Mr. Kaufman Investing Notes:

You want to invest in order to create wealth. Are you guaranteed to be wealthy if you invest? NO! However, if you do not save money and invest it then there is no chance for you to be rich. The most important factors that determine where to invest your money are your risk tolerance and time frame until you might need your money.

Goals:

What are you saving your money for – college, a car, retirement? Decide what you want and how much you will need for each item.

Also, determine how soon you need the money - 3 months, 3 years or 25 years?

VOCBULARY:

1) After tax contribution – Amounts have already been taxed in your paycheck when you make an investment.

2) Dividends on common stock – Companies pay their shareholders a certain amount of money for each share of **common stock** a person owns. Companies are not required to pay dividends and they can change the amount whenever they want.

3) Investing – saving money to build wealth

4) Liquid – how quickly your investment can be turned into cash. Bank accounts are cash. A house will take much longer to turn into cash. A house is considered illiquid. (it does not quickly turn into cash).

5) Maturity – the date a bond is to be repaid.

6) Portfolio – a list of your investments.

7) Pretax contribution – Amounts have not been taxed in your paycheck when you make an investment.

8) Rate of return – convert the amount of money you earned/(lost) on a stock into a %. Use the percent increase/decrease formula:

$$\text{Percent Increase(decrease)} = \frac{\text{New amount} - \text{old amount}}{\text{Old amount}}$$

9) Risk – how much your willing to lose if your investments lose value.

10) Tax deferred – Amounts grow without paying taxes. You are not taxed on contributions when you first put them into an investment, but you are taxed when you take the funds out of the account **OR** you are taxed when you put the funds in, but not when you take the funds out of the account,.

OVERVIEW:

I. Conservative (safe) investments: These investments are low risk. The safest is a bank account or certificate of deposit since they are insured by the government (the FDIC). Money market accounts are also very safe, but they are offered by mutual funds so they are not insured by the US Government. All of these accounts are easily converted to cash (liquid) and do not lose value. However, your rate of return is the lowest of all investments. We know that savings accounts, etc. are returning less than 2%. You earn money based on the interest rate that will be paid.

You want conservative investments if you cannot tolerate having your investments lose value (low risk tolerance) or if you need the money in the near future.

II. Moderate risk investments – Bonds are loans. You buy a bond by giving cash (the loan) to a company. The company you bought the bond from promises to pay back the loaned amount on a specific date (maturity). The bond pays a specified interest rate until its maturity. Bonds can fluctuate up and down in value more often and more quickly then conservative investments. Bonds have more risk than savings accounts, but less risk than stocks.

US Treasury bonds are the lowest risk bonds since they are backed by the US government. The next least risky bonds are those issued by highly rated corporations. Smaller companies issue bonds, and their bonds are considered higher risk. Finally, there are companies with lower quality financial statements and they are called "junk" bonds. These are the highest risk bonds. You earn money based on the interest rate that will be paid.

You will want a higher interest rate the riskier the bond. This means that US government bonds will have a lower interest rate than high quality corporate bonds. High quality corporate bonds will have a lower interest rate than junk bonds.

III. Highest risk - The highest risk investment is a stock. When you buy a share of stock, you literally own some of the company. This can be a very small ownership piece since many companies issue millions of shares of stock. There is no guaranteed rate of return. You earn money if the stock appreciates in value by the company becoming more valuable. However, a stock can also lose value, sometimes overnight.

The more risk you take on, the higher you want your rate of return to be over the long term.

Over the long term, stocks have historically outperformed all other investments. From 1926 to 2008, the S&P 500 returned an average annual 9.6 percent gain. The next best performing asset class is bonds. Long-term U.S. Treasury notes returned, on average, 5.9 percent over the same period. Savings accounts yield less than 2%.

Risk

Risk is how strong your stomach is if you suffer losses from your investments. Can you handle losing 25% of everything you have invested in less than 1 year? Stocks have the greatest return over time, but on a day to day basis their value goes up and down, sometimes a lot.

The different types of cash accounts have low risk and their values will not go up and down.

A portfolio with only stocks is riskier than a portfolio of savings accounts. You can take on more risk when you are young and saving for retirement in 40 years so you will invest a lot more in stocks for your retirement portfolio. You will not take on a lot of risk if you are investing for college that you will be attending next year so you will invest in conservative accounts.

Risk within each category of investment:

Risk varies across investment types as well as within each investment type. Cash accounts are not a concern for the most part although a money market fund could lose value (it has only happened once).

You can buy a bond (give a company a loan) from the US Government, a highly rated corporation or a more risky, but less highly rated corporation. Your risk increases as you purchase from each of these. The chances are that the US government will be around longer than Apple. Apple will be around longer than John's Hardware on the corner.   Because it is riskier to lend to John's hardware than the government, you want John's Hardware to pay a higher interest rate on its bond.

You can buy individual stocks from big name companies like IBM and GE. These are established companies that pay quarterly dividends. (The big names can fail like GM and Merrill Lynch did). There are many small stocks you can buy as well. They have not been around as long and many do not pay dividends. Generally, buying big company common stock is less risky then buying a smaller company's common stock.

Buying stock in one company is very risky so many people buy different stocks. This way, if one company's stock becomes worthless than they still have other stocks that have value (the investor does not lose 100% of the investment). Buying enough individual stocks to reduce risk is very expensive so one way to "own" a bunch of different stocks or bonds is by purchasing shares in a mutual fund. You actually buy

and own shares of the mutual fund which in turn buys a basket of stocks. You can choose from many types of mutual funds. Many funds focus on a specific type of investment:
https://personal.vanguard.com/us/funds/vanguard/all?sort=type&sortorder=asc
Look at the Asset Class column in the middle as you scroll down. Vanguard is a large brokerage firm that lets you choose investments. There are many other brokerage firms where you can choose from many mutual funds.

Diversification:
Diversification is reducing risk by purchasing different types of investments with different risk levels. If one investment goes bad then you will still have your other investments that have value. If all your investments lose value then they should lose different % of their value since they are at different risk levels; i.e., the investments should not all lose the same % of their value.

One way to diversify is to invest in different risk categories – place some of your investments in cash, some in bonds and some in stocks.

Bonds:
A bond is essentially a loan. You give the company money and in return the company will pay you a stated rate of interest for the length of the loan. You can hold your bond until maturity and get your money back; plus, the interest you earned over the years. Bonds usually pay simple interest. A $10,000 bond paying 5% interest annually will pay you $500 each year on the date interest is required to be paid.

A bond is also an investment. Its value fluctuates depending on how interest rates fluctuate. Which bond is worth more to you: a $10,000 bond that is paying 5% or another $10,000 bond of equal risk that is paying 6%? The 6% bond of course. It gives you $600 of interest annually while the 5% bond pays $500. The 6% bond pays more so people will pay more for it than the 5% bond. Your bonds can be sold at any point in time. The amount you will receive for your bond depends on what interest rate similar bonds are paying. Your bond will be worth more if it pays a higher interest rate than other similar bonds and it is worth less than other bonds if it pays a lower interest rate than other similar bonds.

Stocks:
There are 3 major indices that are quoted in the news that people track. When people say the markets are going up or down they are referring to these 3. It does not mean that every single stock is going up or down, only the overall value of the index has increased or decreased.

DOW - Also called the Dow Jones Industrial Average (DJIA)

The DJIA tracks the performance of 30 different companies that are considered major players in their industries and it represents nearly one-fifth of the market value of all U.S. Stocks.

The Nasdaq Composite, tracks approximately 4,000 stocks, all of which are traded on the Nasdaq exchange. It has many technology companies on it as well as smaller, high growth companies than the DJIA.

S&P 500 - An index of 500 of the most widely held U.S.-based common stocks, chosen by the S&P Index Committee for market size, liquidity, and sector representation. "Leading companies in leading industries" is the guiding principal for S&P 500 inclusion. It represents 70% of all U.S. publicly traded companies.

Russell 2000 – It is an index of 2,000 small US stocks.

Dollar cost Averaging:

You put the same amount of money every time in an investment. This results in your buying more shares when the price is lower and less shares when the price is higher.