1. Explain the difference between a stock and a bond in enough detail so that someone who is unfamiliar with these terms can distinguish between the two.

A Stock is a share of a company’s future earnings and a right to a say in how the company is run. More generally, stocks are sold by a company to raise money or capital in return of a share of company’s profits to their investors who bought those shares of stocks. Consequently, owning a share of a company’s stocks means sharing their losses as well when the stock value fall. In contrast, Bonds are a legal arrangement or a promise that tells the borrower to pay the amount owed to the lender at the time its due (maturity date) with interest. This means that bonds are less risky than stocks because there is an element of certainty attached to bonds via legal agreement between the borrower and lender. Credit card debts are a form of bonds because you borrow money from the bank that you will pay in the future with interest. Thus, bonds return less profits than stocks because its less risky and volatile.

1. Describe the concept of diversification in enough detail so that someone who is unfamiliar with it can understand what it is. Then provide one brief example of a diversified investment portfolio.

Diversification in terms of investing is spreading out your money into different investment vehicles. As the famous axiom suggests, “Do not put your eggs in one basket”, as you might lose them all at once. Diversification, given that our investments are well spread out, provides us some security when a given sector or industry is not doing well. We would lose all our money if say, we are invested into just one company, then the next day they went bankrupt, all of our money invested are gone with the company and would never recover. In contrast, having our money “parked” in different vehicles, e.g. commodities, stocks, bonds, etc., we would still keep some profits from our other investments at the event a particular sector or industry is having a hard time.

1. What is a mutual fund? Briefly describe one specific advantage or benefit of investing in a mutual fund.

Mutual fund is a pool of investment hand-picked by professional money managers that are allegedly would make some profits for the fund’s investors. This type of investment by nature is diversified because it contains different types of investment that are less likely to fall all at once. Mutual funds are great for passive investors who wants to diversify their portfolio at a relatively low cost but do not want or have the capacity to cherry pick investments.

1. Explain the difference between a growth stock and a value stock in enough detail so that someone who is unfamiliar with these terms can distinguish between the two.

Growth stocks are companies that promises a higher rate of return once you invest in them because the market underestimates its potential for growth. On the other hand, Value stocks are companies that are deemed undervalued or underpriced by the market. Therefore, value stock is expected to provide higher-than-average return because it is underpriced. In comparison, growth stock gives more rate of return than that of a value stock because investors who seek for growth stocks tend to look for short term investment with high potential for profit. While value stock investors tend to look for slow and steady stocks with consistent higher-than-average return.

1. Choose one specific time-related investment strategy (dollar cost averaging, market timing, CD laddering, etc.). Describe this strategy in enough detail so that someone who is unfamiliar with it can understand what it is and how to do it.

Dollar cost averaging is a type of investment strategy where you buy a fixed number of shares of stock at a fixed interval. This strategy is very effective if you plan to invest in the market more passively and less engaged with the market fluctuations (ups and downs), as opposed to timing the market or active investing. While this strategy doesn’t seem so grandiose, it protects investors from market volatility and heartaches. For instance, buying stock XYZ at a price of $100 then buying another one every month regardless of its future price. Say the stock XYZ fell -5% to $95 at the end of the first month you started to invest and you still bought the stock regardless, your average price would be $97.5 ((100 + 95) / 2). Meaning that stock XYZ needs to go back up to $97.5 or approximately 2.6% gain for you to breakeven. Now say, instead of cost averaging, you decided to time the market and buy the stock XYZ all at once at the price of $100 because you believe it will go up tremendously. The stock goes down to $95 which sets your principal back by -5%. You would need the price to go back up to at least the original price you paid for it to breakeven, which is asking for a roughly 5.26% increase in price from $95!

Consequently, going all in means that if you are right, you would be very happy that you went all in with your investment but that does not happen all the time, unless you are extremely lucky or an insider (which is illegal), it is impossible to be certain of what would happen to the price of the stock in the future. Dollar cost averaging strategy, while not as rewarding as going all in, helps you to minimize that risk of uncertainty by buying fixed number of shares incrementally regardless of the price so you won’t have to time the market and avoid getting whipsawed (buying and selling at the wrong time).