equities you expect to grow in value. This strategy helps you concentrate on specific types of investments, first on equities in general and then more narrowly on those that seem likely to perform best over the long haul.

If you are investing to meet both long- and short-term goals, you might select stocks and stock mutual funds that strive to provide both growth and income, in addition to those emphasizing growth alone. By reinvesting your dividends and capital gains, it's possible to build your investment base more quickly. Of course, stocks and stock mutual funds are more volatile than some other types of investments. So you may lose money if the market takes a sharp downturn.

If you've retired and want to begin collecting income from your portfolio, you may want to shift some of your assets to income-producing investments, such as bonds and dividend-paying stocks.

Any strategy, however, requires attention to basic details: understanding risk, volatility, diversification, and asset allocation, and evaluating yield and return.

RETURN

is what you get back, based on what you invest, usually measured on an annual basis

$$\frac{\text{Price change} + \text{Income}}{\text{Investment \$s invested}} = \%$$

KEEPING ON TRACK

Picking the right investments is only the first step in achieving your financial goals. You also have to monitor their performance regularly, asking whether these investments are still right for your portfolio as your goals shift and your lifestyle changes. And—this is where many investors falter—you have to be ready to make adjustments, sometimes even major changes, when you redefine your goals, or when the investments you've made aren't performing the way you expected.

It can be hard to move in new directions. If you feel comfortable relying on the investments you already know—perhaps CDs, money market accounts, or stock in the company you work for—there's always the temptation to stick with them. And while they may have their place in your investment plan, tying up your money in one or two places exposes you to greater investment risk.

YIELD

is the income you receive as a percent of what your investment cost you

$$\frac{\text{Income}}{\text{Investment \$s invested}} = \%$$

A DISTINCTIVE DIFFERENCE

Saving and investing are both ways to meet financial goals, but they're not the same:

- Saving is holding money, usually in bank accounts or money market funds, for a specific **short-term** purpose.
- Investing is buying things of intrinsic value—stocks, bonds, and real estate, for example—that have the potential to provide income or increase in price, or both, over the **long term**.

Though your savings earn interest, they may actually shrink in value over time. That's because the interest you earn is rarely more than the rate of inflation. On the other hand, insured savings, such as money market accounts and certificates of deposit (CDs), are well suited for meeting short-term goals, such as the down payment on a home you hope to buy within a year or two, since your principal is safe.

There's also a middle ground between saving and investing, where short-term bond funds and US Treasury bills fit. You generally earn more than on insured accounts, but the market values of these investments fluctuate as interest rates change.

Mutual Funds: Putting It Together

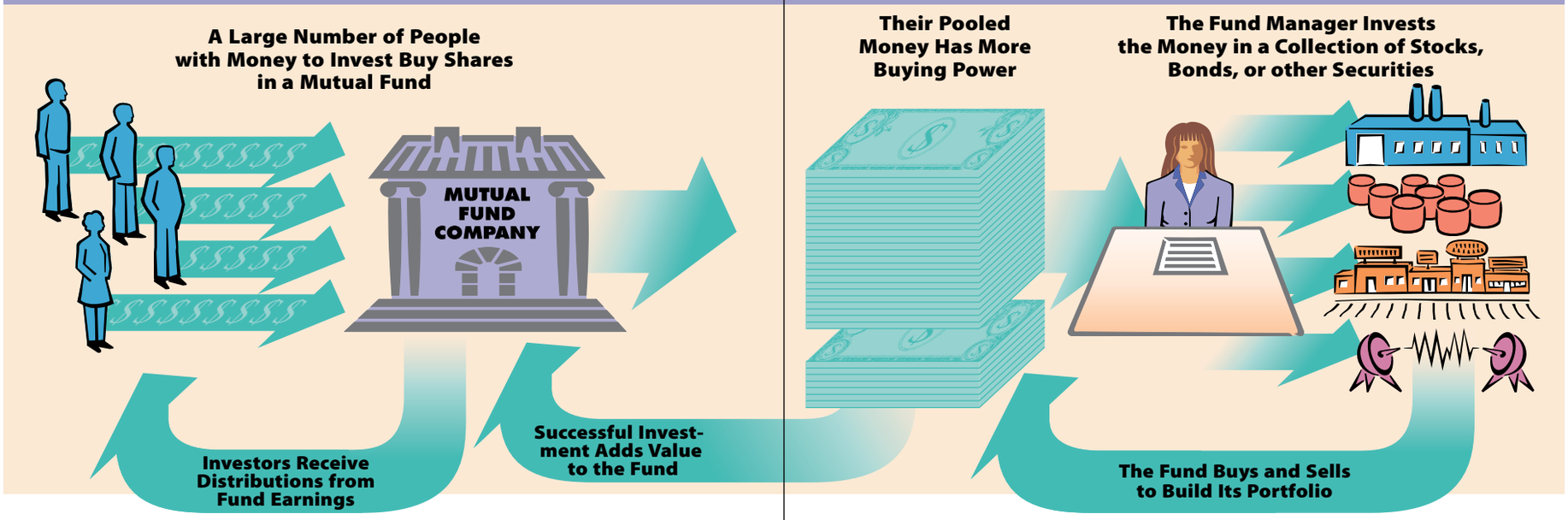
A mutual fund buys investments with money it collects from selling shares in the fund.

The idea of diversification is that it's smarter to own a variety of stocks and bonds than trying to meet your financial goals based on the successful performance of just a few. But diversifying can be a challenge because buying a portfolio of individual stocks and bonds can be expensive. And knowing what to buy—and when—takes time and concentration.

Mutual funds offer one solution: When you put money into a fund, it's pooled with money from other investors to create much greater buying power than you would have investing on your own. In an **actively managed** fund, professional managers decide what to buy and when to sell. An index, or passively managed, fund holds all or some of the securities in an index.

As a fund shareholder, you own the fund's **underlying investments** indirectly rather than outright, as you do when you buy stock. Since a fund may own dozens of different securities, its **return** isn't dependent on just a few holdings.

How Mutual Funds Work



PAYING OUT THE PROFITS

A mutual fund may make money in two ways: by earning dividends or interest on its investments and by selling investments that have increased in price. The fund distributes, or pays out, these profits (minus fees and expenses) to its investors.

Income distributions are paid from the income the fund earns on its investments. **Capital gains distributions** are paid from the profits from selling investments. Different funds pay their distributions on different schedules—typically monthly or quarterly. Many funds offer investors the option of reinvesting their distributions to buy more shares.

If you hold the fund in a taxable account, you owe taxes on the distributions you receive, whether the money is reinvested or paid out in cash. But if a fund loses more than it makes in any year, it can use the loss to offset future gains. Until profits equal the accumulated losses, distributions aren't taxable, although the share price of the fund may increase to reflect the profits.

HOW A MUTUAL FUND IS CREATED

A mutual fund company decides on an investment concept

Then it issues a prospectus

Finally, it sells shares

A FUND SNAPSHOT

Investment companies (also called mutual fund companies), brokerage firms, banks, and insurance companies offer mutual funds for sale to individuals and institutional investors, such as money managers or pension funds. Most fund sponsors offer a range of funds, but some specialize in bond funds or stock funds.

Each actively managed fund has an investment objective and a strategy for building its portfolio. The manager invests to produce a return, or gain, that's stronger than the return of the market from which the fund's investments are chosen and to outperform competing funds. Most index funds seek to replicate market returns.

OPEN- AND CLOSED-END FUNDS

Most mutual funds are **open-end funds**. This means the fund sells as many shares as investors want. As money comes in, the fund grows. If investors want to sell, the fund buys their shares back. Sometimes open-end funds are closed to new investors when they grow too large to be managed effectively—though current shareholders can continue to buy shares. When a fund is closed in this way, the investment company may create a similar fund to capitalize on investor interest.

Closed-end funds more closely resemble stocks in the way they are traded. While these funds do invest in a variety of securities, they raise money only once and offer only a fixed number of shares that are traded on an exchange or over-the-counter. The market price of a closed-end fund fluctuates in response to investor demand as well as to changes in the value of its holdings.