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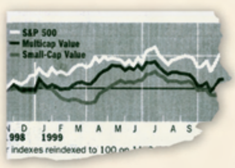
INVESTING ESSENTIALS

An Easy-to-Understand, Easy-to-Use Primer That Helps Take the Mystery Out of

- *Mutual Funds*
- *Liquidity*



- *Tracking Performance*
- *Stocks*

- *Risk/Return*

- *Diversification*

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INVESTING ESSENTIALS

CONTENTS

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Investing

When you invest, you're trying to increase your income and build the value of your assets.

It's never too soon to start thinking about **investing**. Investing means putting your money to work earning more money. Done wisely, it can help you meet your financial goals: buying a home, paying for a college education, enjoying a comfortable retirement, or whatever is important to you.

You don't have to be wealthy to be an investor. Investing even a small amount has the potential to produce considerable rewards over the long term, especially if you do it regularly. For example, investing just $50 a week can add up to more than $300,000 in 30 years if it grows at an annual rate of 8%.

But you do have to make decisions about how much to invest and where to invest it. To choose wisely, you need to know what alternatives you have and what risks you take when you invest in different ways.

INVESTMENT BASICS

There are three basic investment categories: **stocks**, **bonds**, and **cash**.

Each of these **asset classes** puts your money to work in a different way. The return on investment that they provide varies from class to class and from year to year. But over time all three types have provided positive results.

Stocks are ownership shares investors buy in a corporation

Bonds are loans investors make to corporations and governments

Cash investments include money in bank accounts, certificates of deposit (CDs), and US Treasury bills

WAYS TO INVEST

You can invest directly in individual stocks, bonds, and cash or cash equivalents and hold them in your own name or jointly with someone else. You can invest indirectly by putting money into mutual funds, exchange traded funds (ETFs), or annuities that buy stocks, bonds, or cash.

You can open accounts with brokerage firms, investment companies, banks, and insurance companies. And you may have the opportunity to invest through a retirement plan your employer offers. The assets you own in all these accounts make up your **investment portfolio**.

CHOOSING THE BEST INVESTMENT

Selecting investments that are right for you depends on your financial goals and timeframe. For example, a smart investment for a long-term retirement plan may not be a good choice for accumulating a down payment. In each case, you're seeking a different balance of three things: **liquidity, safety**, and **return**.

LIQUIDITY

How accessible is your money?

If your investment money must be available to cover financial emergencies, you'll be concerned about **liquidity**, or how easily it can be converted to cash. Money market funds and savings accounts are very liquid, as are investments with short maturity dates like CDs. But if you're investing for longer-term goals, liquidity is not a key issue. What's more important is increasing the value of your portfolio so that it can provide future income and perhaps assets to leave to family, friends, or charities.

SAFETY

What's the risk involved?

Investing means taking some risks. To many people, the biggest risk is losing money, so they look for investments they consider safe. Usually that means putting money into bank accounts and US Treasurys. The opposite but equally important risk is that your investments will not provide enough growth or income to offset the impact of inflation, the gradual increase in the cost of living. One solution may be choosing a variety of investments with different levels of risk, to provide both safety and growth.

RETURN
What can you expect to get back on your investment?
Safe investments often promise a specific, though limited, return. Those that involve more risk offer the opportunity to make—or lose—more money.

OTHER INVESTMENTS
You can find many other things to invest in, like gold, real estate, or private partnerships, if you're looking for more variety or can afford to take added risks. But most experts agree that the basic three—stocks, bonds, and cash—should be the core of any investment portfolio. High on the list of reasons for that advice are the easy-to-understand structure and the regulatory requirements that govern these standard investments.

In addition, if you need to liquidate your assets, you can sell these investments easily, but you may not necessarily sell at a profit. Selling other types of investments may be slower or more difficult.

WAYS TO INVEST
Just as there are different types of investments, there are different types of investment accounts.

You can put as much money as you wish in a **taxable** account each year and choose from a full menu of investments. You pay tax on any earnings your investments produce and on any gain in value from selling an investment for more than you paid to buy it. Qualifying dividends and long-term capital gains are taxed at a lower rate than your other income.

You may also have one or more **tax-deferred** retirement accounts. You can postpone taxes on investment earnings in a tax-deferred account until you withdraw. In some accounts you can also defer taxes on the amounts you invest. When you do withdraw, the tax that's due is figured at the same rate as you pay on other income. There are some limitations: The annual investment is often capped, and in some plans the investment menu may be limited. You may also owe a penalty if you withdraw early, which is usually before 59½.

Tax-exempt accounts are designed to help you pay for specific goals, such as retirement or education. If you follow the rules of the specific account you're using, no tax is due on any earnings in the account, either as they accumulate or when you withdraw. You do pay tax on the amounts you invest, and there may be limits on amounts you can invest each year.

Securities, by definition, are written proofs of ownership, like stock or bond certificates. But as electronic records replace paper, the term survives, even though it now refers to investments that are secured as computer files.

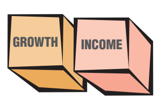
Basics of Investing

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

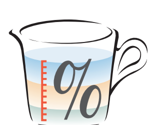
As you make individual investment decisions, you'll want to ask where each investment fits in your overall **asset allocation** and **diversification** strategies. You'll want to evaluate the **yield** the investment may provide and the level of **return** it's reasonable to expect. And you'll want to 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.

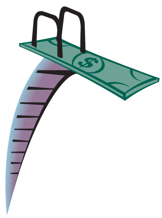
VOLATILITY
is how much and how quickly the value of an investment changes



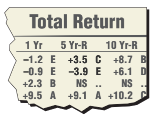
DIVERSIFICATION
is making several different types of investments rather than just one or two



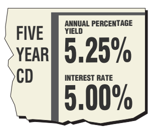
ALLOCATION
is deciding what percentage of your portfolio goes into which categories of investments



RISK
includes all the reasons you may have a loss or a weak return



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



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

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.

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.

A DISTINCTIVE DIFFERENCE

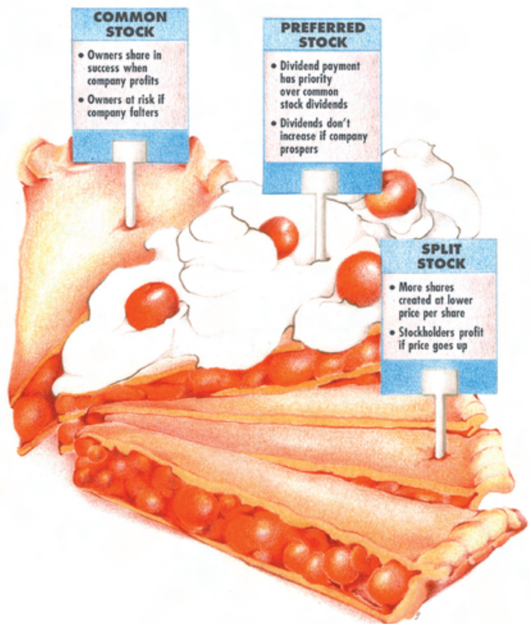
Saving and investing are both ways to meet financial goals, but they're not the same:

- 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.



Stocks: Sharing a Corporation

Stocks are pieces of the corporate pie. When you buy stocks, or shares, you own a slice of the company.

Stocks are **equity** investments. If you buy stock in a corporation, you own a small part of that corporation and are described as a **stockholder** or **shareholder**. You buy stock because you expect it to increase in value, or because you expect the corporation to pay you dividend income, or a portion of its profits. In fact, many stocks provide both growth and income.

When a corporation issues stock, the company receives the proceeds from that initial sale. After that, shares of the stock are **traded**, or bought and sold among investors, but the corporation gets no income from those trades. The price of the stock moves up or down depending on how much you and other investors are willing to pay for it at the time.

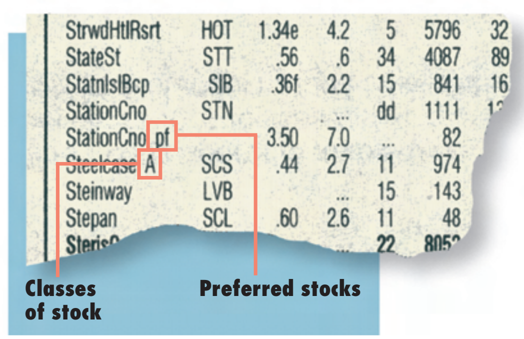
COMMON STOCK

Most stock in the US is **common stock**. Owning common stock entitles you to collect dividends if the issuing corporation pays them, and to sell your stock at a profit if its price increases. But since common stock prices aren't fixed, they can lose as well as gain value. And some stocks are volatile, which means their prices may increase or decrease rapidly.

Despite these risks, investors are willing to buy common stock because over time stocks in general—though not every individual stock—have provided a stronger **return** than other securities.

PREFERRED STOCK

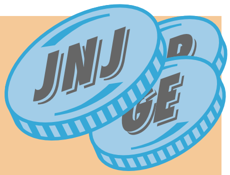
Preferred stocks are also ownership shares issued by a corporation and traded by investors. They differ from common stocks by reducing investor risk—but they may also limit return. The amount of the dividend is usually guaranteed and paid before dividends on common stock. And preferred stockholders have a greater chance of getting some of their investment back if a company fails. But the dividend isn't increased if the company profits, and the price of preferred stock tends to be stable over time.



StrwdHtlRsrt	HOT	1.34e	4.2	5	5796	32
StateSt	STT	.56	.6	34	4087	89
StatnlslBcp	SIB	.36f	2.2	15	841	16
StationCno	STN		...	dd	1111	
StationCno pf		3.50	7.0	...	82	
Steelcase A	SCS	.44	2.7	11	974	
Steinway	LVB		...	15	143	
Stepan	SCL	.60	2.6	11	48	

CLASSES OF STOCK

Companies may issue different classes of stock, label them differently, and list them separately on a stock market. Sometimes a class indicates ownership in a specific division or subsidiary of the company. Other times it indicates shares that sell at different market prices, have different dividend policies, or impose voting or sales restrictions on ownership.



BLUE CHIP

is a term borrowed from poker, where the blue chips are the most valuable. Blue chips refer to the stocks of the largest, most consistently profitable —corporations. The list isn't official — and it does change.

STOCK SPLITS

When the price of a stock increases significantly, you and other investors may be reluctant to buy, either because you think the price has reached its peak or because it costs so much. Corporations have the option of splitting the stock to lower the price, which they expect to stimulate trading. When a stock is split, there are more shares available, but the total market value is the same. Say a company's stock is trading at $100 a share. If the company declares a two-for-one split, it gives you two shares for each one you own. At the same time the price drops to $50 a share. If you owned 300 shares selling at $100 you now have 600 selling at $50—but the value is still $30,000.

The initial effect of a stock split is no different from getting change for a dollar. But the price may move up toward the presplit price, increasing the value of your stock.

Stocks can split three for one, three for two, ten for one, or any other combination.

REVERSE SPLITS

In a **reverse split** the corporation exchanges more shares for fewer—say ten shares for five—and the price increases accordingly. Typically the motive is to boost the price so that it meets a stock market's minimum listing requirement or makes the stock attractive to institutional investors, including mutual funds and pension funds, which may not buy very low-priced stocks.

LOVE ME TENDER

Just as it may issue additional shares, a company may choose to **repurchase**, or buy back, shares of its stock, either gradually in the stock market or by **tender offer**, giving shareholders the right to sell at a specific price. The company's motive may be to boost its stock price or to reduce dilution that results from granting stock options. Or it may decide a buyback is a better use for extra cash than investing in a new company, reinvesting in its own business, or paying a dividend.

Buying Stocks

Buying stocks isn't hard, but the process has its own rules, its own language, and a special cast of characters.

To buy or sell a stock, you usually must open an investment account with a traditional or online brokerage firm, mutual fund company, or bank. Your order is handled by a **stockbroker** who has passed an exam on securities law and is registered with FINRA, the Financial Industry Regulatory Authority, and with one or more states.

You may also be able to buy stock directly from the company that issues it through a **dividend reinvestment plan (DRIP)** or a **direct stock plan (DSP)**. A number of large companies offer DRIPs and charge only a minimal fee to handle your transactions. If you sign up, your dividends are automatically reinvested to buy more shares, and you can make cash purchases as well.

WHAT'S IN A NAME?

Though you probably use the term broker to describe all of the professionals who buy and sell stocks, the financial markets use other, more specific titles to describe the ways securities change hands.

Brokers handle buy and sell orders placed by individual and institutional clients in return for a commission. A floor broker handles buy and sell orders on the floor of an exchange.

Dealers buy and sell securities for their own accounts or the firm's account rather than for a client. Dealers make their money on the difference between what they pay to buy a security and the price they get for selling it.

Traders, also called registered or competitive traders, buy and sell securities for their own portfolios. The term traders also describes those employees of broker-dealers who handle the firms' securities trading.

CUSTOMER

Places orders to buy and sell

When you tell your broker to buy or sell a stock at the current price, called the **market price**, you're giving a **market order**. The price you pay (or get) is usually the same as or close to the quote you're given when you place the order, depending on how quickly it's handled and how actively traded the stock is.

If you think the price of the stock you want to trade is going to change, you can place a **limit order**, which instructs your broker to buy or sell only when the stock is at the price you've named, or better.

A **stop order** instructs your broker to buy or sell at market price once the stock hits a specified target price, called the **stop price**. Stop orders are usually placed to limit losses or protect profits. Their downside is that they may be executed at a price higher or lower than the stop price since the stock trades at the current market price after it hits the stop price.

When you give a stop order or a limit order, your broker will ask if you want a **good 'til canceled (GTC)** or **day order**. A GTC stands until it is either filled, you cancel it, or the firm's time limit expires. A day order is canceled automatically if it isn't filled by the end of the trading day.

A broker, originally, was a wine seller who broached — broke open — wine casks. Today's broker has a less liquid but often heady job as a financial agent.

BROKERAGE FIRM

Handles transactions

Some brokers, usually called **full-service brokers**, provide a range of services beyond executing buy and sell orders for clients, such as researching investments and developing long- and short-term investment goals.

Discount brokers carry out transactions for clients but typically offer more limited services. Their fees, however, are usually much lower than full-service brokers'. And for experienced investors who trade often and in large blocks of stock, there are **deep discount brokers**, whose commissions are even lower.

The cheapest way to trade securities, however, is usually with an **online brokerage firm**. Many established full-service and discount brokerage firms offer substantial discounts to their customers who buy and sell securities online.

BROKER-DEALER

A broker-dealer (B/D) is a license granted by the SEC that entitles the firm's employees to buy and sell securities for its clients' accounts and to trade securities for its own account. B/Ds range in size from independent one-person firms to multi-office firms with thousands of employees.

STOCK MARKET

Reflects activity

Up-to-date information is the lifeblood of stock trading. It not only reflects current investment decisions but also influences what happens in the hours and days that follow.

Trading activity in individual stocks and the market as a whole is reported constantly online, on radio and television, and is summarized daily in the business pages of many newspapers. Overall movement in the stock markets is tracked by a variety of indexes and averages, such as the Dow Jones Industrial Average (DJIA), the Standard & Poor's 500 Index (S&P 500), and the Russell 2000.

Access to online information in particular is dramatically changing the way individuals invest. With just a little practice, you can research the financial history of a particular company, take advantage of online software that will help you choose an appropriate stock, or access real-time stock quotes. You can also use this information to analyze the impact of your buy and sell decisions on your portfolio and plan your future trades.

WHERE THE COMMISSION GOES

The commission you pay to buy and sell stocks is divided — by prearranged contract — between your broker and the brokerage firm. The commissions and any additional fees are set by the firm, but your broker may be able to give you a break if you trade often and in large volume. Generally, the higher the commission rate the firm usually charges, the more room there is for negotiation.

Bonds: Financing the Future

Bonds are loans that investors make to corporations and governments. The lenders earn interest, and the borrowers get the cash they need.

A bond is a loan that pays interest over a fixed **term**, or period of time. When the bond **matures** at the end of the term, the **principal**, or investment amount, is repaid to the lender, or owner of the bond.

Typically, the rate at which interest is paid and the amount of each payment is fixed at the time the bond is offered for sale. That's why bonds are also known as **fixed-income securities**. That's one reason a bond seems less risky than an investment whose return might change dramatically in the short term.

A bond's interest rate is competitive, which means that the rate it pays is comparable to what other bonds being issued at the same time are paying. It's also related to the cost of borrowing in the economy at large, so when mortgage rates are down, for example, bond rates also tend to be lower.

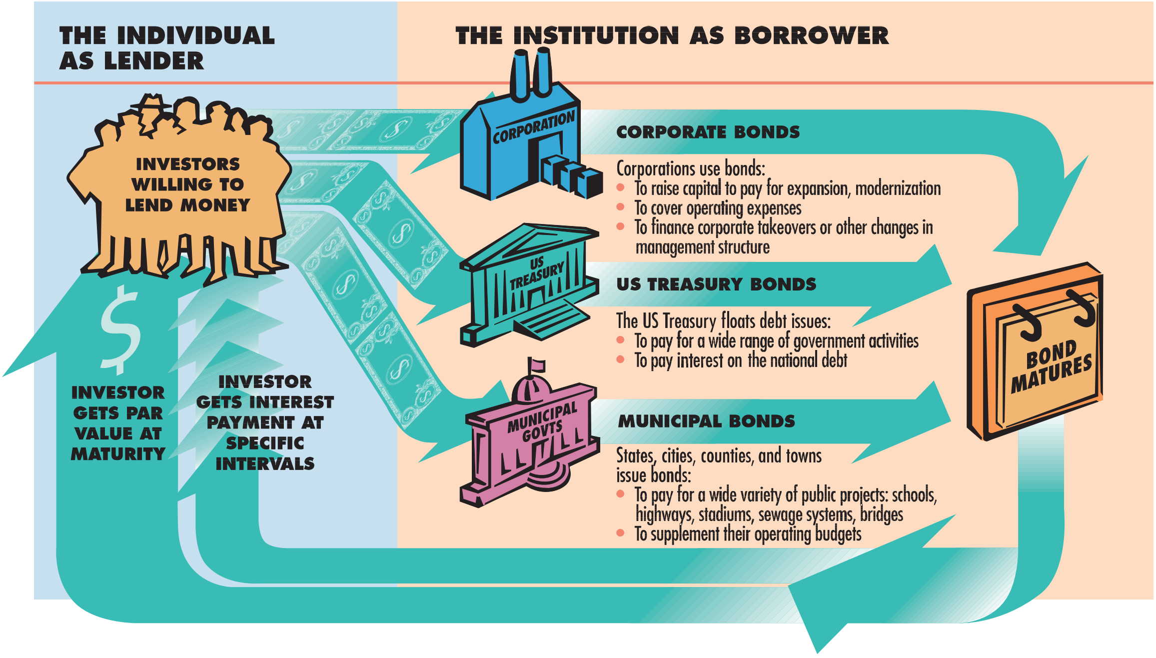
TYPES OF BONDS

You can buy bonds issued by US companies, by the US Treasury, by various cities and states, and various federal, state, and local government agencies. Many overseas companies and governments also sell bonds to US investors. When those bonds are sold in dollars rather than the currency of the issuing country, they're sometimes known as **yankee bonds**. There is an advantage for individual investors: You don't have to worry about currency fluctuations in figuring the bond's worth.

ISSUERS PREFER BONDS

When companies need to raise money to invest in growth and development, they can issue stock or sell bonds. They often prefer bonds, in part because issuing more stock tends to **dilute**, or lessen, the value of shares investors already own. Bonds may also provide some income-tax advantages.

Unlike companies, governments aren't profit-making enterprises and can't issue stock. Bonds



are the primary way they raise money to fund capital improvements like roads or airports. Money from bond issues also keeps everyday operations running when other revenues (like taxes, tolls, and other fees) aren't available to cover current costs.

ISSUING A BOND

When a company or government wants to raise cash, it tests the waters by **floating a bond**. That is, it offers the public an opportunity to invest for a fixed period of time at a specific rate of interest. If investors think the rate justifies the risk and buy the bond, the issue floats.

THE LIFE OF A BOND

The life, or term, of any bond is fixed at the time of issue. It can range from **short-term** (usually a year or less), to **intermediate-term** (two to ten years), to **long-term** (more than ten years). Generally speaking, the longer the term, the higher the interest rate that's offered to make up for the additional risk of tying up your money for so long a time. The relationship between the interest rates paid on short-term and long-term bonds is called the **yield curve**.

MAKING MONEY WITH BONDS

Conservative investors use bonds to provide a steady income. They buy a bond when it's issued and hold it, expecting to receive regular, fixed-interest payments until the bond matures. Then they get the principal back to reinvest.

Bonds that are issued when interest rates are high become increasingly valuable when interest rates fall. That's because investors are willing to pay more than the face value of a bond with a 7% interest rate if the current rate is 4%.

That means an increase in the price of a bond, or **capital appreciation**, can produce more profits for bond sellers than holding the bonds to maturity. More aggressive investors **trade** bonds, or buy and sell as they might with stocks, hoping to make money by selling a bond for more than they paid for it.

But there are risks in bond trading. If interest rates go up, you can lose money if you want to sell an existing bond that is paying a lower rate of interest. That's because potential buyers will typically pay less for the bond than you paid to buy it.

The other risk bondholders face is rising inflation. Since the dollar amount you earn on a bond investment usually doesn't change, the value of that money can be eroded by inflation. For example, if you have a 30-year bond paying $5,000 annual interest, the income will buy less at the end of the term than at the beginning.

HOW BONDS ARE SOLD

For corporations, issuing a bond is a lot like making an initial public offering. An investment firm helps set the terms and underwrites the sale by buying up the issue. In cooperation with other companies, the investment firm then offers the bonds for sale to the public.

When bonds are issued, they are sold at **par**, or face value, usually in units of $1,000. The issuer absorbs whatever sales charges there are. After issue, bonds trade in the **secondary market**, which means they are bought and sold through brokers, similar to the way stocks are. The company gets no money from these secondary trades.

Government issues (US Treasury bonds, bills and notes) are available directly to investors through a Federal Reserve Bank program called Treasury Direct or through your broker. Most agency bonds and municipal bonds are sold through brokers, who often buy bonds in large denominations ($25,000 or more) and sell pieces of them to individual investors.

Mutual Funds: Putting It Together

A mutual fund buys investments with money it gets from selling shares in the fund and manages its portfolio to meet its financial goals.

Most investment professionals agree that it's smarter to own a variety of stocks and bonds than to gamble on the successful performance of just a few. But diversifying can be tough 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.

Since a fund can own hundreds of different securities, its success isn't dependent on how one or two holdings do. And the fund's professional managers keep constant tabs on the markets, trying to adjust the portfolio for the strongest possible performance.

CREATING A FUND

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 fund types, while others specialize in one category of funds.

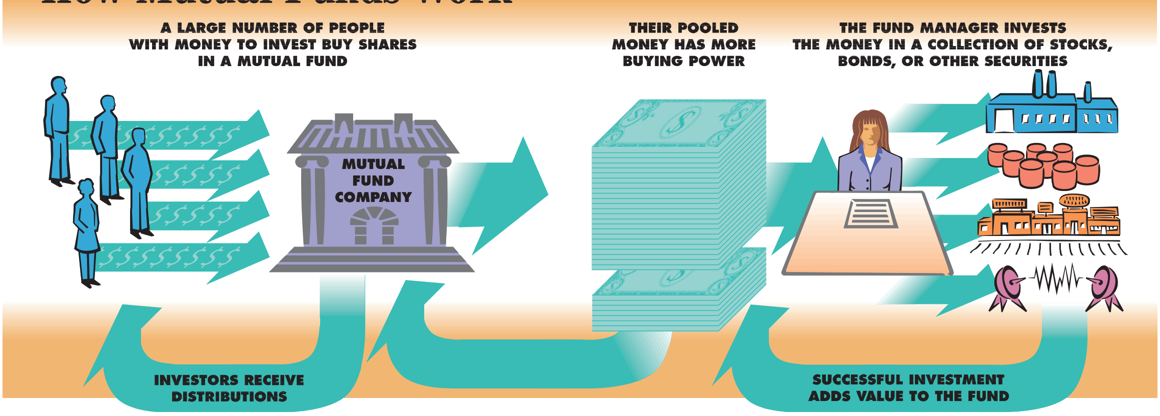
Each new fund has a professional manager, an investment objective, and a plan, or investment program, it follows in building its portfolio. The funds are marketed to potential investors with ads in the financial press, through direct mailings and press announcements, and often with the support of registered representatives who make commissions selling them.

PAYING OUT THE PROFITS

A mutual fund makes 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.

How Mutual Funds Work



HOW A MUTUAL FUND IS CREATED

A mutual fund company decides on an investment concept

Then it issues a prospectus

Finally, it sells shares

Capital gain distributions are paid from the profits from selling investments. Different funds pay their distributions on different schedules—from once a day to once a year. Many funds offer investors the option of reinvesting all or part of their distributions to buy more shares in the fund.

You pay taxes on the distributions you receive from the fund, 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 may increase to reflect the profits.

OPEN- AND CLOSED-END FUNDS

Most mutual funds are **open-end funds**. That 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 invest money. When a fund is closed this way, the investment company often creates 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.

The Mutual Funds Market

Mutual funds never invest at random. Each shops for products that fit its investment strategy.

There are three main categories of mutual funds:

- **Stock funds**, also called equity funds, invest primarily in stocks
- **Bond funds** invest primarily in corporate or government bonds
- **Money market funds** make short-term investments to keep their share value fixed at $1

THE PART DIVERSITY PLAYS

Most funds diversify their holdings by buying a wide variety of investments that correspond to their category. A typical stock fund, for example, might own stock in 100 or more companies providing a range of different products and services. The charm of diversification is that losses on some stocks may be offset—or even outweighed—by gains on others.

On the other hand, some funds are extremely focused. For example:

- **Precious metal funds** trade chiefly in mining stocks
- **Sector funds** buy shares in a particular industry, such as healthcare, electronics, or utilities
- **High-yield bond funds** buy risky bonds to produce high income

The appeal of focused funds is that when they're doing well, the returns can be outstanding. The risk is that a change in the economy or in the sector can wipe out any gains.

STOCK FUNDS

The name says it all: Stock funds invest in stocks. But stock fund portfolios vary, depending on the fund's investment objectives. For example, some stock funds invest in well-established companies that pay regular dividends. Others invest in younger, more growth-oriented firms or companies that have been operating below expectation for several years.

Unlike individual investors, who might buy several different types of stocks to diversify their portfolios, a fund typically concentrates in one area, like blue chips or small-company stocks. A fund's prospectus identifies its major holdings and its investment goals—though funds sometimes buy more widely to try to provide stronger returns.

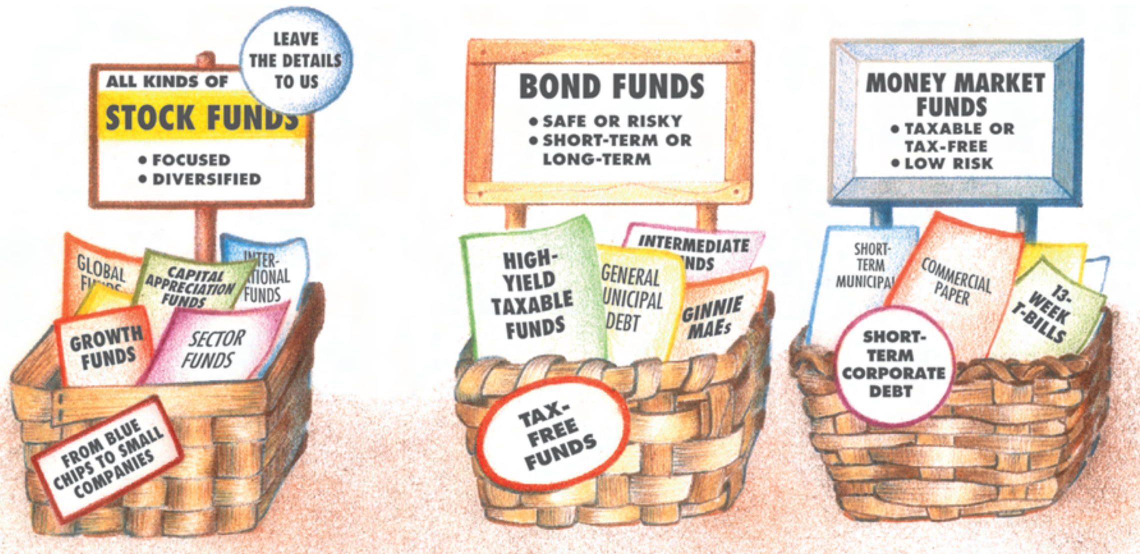
BOND FUNDS

Like bonds, bond funds provide income. Unlike bonds, however, these funds have no maturity date and no guaranteed repayment of the amount you invest, in part because the fund's holdings have different terms.

On the plus side, you can automatically reinvest your distributions to buy more shares. And you can buy shares in a bond fund for much less than you would need to buy a bond on your own—and get a diversified portfolio to boot. For example, you can often invest $1,000 to open a fund, and make additional purchases for smaller amounts.

Bond funds come in many varieties, with different investment goals and strategies. There are investment-grade **corporate bond funds** and riskier junk bonds often sold under the promising label of high-yield funds. You can choose long- or short-term **US Treasury funds**, funds that combine issues with different maturities,

IT'S ALL IN THE FAMILY
Mutual fund companies usually offer a variety of funds—referred to as a family of funds—to their investors. Keeping your money in the family can make it easier to transfer money between funds, but like most families, some members do better than others.



There are several different types of stock funds. A key distinction among them is that some stress growth, some value, and some a combination of the two. Some funds involve more risk to capital than others because they buy stock in emerging companies. The profits on all stock fund distributions are taxable (unless held in certain education or retirement accounts), but no tax is due on the increased value of a fund until you sell it.

The two main categories of bond funds are **taxable** and **tax-free**. Distributions earned on corporate and US government funds (including Treasurys and agency funds) are taxed. There's no federal tax on municipal bond fund distributions, and no state or local taxes for investors who live in the municipality that issues the underlying bonds. New Yorkers, for example, can buy **triple tax-free** New York funds and keep all their earnings.

Money market funds also come in two varieties, **taxable** and **tax-free**. Taxable funds buy the best-yielding short-term corporate or government issues available, while tax-free funds are limited to buying primarily municipal debt. Taxable funds pay slightly higher dividends than tax-free funds, but investors must pay tax on any distributions they receive. In either case, the rate a fund pays is roughly the same as bank money market accounts or CDs.

and a variety of tax-free **municipal bond funds**, including some limited to a particular state.

MONEY MARKET FUNDS

Money market funds invest to maintain their value at $1 a share, so they're often described as cash equivalent investments. Since these funds are considered stable in value, some investors prefer them to stock or bond funds. On the down side, they have little long-term growth potential, the interest the funds pay is low when interest rates are low, and they aren't insured by FDIC. Most money market funds let investors write checks against their accounts. There's usually no charge for check-writing—although there may be a per-check minimum.

INDEX INVESTING

Indexes track the performance of almost every segment of the investment markets. Fund companies license indexes from their creators and offer **index mutual funds**. Each fund provides the approximate return you would get if you owned all the securities in the index it's linked to, such as the Russell 2000. Owning a range of index funds is one way to diversify your portfolio.

Exchange traded funds (ETFs) are similar to index funds in some ways. When you invest in an ETF, you also buy shares in a fund that owns all the securities in a particular index. For example, the ETF known as SPDR tracks the S&P 500. But ETF shares trade like shares of stock, changing hands throughout the day, rather than just once, at the end-of-day price.

Allocating Your Assets

Divide and conquer is often the best way to win your investment battle.

Asset allocation—the way you divide your portfolio among **stocks**, **bonds**, and **cash**—has a major impact on reaching your financial goals. Stocks include stock mutual funds. Bonds include bond mutual funds. Cash is usually invested in money market funds, CDs, and Treasury bills.

Here's why asset allocation is such a critical principle of sound investing:

- **No single type of investment produces the best return year in and year out**
- **Stocks have historically turned in a strong performance in some years and a weak one in others**
- **Bonds produce better returns in some years and weaker returns in others**
- **Cash usually provides the smallest but most consistent returns**

One word of caution: These results reflect the performance of an entire **asset class**, or group of investments. They don't report the return of any individual stock or bond.

KEEPING YOUR BALANCE

To maintain the asset allocation that you've selected, you may need to **reallocate**, or rebalance, your holdings from time to time. If you don't, you may find that your investment portfolio exposes you to more risk or is less likely to provide the long-term return you had anticipated.

1. You can sell off a portion of the asset class that has increased more in value than the others and reinvest your profits in a lagging class. In some accounts, this may mean a taxable gain, so you may want to consult our tax adviser before selling.
2. You can change the way you invest new money, putting more into the lagging class until you get back to the balance you intended.
3. You can put extra money into the lagging class to correct the drift.

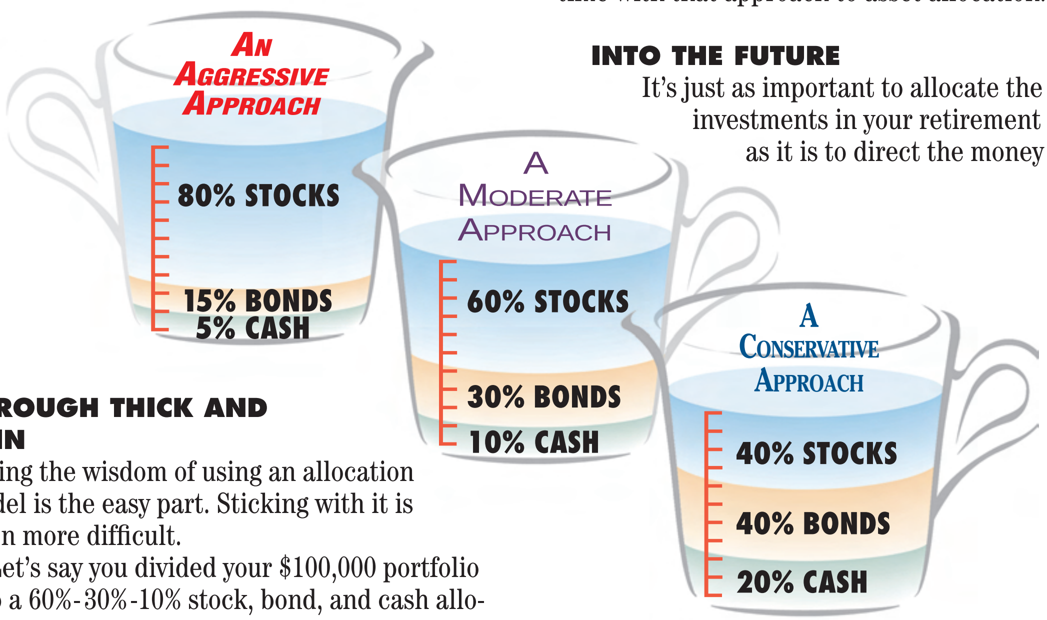
You may want to consider an annual reallocation. Or, you might plan to sell off holdings in an asset class when its value exceeds your target allocation by a specific percentage—say 10% to 15%.

CREATING A FORMULA

As the evidence piles up on the importance of asset allocation, financial experts have devised some formulas, called models, for dividing up your overall portfolio.

Don't be confused if you encounter a range of suggested allocations. Brokerage firms and other advisers, for example, modify their recommendations regularly, though rarely dramatically, in response to changes in the economy.

Any standard allocation model can be modified to suit your **goals, timeframe**, and your **tolerance for risk**. For example, you may decide on a single allocation model—say 60% in stocks, 30% in bonds, and 10% in cash—and stick with it. Or you may decide to modify your allocation over time, perhaps increasing your stock holdings to 80% earlier in your financial life, and reducing them to 40% after you retire.



THROUGH THICK AND THIN

Seeing the wisdom of using an allocation model is the easy part. Sticking with it is often more difficult.

Let's say you divided your $100,000 portfolio into a 60%-30%-10% stock, bond, and cash allocation a year ago. Since then, the bond market has been booming, and the stock market has faltered. If you calculate your investment worth, your portfolio may have 55% of its value in stocks, 40% in bonds, and 5% in cash.

If you're committed to your strategy, you can put new investment money into stocks and cash equivalents, to bring the value of your overall holdings back into balance. Or you might sell off some of your bonds and buy stocks with the proceeds to return to the original balance.

AN EASIER APPROACH

If juggling your investments to keep your allocation mix the way you want it seems complicated, there's an easier strategy. If you're using the moderate approach suggested above, for example, each time you have money to invest—say $1,000—you could put $600 into stocks, ETFs, or a stock mutual fund, $300 into a bond fund, and $100 into a money market fund toward the pur chase of your next CD or T-bill.

While your overall portfolio may never be allocated as precisely as a hypothetical model, perfection isn't what you're after. But by adding money to all three investment categories, in the approximate proportions you've decided on, you've made asset allocation easier.

And remember, while it may seem smart to keep investing in whichever asset class is hot at the moment, you may increase your risk over time with that approach to asset allocation.

INTO THE FUTURE

It's just as important to allocate the investments in your retirement funds as it is to direct the money you're investing on your own. That may mean putting a substantial part of your 401(k) or IRA account, for example, into equities and some into fixed-income investments, though probably little or nothing in cash.

And it also means looking at the bigger picture of your retirement and non-retirement investments together. For example, if you're putting most of your 401(k) money in mutual funds, you may want to balance that by putting a larger share of your nonretirement money into individual investments.

Or, if you know you're eligible for a defined benefit pension when you retire, you may want to invest more heavily in stocks on your own. Sorting out all these details is one of the ways working with a financial adviser may make a real difference to your bottom line.

ADDED FLAVORS

While stocks and bonds are the meat and potatoes of asset allocation, many financial advisers suggest adding a little spice. You could put some money in gold, or funds that invest in gold, some in real estate, and perhaps some in international equity or fixed income.

The idea is that by including investments whose returns are influenced by factors different from those influencing the returns on investments you already own, you can reduce risk without significantly reducing potential return.

Diversification

If variety is the spice of life, diversification is the heart and soul of investing.

While some of your investments are living up to expectations, others may be in the dumps. If you want your **portfolio**, or list of investment holdings, to provide the return you need to meet your long-term goals, you have to **diversify**, or spread your investment money around within the **asset classes** you've selected.

That's because any time all of your money is concentrated in one or two places, your financial security depends on the strength of those investments. And no matter how sound an investment may be, there will be times when its price falls or its interest payments don't keep up with inflation.

THE FIRST STEPS

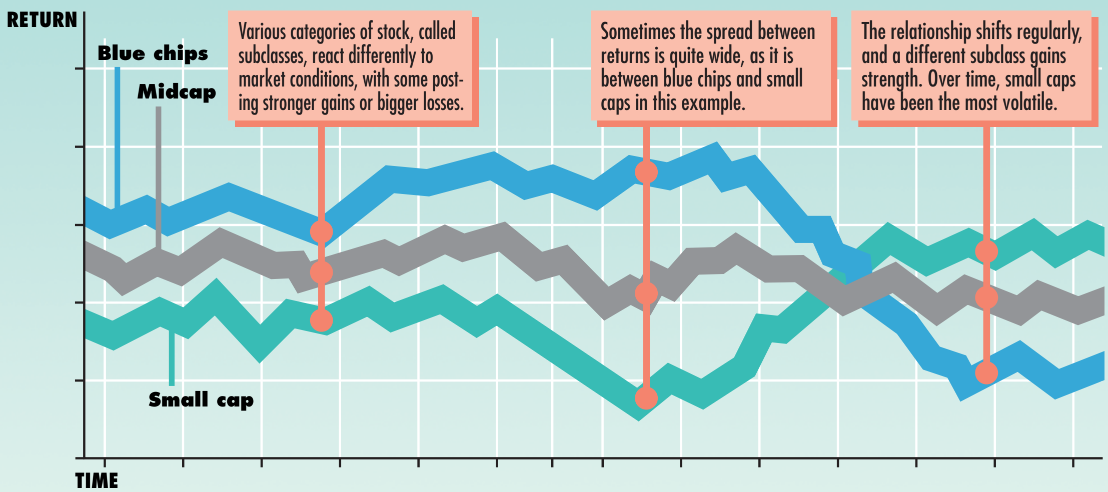
The way you diversify is by developing a plan for making investments within each asset class. Your goal is to include a variety of securities that typically react differently to changing economic conditions.

On the equity side, what you're trying to achieve is a portfolio that includes:

- Investments in large, medium-sized, and small companies, since size affects volatility and potential return
- Investments in growth and in value companies, since growth surges in some periods but falters in others
- Investments in cyclical companies and in noncyclicals, since some goods and services are necessities in all economic climates and others are not

On the fixed income side, you're looking for bonds or bonds funds that invest in debt securities from a variety of issuers, with terms that range from short to long, and possibly some with

HOW DIVERSIFYING CAN BALANCE GROWTH OVER TIME



different ratings. You'll also want to include several types of cash investments, including bank CDs and US Treasury bills.

THE SECOND STAGE

Diversification is not the same as simply building a big portfolio. You do need a certain number of investments, so that potential gains in some can prevent losses in others from pulling the total value too far down. But owning stock in dozens of large companies won't help you if large company stocks in general are in a slump.

The story could be different if you owned roughly equal numbers of large and small company stocks or funds that invested in those categories of stock. Historically, small companies have done well in periods when large companies faltered and the reverse, though past performance is no guarantee that will happen in the future.

Increasingly, real diversification calls for international investments. Because the world economies remain distinct, although they are linked by round-the-clock trading, many investors—and their professional advisers—believe that putting money into overseas markets is a good way to balance investments at home. Generally, buying mutual funds, exchange traded funds (ETFs), or American Depositary Shares (ADSs) is the simplest way to invest internationally.

THE VALUE OF FUNDS

One of the reasons mutual funds and ETFs keep cropping up in discussions of diversification is that they are, by definition, diversified. A fund may own hundreds of stocks, bonds, and other investments. That way, if some of the holdings aren't performing well, they may be offset by others that are doing better. In fact, some mutual funds include both stocks and bonds to provide diversification in different categories of investment and within each of those categories.

Because a fund has so much money to invest, it can achieve a breadth of diversification that no individual can. And because a fund buys and sells in such volume, the cost of diversifying may be reduced as well.

ONE MORE THING TO REMEMBER

As you build your diversified portfolio you'll want to evaluate your investments—and your potential investments—on their own merits first, and then by looking at what they contribute to your overall portfolio. While your priority may be to add an investment that's in a particular asset class or **subclass**, any one you select should meet the broader criteria you set for buying.

This means doing your research before you invest. For example, when you consider a stock, you may want to look at **fundamentals**: the company's earnings and sales history, its level of debt, its management, and its current price. Another approach to research, called **technical analysis**, looks at price patterns.

With a bond, you may look at its rating, its term, and its current yield. With mutual funds, you may be interested in investment objective, manager style, long-term performance, and fee structure.

THE LONG HAUL

Just as you may modify your asset allocation, you may rethink the way you diversify. You may begin by buying mutual funds or ETFs to get the greatest variety with limited resources. As your portfolio grows larger, you may add individual securities to the mix or investigate using managed accounts.

You also have to think about changes that occur in the securities you've selected. A strong company may lose its way, or an entirely new method for investing may emerge. The bottom line is that you don't want to assume that diversification is a one-time activity.

ASK YOURSELF

Diversification isn't a one-shot deal. In analyzing your portfolio, ask the following questions to measure where you are and what's next:

1. What resources have I committed to buying stocks, bonds, mutual funds, real estate, and other money producing investments?
2. What are those investments worth in relation to each other? How about in comparison to last year? Five years ago? Ten years ago?
3. What investments have I made lately? Are they all basically the same?
4. What am I going to buy next? Why?

Coping with Risk

Recognizing the threats to your goals can help you figure out diversionary tactics.

For you, as an investor, **risk** means the possibility that you'll lose some or all of your **principal** or that the **return** your principal provides won't be enough to meet your financial goals. Return is your profit or loss on an investment, which is based on dividend or interest earnings plus increases or decreases in value.

ANATOMY OF RISK

Risk comes in several forms, and so do the strategies you can use to protect your investment portfolio.

Asset allocation helps protect you against what are called **systematic**, or predictable, risks. One example is the recurring pattern that a period of stock market gains is always followed by a period of losses. If you always hold bonds and cash as well as stock, you reduce the risk of loss when stocks slide.

Diversification, on the other hand, can help insulate you from **nonsystematic**, or security-specific, risks. For example, you may select a highly rated bond for your portfolio. But bonds can be downgraded for a variety of reasons, which usually means their market value drops. What's unlikely in a diversified bond portfolio, though, is that all your holdings would be downgraded at the same time.

COPING WITH THE EXPECTED

While there are no guarantees that history will repeat itself, there are some risks you should fully expect to encounter:

Market risk refers to the recurring pattern of ups and downs in the securities markets. Many factors—economic, political, and sometimes emotional—can drive prices up or down. When the value of a market or asset class drops, most of the individual investments in that market or class suffer losses as well.

Interest-rate risk occurs because bond prices tend to move in the opposite direction from interest rates. If rates go up, the market prices of existing bonds go down. That means you could lose principal if you sold, just as you would if you sold stocks when their prices dropped.

Currency risk affects you if you have international investments. As the exchange rate between the US dollar and the currencies in which your investments are sold fluctuate, the value of your return on those investments reflects that change.

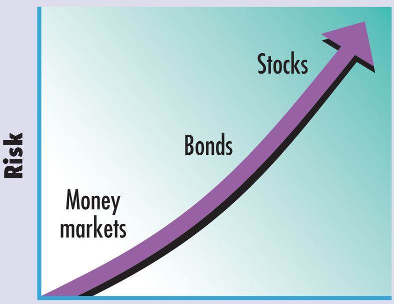
And don't underestimate **inflation risk**. The cost of things goes up over time, reducing your buying power. If your return is less than the rate of inflation, you lose.

PREPARE FOR THE UNEXPECTED

No matter how carefully you select the investments for your portfolio, there are always things that take you and other investors by surprise.

RISK AND RETURN

Historically, stocks have exposed investors to greater risks but provided higher returns.



Company risk is the possibility that a once-powerful company will falter. A competitor could produce a better product, the management could make a series of bad decisions, or scandal could taint its reputation. In such cases, investors tend to sell and the stock or bond price falls.

Credit risk is the possibility that a bond issuer won't be able to make regular interest payments or repay your principal when the security matures. You face the same risk with fixed annuities.

Political risk is a factor in international investments, especially those in emerging markets where instability may undermine markets or a new regime may limit outside investment.

RISK TOLERANCE

When you understand the link between risk and return, you can figure out ways to take calculated risks to improve the likelihood of meeting your goals. For example, you may be willing to buy a potentially risky investment if you expect that its long-term return will be greater than the return on a risk-free investment. That's called a **risk premium**.

The risk-free investment you typically use as a **benchmark**, or standard for comparison, is the 13-week US Treasury bill, also called the 90-day bill. A **T-bill** is considered risk free for two reasons:

- It's issued by the federal government, which makes it virtually free of default risk, though you could lose money if you sold before its expiration date
- Its short term means it's not vulnerable to inflation risk

You can calculate the past risk premiums, using different formulas for specific investments. With a large company stock, for example, you divide the **total return**, or earnings plus change in value, by the total return for T-bills. If the result is positive, taking the risk has paid off.

In 50 of the 78 years from 1926 through 2004, or roughly 64% of the time, large company stocks as a group had a positive risk premium, while in the other 28 years it was negative.

THE RISK OF SAFETY

If you're so worried about the possibility of losing money that you put most of your money into investments you consider absolutely safe—like insured CDs and US Treasury bills—you're investing to preserve principal. Basically you can expect to get back what you put in, plus interest.

As a long-term investment strategy, **preservation of principal** has its own serious risks. First, insured investments usually pay less than uninsured ones. And inflation steadily erodes your **real return** and your purchasing power.

Figuring Your Return

The bright side of taking investment risks is the potential for reaping rewards.

Successful investing is usually the result of making educated decisions and taking calculated risks. Nothing brings that essential combination into clearer focus than evaluating the **return**, or rewards, of your portfolio.

Total return, or the amount your investment increases or decreases in value plus the earnings it pays, is the most accurate measure of an individual security or mutual fund performance.

COMPARING RETURNS

Figuring out the actual return on your investments can be difficult. And you can't expect to compare the performance of different kinds of investments solely on their returns. Here are some of the reasons:

- The amount and makeup of your portfolio changes. Most investment portfolios are active, with money moving in and out.
- The time you hold specific investments varies. When you buy or sell can have a dramatic effect on your overall return.
- The return on some investments—like real estate holdings, zero-coupon bonds, and limited partnerships—is difficult to pin down, partly because they're more difficult to liquidate easily. You have to evaluate them by different standards, including their tax advantages.
- The method of computing return on different investments may vary. For example, performance can be averaged or compounded, which changes the rate of return dramatically.

These examples are hypothetical. They do not reflect the past performance of any particular investment or predict future performance. Sales charges and taxes are not included.

The best way to evaluate an investment's performance against other investments is by calculating **percentage return**, or total return divided by initial cost. And since the most accurate comparisons are on a yearly basis, you can find the **annual percentage return** by dividing the percentage return by the number of years you've owned the investment.

Remember, though, that comparing returns as a way to decide which investments to keep and which to sell works best if you compare similar investments or investments with similar goals.

For example, if you compare the total return of one small-company stock fund with another fund investing in the same kinds of companies, you can tell which fund is performing better. The same is true for two bond funds, or other investments of the same type.

KEEPING UP TO DATE

You don't have to wait until you sell an investment to get a sense of the kind of return you're getting. If you're tracking a stock's performance, total return isn't reported in the press, but you can use the current price of the stock to estimate your unrealized gain in value. (It's unrealized because you still own the stock. When you sell, you realize the gain.) Then use the formulas on the opposite page, just as you would if you'd sold.

If you're tracking mutual fund performance, you can find updated information on every fund's total return—which includes earnings and increases in value—regularly in the financial pages of major newspapers, in magazines, or on financial websites or the fund company's website.

CALCULATING RETURN

When you invest for long-term growth, as you do, for example, when you buy stocks and stock mutual funds, one measure of your success is the **return**, or the amount you get back, in comparison to what you invest. With a little calculation, you can use return figures to evaluate the performance of investments in relation to each other.		**For example** In the hypothetical case used in this example, an investor bought 200 shares of a stock for $25 a share and sold it ten years later for $35 a share, a gain of $10. The stock paid a steady dividend of $1 per share, or $200 a year.*
TOTAL RETURN is the amount your investment increases in value plus the dividends it pays.	**Dividends** + **Gain in value** = **TOTAL RETURN**	The information you need to figure your return is all part of your tax records. **$2,000** ($200 per year x 10 years) + **$2,000** ($10 per share x 200 shares) = **$4,000** Total return
PERCENTAGE RETURN is the total return divided by the cost of the investment.	**Total return** ÷ **Price of investment** = **PERCENTAGE RETURN**	In an actual case, the gain in value would be reduced by the cost of commissions. **$4,000** Total return ÷ **$5,000** (200 shares @ $25 a share) = **80%** Percentage return
ANNUAL PERCENTAGE RETURN is the percentage return divided by the number of years you held the investment. That's the number you need to make your comparisons.	**Percentage return** ÷ **Years you held investment** = **ANNUAL PERCENTAGE RETURN**	When you're making long-term investments,a decline in value in one or more years may be offset by stronger performances in other years. **80%** Percentage return ÷ **10** Years you held investment = **8%** Annual percentage return

*These examples are hypothetical. They do not reflect the past performance of any particular investment or predict future performance. Sales charges and taxes are not included.

And your financial adviser, the brokerage firm where you have an account, or your mutual fund company will include information on the return of the investments in your portfolio in their monthly, quarterly, or annual reports.

USING BENCHMARKS

While it's useful to compare the return on an investment with what you might have earned on a similar investment, you may also want to compare individual investments, such as stocks or mutual funds, with an appropriate unmanaged benchmark index, even though you can't invest directly in the index.

For example, you might use the Lipper mutual fund index that tracks the performance of a group of funds with the same characteristics as the one you own. Or you might compare a stock's performance to the most appropriate stock market index. For a small-cap stock, that could be the Russell 2000, and for large-cap stock, it could be the S&P 500.

Many indexes give more weight to securities with the largest market capitalization. That means the results may indicate a greater gain or larger loss than would be the case if all the securities were equally weighted.

HOW MUCH IS ENOUGH?

How much return do investors expect? It changes over time, if the market price of stocks is any indication. One explanation seems to be that investors demand returns on their equity investments that beat the yields on government bonds. In some but not all market environments, investors will pay more for equities as the interest rate drops than they'll pay when yields are high because the return they expect offsets the risk.

Glossary

Asset allocation is a strategy for off-setting certain types of investment risk by investing specific percentages of your investment principal in different asset classes, including stocks, bonds, and cash. Asset allocation models and the asset classes they include vary based on objectives, timeframe, and risk tolerance.

Benchmark is a standard against which investment performance or other variables are measured. A market index or average whose gains and losses reflect the changing direction of the market segment it tracks may serve as a benchmark for individual securities or mutual funds.

Capital gain is the profit you make when you sell an asset for more than you paid to buy it. A capital loss, in contrast, results when you sell an asset for less than it cost. In a taxable investment account, long-term gains on assets you've held for more than a year are taxed at a lower rate than ordinary income, and you can use long-term losses to offset long-term gains.

Cash equivalents are low-risk, short-term investments, such as certificates of deposit (CDs) and US Treasury bills, that can be sold easily, usually with little or no loss of value.

Debt securities, also called notes and bonds, are investments that involve lending money to an issuer, such as a corporation or government, in exchange for interest payments for the use of your money and the promise that your principal will be returned at the end of a specific term. They're sometimes also known as fixed income investments.

Diversification is an investment strategy for offsetting certain types of investment risk that involves buying a number of different securities, mutual funds, or exchange traded funds (ETFs) in different categories or subclasses within a single asset class.

Dividends are the portion of a company's earnings that it chooses to pay to its shareholders as income. Dividends on most US stocks and some non-US stocks are taxed at your long-term capital gains tax rate.

Equity securities are ownership shares in a corporation. Buying shares gives you the right to benefit from the corporation's business success, by receiving a dividend, selling your shares at a profit, or both.

Index is a list of securities that share a relevant characteristic, such as asset classification, market capitalization, or investment objective, and whose collective performance is taken as a sign of how that segment of the market is faring.

Issuer is a corporation, government, agency, or investment trust that sells securities, such as stocks and bonds, to investors. Stock issuers pay dividends when they are declared. Bond issuers pay interest and repay principal.

Market capitalization is one measure of a company's value, calculated by multiplying the number of outstanding shares in the company times the current stock price.

Portfolio is the group or collection of investments that you own. Each time you purchase a new investment, you expand your portfolio, ideally making it more diversified.

Principal is your capital, or the amount you invest. When your investment account is insured, as bank accounts are, your principal is guaranteed. If the account is not insured, you could lose some or even all of that money.

Public company is one that sells its shares to investors in the marketplace, such as a stock exchange, and is registered with the Securities and Exchange Commission (SEC) or with state regulators, or both. In contrast, shares in a private company are held by its founders, employees, and sometimes outside investors but are not publicly traded.

Return is the profit you make on an investment, usually expressed as a percentage of your investment cost. It includes any increase or decrease in the value of the investment plus any earnings you receive from the investment.

Secondary market refers to the buying and selling of securities after they are initially issued and also to the environment where the trading takes place. The New York Stock Exchange and The Nasdaq Stock Market are secondary markets.

Underlying investments are the stocks, bonds, or cash equivalents owned by a mutual fund, exchange traded fund (ETF), or other pooled investment. The return of the fund is based on the return of these investments.

Yield is the income you receive annually from an investment, expressed as a percentage of the price you paid to buy it. For example, you can calculate a stock's yield by dividing your dividend per share by your purchase price per share.

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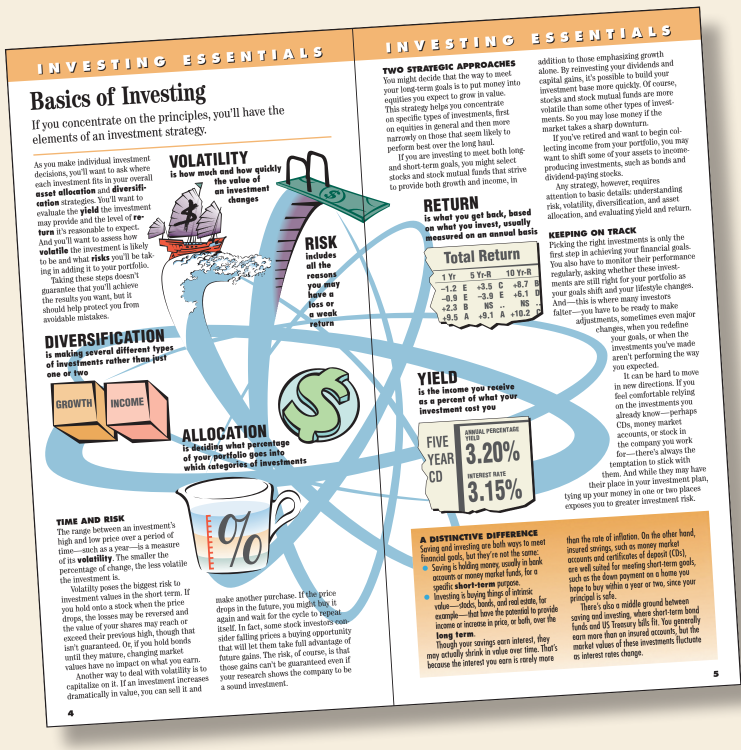
I N V E S T I N G   E S S E N T I A L S

with its distinctive blend of straightforward language and imaginative graphics, provides a clear, user-friendly introduction to the world of Wall Street. The guide covers the basics of stocks, bonds, and mutual funds, and explains key strategies you can use to create and manage an investment portfolio. If you know you should be investing, but you aren't sure where or how to begin, this illuminating guide is the place to start.



INVESTING ESSENTIALS

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.

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.

4

INVESTING ESSENTIALS

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.

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.

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.

5

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