Unbiased Financial Information Provided by Financial Wisdom.

Fundamentals of Investing

Investing is simply the process of acquiring assets that you hope will grow in value. Investments can include owning a home, owning a business, owning real estate or having money in savings accounts and CDs at a bank or credit union. This article addresses investing in stocks and bonds and various ways to own them.

Some basics
Owning a share of stock is owning a portion of the company. If you buy 100 shares of General Electric stock, you actually own a portion of GE. You can profit by owning shares when the company pays a dividend or if the value of the shares increases while you own them. You can also lose money if the value of the shares goes down before you sell them.

When you own a bond, you are lending money to the company or institution issuing the bond. You profit when you receive interest payments and if the value of the bond increases while you own it. You can lose money if interest payments are not made, if the principal of the bond is not repaid when it is due or if the value of the bond falls and you sell the bond.

When you buy mutual funds, you are buying shares in a company that in turn owns stocks in other companies or owns bonds issued by other companies or institutions. By investing in mutual funds, you get the professional services of the mutual fund manager who decides where and when to invest. You profit when the mutual fund distributes dividends (and capital gains and interest) and if the value of your mutual fund shares increases because of the increases in the underlying values of the stocks and bonds it owns.

There are several ways you can own investments. Most people start out with individual accounts set up at brokerage firms or mutual fund companies, in their IRAs and through their company retirement plan. If you invest through an individual account, the income (dividends, interest and capital gain distributions) from the account is taxable. If the investments are within an IRA or a qualified plan, you will probably not owe any tax on the returns until you take funds out.

Some common sense rules
Understand that there are risks with investing. When you make the decision to invest, you are leaving the world of insured and guaranteed returns found with savings accounts and CDs from a bank or credit union. The values of stocks rise and fall depending on the success of the company and the overall direction of the stock market. The value of bonds can rise and fall depending on changes in interest rates and the financial condition of the institution issuing the bonds. In return for taking these risks, you hope to earn returns greater than what you would have earned in a savings account or with a CD.

Be realistic in your expectations. The year of 2008 was a bad one for stocks with the S&P 500 index falling 38% while it has risen each year since then. Over the 20-year period ending in 2018, the average total return for large company stocks (comparable to the S&P 500 index) was

13.1%. The best year (2013) had a return of over 32% and the worst year was 2008 when the return was a negative 37%. While the bull market of 1995 to 1999 produced average returns of over 28% and the bear market of 2000 to 2002 (and 2008) saw the market fall by over one third, returns during those years were well outside the long-term average returns.

Take a long term approach. The returns from investing will vary greatly from year to year. It is only by viewing your investments as long-term can you hope to earn returns to justify the risks. Trying to guess the near term direction of the market or an individual stock's price is foolish.

Use an asset allocation strategy.
You should also consider how you divide your investments among the different types of investments. How you divide your investments among stocks, bonds and cash investments is called asset allocation. It can serve as a logical starting point for your investment strategy. Individuals should base their asset allocation on their time horizon and risk tolerance. Here are some sample allocations based on age.

Sample Asset Allocations

Age	**Stocks**	**Bonds**	**Cash**
30's	65%	25%	10%
40's	60%	30%	10%
50's	50%	40%	10%
60's	30%	55%	15%

You will note that the chart shows younger individuals having more stocks with the percentage being reduced over time. This is only logical. While you are younger, you can take a longer term approach – you have more time to recover from declines in your investments and you have more time to try to participate in the long term performance trends of different types of investments.

The numbers in this chart are only sample guidelines and you may want to vary from them depending on your feelings about risk and other aspects of your situation.

Diversify your investments. If you are investing in stocks, you should try to have investments in at least 3 or 4 stocks in at least 4 or 5 industries. A portfolio of 15 technology stocks is not diversified. A portfolio of one stock in each of 15 different industries probably also is not a good example of diversification. A portfolio of more than 25 or 30 stocks can make it difficult to stay aware of what each company is doing.

Spreading ownership over different stocks in different industries reduces the risk that the particular stock you choose in a good industry turns out to be the wrong one. It also reduces the risk that you invested in the wrong industry.

Diversify your timing. Another way to reduce your risk is to make your investments over a period of time. That way, you assure yourself that you are not investing all your money at the top of a bull market cycle. You may miss some appreciation if the market continually goes up, but

that seldom happens. Remember, no one can predict short-term movements in the stock market with any degree of accuracy.

By spreading your investments over 4 to 6 months, you will eliminate the risk of making all your purchases when stocks are at their highest points. There are two types of risk that this strategy reduces. First, it reduces the risk of losing a significant part of your money quickly. Many people dread making an investment and then seeing the value go down dramatically. By spreading out your buying, this will not happen.

The other risk you can reduce by spreading out your investments is price volatility. By taking this approach, the average price for the stocks you buy will probably reflect the average market values for that period.

Consider the diversification benefits of mutual funds. When you buy mutual fund shares, you are buying into a broad portfolio of stocks that the portfolio manager has selected. In addition, most mutual funds offer a system of purchasing called “dollar cost averaging.” With this, you buy an equal dollar amount of shares on a periodic basis.