Invest for Success

Types of Investments

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So What?

You may have heard the terms "risk" and "reward" when talking about finance or investing, but did you know that the risk-reward concept is something you experience frequently in your own life? When you ask someone on a date, you're taking a risk because s/he might say no. However, if you don't take that risk, you certainly won't get the reward of her/him saying yes! The same concept is true if you're applying to your dream college—you risk your hopes (and your application fee!), but you might just get accepted. What about skydiving? Jumping from a plane is definitely a risk, but, for many who try it, the reward of exhilaration is more than worth it!

Considering how risk and reward play out in your own life can help you understand how these factors affect investors and the types of investments they make. Read on to learn more!

Objectives

A Discuss the risks and returns involved with lending investments.

B Discuss the risks and returns involved with ownership investments.

On Loan

If you could do anything you wanted this weekend, what would you do? Would you race a fast car, ride your skateboard, go bicycling, or read a good book? If you're a risk-taker, you might try something new, such as singing at an "open mic" night. If you're not a risk-taker, you might stick with something more familiar, such as going to see the next film in your favorite series. Willingness to take physical or social risks is determined by your **temperament** (nature) and your attitude.

People who face **risk** (the possibility of loss) with a positive attitude are described as **risk-tolerant** or risk-takers. Risk-takers know that trying something doesn't guarantee success. But, they're willing to "chance it" for the potential **return** (reward or benefit). For a racecar driver, the return is likely the thrill of the experience or of victory. For an investor, the return is what the investment could earn—the additional money s/he could receive. People who face risk with a negative attitude are called **risk-averse**. For them, the potential return is often not worth the uncertainty or the possibility of loss.

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▲ To earn a greater reward, investors must be willing to take greater risk.

Test your risk-taking attitude by taking CNN's quiz at http://edition.cnn.com/2008/BUSINESS/09/26/risk.quiz/index.html?cc=us&selLanguage=en.

Investors know they're taking a risk when they invest. They could lose money. They might not get back more than they've put in, or they might lose everything they've invested. So, why would anyone want to invest? For the earnings, pure and simple. Accepting a level of risk is just part of investing.

Too much to handle?

If you're an investor and want the potential of a high return, you accept a high risk. If you can't handle a high risk, you select a moderate- or low-risk investment instead—with the understanding that taking a lower risk brings you the potential of a lower return, in general.

Three things tend to determine how much risk you can handle:

1) What you want to accomplish
2) How much time you have to accomplish it
3) Your personality

Let's say your financial goals are to buy a house and to save for your retirement. If you're in your teens or twenties, preparing for retirement is a long-term goal, while saving for a down payment on a house is something you could do in just a few years. This means that for your retirement investment, you might take a little more risk—because you don't need the money right away. For your down payment, however, you wouldn't want to risk what little you have so far—because you're going to need the money in the near future.

Your goals and timetable are not the only determining factors of how much risk you can tolerate, however. If you have a personality that is uncomfortable with risk, you might not care how much time is involved. You might be willing to sacrifice the reward you *could* gain in the future for the certainty you have *right now*.

Investors who try to avoid risk are mainly interested in protecting their initial investments—and they should be! To "grow" your money, you need to make sure that what you've invested will remain safe. Before you choose a specific investment, consider how *likely* it is that you'll lose what you initially put in. When there's a good chance you may lose what you've invested, the risk is "high." When there's a small chance (or no chance) that you'll lose what you've invested, the risk is "low." Higher risks usually bring higher returns.

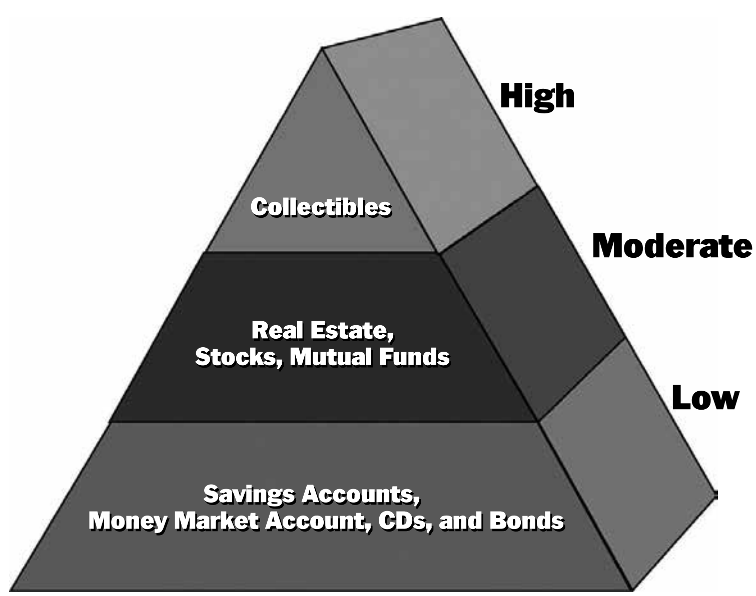
For a more in-depth look at investment risk and return, read Ted Schwartz's column "What Investors Must Know about Risk and Return" at http://abcnews.go.com/Business/investors-risk-return/story?id=20357473.

From my point of view...

One way to put your investment risk in perspective is to look at the risk pyramid, a graphic way of comparing investments. With high-, moderate-, and low-risk categories, the pyramid helps you to see which investments are more or less risky than others. Near the peak are the most risky investments, while at the base are the most reliable returns.

If an investment you're considering is located near the middle of the pyramid—but you think you can handle more risk—you might select an investment closer to the peak. If you feel that you can't afford any large losses right now, you might choose an investment closer to the base. When you visualize how likely it is that you'll receive a particular return, you can see which selection is the best choice to move you toward your goal.

Investment Risk Pyramid



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Skeptics may think that investing is similar to playing the lottery. Yes, investing is risky, but wise investors make sure their chances of succeeding are good. With the Powerball lottery, the chances aren't so good—about one in 175 million. Buying two tickets increases the odds to only two in 175 million. Still not very promising!

Lending investments

Right now, you could select from almost any number of investment opportunities to make your money work for you. These opportunities are called **securities**—the legal lending or owning agreements between individuals, businesses, or governments. Since there are many different types of securities, you might find it helpful to separate them into "lending" and "owning" categories. These categories are sometimes referred to as "debt" and "equity."

Investors who can't handle much risk put their money into lending investments. With a **lending investment**, you allow someone to borrow your money for a period of time—for a price.

The extra money you receive provides the motivation for lending. Examples of lending investments are savings accounts, money market accounts, certificates of deposit, and bonds.

Savings accounts. A **savings account** is an investment in which you lend money to a bank for the benefit of being able to access it at pretty much any time (you can make up to six withdrawals a month, per federal law). Of course, you can access your money with complete freedom if it's hidden in your sock drawer. The difference is that you get paid to put your money in a savings account (and you don't have to worry about your little brother stealing it!)—and that's what motivates people to do it.

Another benefit of a savings account is that you can leave your money in it for an indefinite period of time. This means that you don't have to move your savings from one place of investment to another. You can keep a savings account open for your entire life. In addition, savings accounts are insured by the **FDIC (Federal Deposit Insurance Corporation)** for up to $250,000. No investor has lost a penny in an account insured by the FDIC since its creation in 1933.

▲ The FDIC (Federal Deposit Insurance Corporation) was developed in response to bank failures that occurred during the Great Depression.

The downside to a savings account is twofold. First, you receive a low rate of return. Right now, savings accounts are returning an average of 0.07 percent interest per year (for updated information, check http://www.nerdwallet.com/rates/savings-account). This means that if you put $1,000 in your savings account, your investment will earn you less than $1 in interest over an entire year. Second, this low return doesn't even keep up with inflation—which is a double-whammy. Your savings grows at a slower rate than the cost of goods and services. In effect, your money has less buying power.

The Gray Zone

"Heavy" industries such as energy and manufacturing have been known to cause environmental damage (pollution, deforestation, etc.). Investing in these industries, however, may bring an investor a good rate of return. It's certainly not illegal to invest in these types of companies, but is it ethical, considering their negative impact on the environment? What do you think?

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You can learn more about the pros and cons of putting your money in a savings account by visiting http://finance.zacks.com/advantages-disadvantages-savings-checking-accounts-3843.html and reading Calia Roberts' article "Advantages and Disadvantages of Checking and Savings Accounts."

Money market accounts. Another bank account that earns interest is a **money market account**. A money market account is very similar to a savings account. It's insured by the FDIC, and you can leave your money in it as long as you'd like. However, a money market account may have some additional restrictions. You may be allowed fewer than six withdrawals per month (perhaps only three), and your account may also have a minimum-balance requirement.

So, what is the benefit of a money market account over a savings account? Unlike savings accounts, you can write checks from some money market accounts (again, usually a limited number each month). And, traditionally, you should get a better interest rate. However, current money market account rates are about the same as savings account rates. You can look up rates in your area by visiting http://www.nerdwallet.com/rates/Money-Market-Rates.

Learn more about the differences (or lack thereof!) between savings accounts and money market accounts by reading Trent Last's article "Personal Finance 101: Money Market Accounts Versus Normal Savings Accounts" at http://www.thesimpledollar.com/personal-finance-101-money-market-accounts-versus-normal-savings-accounts/.

Online banks often offer more attractive interest rates for savings accounts and money market accounts than traditional, "brick-and-mortar" banks do. If you conduct a Google search for "online savings account," you'll be able to check out some of the most up-to-date rates.

Certificates of deposit. A **certificate of deposit** (CD) is a lending investment in which you lend money to a bank at a set interest rate for a particular period of time. Typical time frames can be as short as 28 days or as long as 10 years. With CDs, you are guaranteed a certain rate of return, but you can't access your money before the end of the time period without paying a penalty. By giving up the right to use your money for a period of time, you can earn a higher return than with a savings or money market account. Good interest rates for five-year CDs are currently around 0.8 percent. To get this interest rate, though, you usually have to invest a minimum amount of money—such as $500 or $1,000.

Bankrate.com offers further insight on CD investing in a post entitled "The Pros and Cons of CD Investing." You can read it here: http://www.bankrate.com/finance/cd/the-pros-and-cons-of-cd-investing.aspx.

Bonds. While a CD is offered by a bank, a **bond** is offered by a government, municipality, or corporation. A bond is similar to a CD in that it's a lending investment at a set interest rate for a particular period of time—such as a year, 10 years, or longer. With a bond, however, you don't pay a penalty if you withdraw the invested amount before the end of the time frame. You just lose the amount you would have received if you'd left it alone.

▲ Did you know that by purchasing a federal bond, you are lending money to the U.S. government?

In general, bonds are considered to be *guaranteed* money. They are very low risk. The trade-off is that you have to be willing to leave your money with the borrower for the entire time period. In some cases, that's 30 years! But, the reliability of bonds appeals to many investors who can handle only small amounts of risk.

A newer trend in bond investing allows investors to positively influence society while still getting a return on their investments. Learn more about social impact bonds by watching this video from Goldman Sachs: http://www.goldmansachs.com/our-thinking/trends-in-our-business/social-impact-bonds.html.

Summary

People who have a positive attitude toward risk are risk-tolerant. Those with a negative attitude toward risk are risk-averse. Risk is an important concept in investing. How much risk you can handle as an investor depends on your goals, your timetable, and your personality. Lending investments are generally low risk. These include savings accounts, money market accounts, certificates of deposit (CDs), and bonds.

1. Explain what it means to be risk-tolerant or risk-averse.
2. What factors determine how much risk an investor wants to take?
3. What are lending investments?
4. Briefly explain the following lending investments:
    a. Savings accounts
    b. Money market accounts
    c. Certificates of deposit
    d. Bonds

Owning It

Investors who are not afraid of risk often put their money into **ownership investments**—investments that provide owners' rights in return. Types of ownership investments include stocks, mutual funds, real estate, entrepreneurship/business opportunities, and collectibles. Each ownership investment provides an opportunity for a return by letting you own something of significance. Let's take a look at each.

Stocks. A **stock** (or share) is a piece of paper—whether real or virtual—that says you own part of a corporation. As an owner (or shareholder), you have the rights and responsibilities of ownership. This means you can attend shareholders' meetings, vote for issues you support, and receive a portion of the company's earnings. In addition, you may be able to sell your stocks for a profit, making a sizeable sum of money. But, being an owner also means you risk losing money. If your stocks decrease in value, you can lose a lot. If the corporation goes out of business, you can lose your whole investment—because, as an owner, you're part of the corporation. (Since bond holders are *not* owners, they will get paid back before you.) But, even if the corporation *doesn't* go out of business, you can lose everything you've invested just due to the up-and-down nature of stock values.

▲ Stocks typically increase and/or decrease multiple times each day.

There are many different kinds of stocks. If you're interested in learning more about them, check out the article here: http://www.investopedia.com/university/stocks/stocks2.asp.

Mutual funds. If you're concerned about the risks of owning stocks, you could invest in a stock mutual fund. A **stock mutual fund** is a combination of stocks from different corporations or agencies, usually from different industries. The idea behind mutual funds is that you don't take as much of a risk as you do when you buy individual stocks—but, as an owner, you still have a good chance of receiving a return. How much you receive usually depends on how much risk you're willing to take. If you buy a combination with more risk, you might get a greater return.

One benefit of investing in mutual funds is access to the expertise of the fund's manager. The manager is directly responsible for deciding which investments best meet the mutual fund's stated purpose. Fund managers can make mistakes, though, so you should pay attention to who's in charge of directing your fund. You should also find out about any fees associated with a mutual fund. Fees vary dramatically and can have a negative impact on your return.

For a more in-depth look at the advantages of mutual fund investing, read Austin Pryor's article "20 Major Advantages of Investing in Mutual Funds" at http://www.crown.org/Articles/tabid/107/entryid/167/Default.aspx.

Mutual funds aren't just for stocks. Some mutual funds include money market accounts, bonds, or even mixtures of several different types of securities. Depending on what the mutual fund contains, it may be considered a lending investment, an ownership investment, or a hybrid of the two.

Real estate. Another ownership investment is **real estate**. You can buy a home to live in, a vacation spot for the summer, an investment property that will bring in rent money, or land that might be developed sometime in the future. There are a lot of choices, but the one almost everyone can participate in is home ownership. When you buy a home, you pay a certain amount toward the value of the house. While you're living there, the home's value can increase along with the property values around you. This means that for the amount of money you invest, you are likely to get more out of the real estate than you pay for it.

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▲ In 2006-2008, a rapid decline in home values helped to cause what many economists call the worst financial crisis since the Great Depression.

With property values, your day-to-day risk is **depreciation**, the loss of value due to market forces. This means that if others see your property as less valuable, your real estate is not worth as much. When other properties around yours decrease in value—because they're run-down or flood-prone—you suffer, too.

Ian Woychuk explores the ups and downs of investing in real estate in his Investopedia article "Exploring Real Estate Investments: Advantages and Disadvantages." You can find it here: http://www.investopedia.com/university/real_estate/real_estate4.asp.

Entrepreneurship/Business ownership. You might not realize it, but the money it takes to start and run a business is an investment. **Entrepreneurship** is one of the riskiest and hardest investments a person can make. That's because it involves a lot more than just money. Entrepreneurs invest their time, their hard work, their ideas, and their hopes and dreams. When a business fails, the entrepreneur loses a lot. However, entrepreneurship carries the potential of a very high return. Think of Bill Gates of Microsoft, Larry Page of Google, or Mark Zuckerberg of Facebook.

Collectibles. Collectibles are items that gain or lose value over time. For example, you buy a baseball card when it's not too expensive, and you wait for it to become really valuable. Once it's worth a lot more than you paid for it, you sell it to someone else to make a profit. Sounds easy, doesn't it?

Getting a good return from a collectible, though, depends on two key things. You have to be sure that the item is important to other people, not just you. And, you have to be sure that the item will be *more* important to other people *in the future*. It's impossible to be absolutely certain of either one of these two things. That's what makes a collectible item a risky investment. You might not be able to sell the item at all—let alone for more money than you've paid for it. Even so, many people enjoy investing in collectibles such as antiques, gems, stamps, dolls, or sports memorabilia. When investors *like* to collect these items, you figure that they probably don't mind keeping some of the things they can't sell.

Interested in investing in collectibles? Check out the MoneyTalksNews article and video at http://www.moneytalksnews.com/2013/08/14/are-grandmas-collectibles-worth-anything/ to get some helpful hints and suggestions for making money off old comic books, vinyl records, and other random items in your attic.

All business

Individuals aren't the only ones who make investments. Businesses and other organizations do as well. Why wouldn't they? They want to grow their wealth just as individuals do. Most businesses' main form of investment is investing back into the company itself—researching and developing new products, purchasing the latest and most efficient technologies, expanding into new markets, etc. However, businesses also participate in other forms of investing—they may put cash into savings or money market accounts, purchase bonds or stocks, or buy real estate.

Sometimes, businesses invest money that isn't their own. A common example is a non-profit organization's **endowment fund**. Funds obtained from donors are pooled together and invested to create additional income. A great number of colleges and universities have endowment funds. You can learn a bit more by reading Albert Phung's article "How Do University Endowments Work?" at http://www.investopedia.com/ask/answers/06/universityendowment.asp.

Summary

Risk-tolerant investors often choose ownership investments. Types of ownership investments include stocks, mutual funds, real estate, entrepreneurship/business opportunities, and collectibles. Businesses also make investments as a way to grow their wealth.

1. What are ownership investments?
2. Briefly explain the following ownership investments:
   a. Stocks
   b. Mutual funds
   c. Real estate
   d. Entrepreneurship/Business ownership
   e. Collectibles
3. Explain how businesses participate in investing.

Make It Pay!

Do you consider yourself risk-tolerant or risk-averse? What examples can you give to support your claim? How do you think your age, personality, and goals will affect your future as an investor?