A Publication of the Texas State Securities Board
Regulating the securities industry and
protecting investors since 1957

For Investors

MAKING INVESTMENTS

Before making investments, the question to ask is why invest at all? For several reasons:

1. You won't meet your financial goals by burying your money in the back-yard or under your mattress. Over time the value of the money you've stored will be eaten away by inflation, or the rising cost of goods and services. So you simply won't be able to buy or afford the things you'll need in the future by paying with today's dollars.
2. You invest so you'll have the financial means to buy a home, send your children to college, start your own business, or expand your horizons by continuing your own education or traveling.
3. One of your most important goals may be a secure retirement. Investing helps makes that possible by supplementing your savings to cover retirement costs, including healthcare expenses, over what could be a decades-long retirement.
4. Investing helps provide financial security for your family, and for the people and organizations that depend on your generosity.

All investing, however, carries some degree of risk. So it pays to learn the investment basics before you get started.

Factors to Consider in Making Investments

Several important things to consider when making investments include:

- **The length of time you have to achieve the different goals for which you're investing.** Investing for a mortgage you'll start to pay in five years is a lot different from investing for retirement that will start in 30 years.
- **The amount of risk you are comfortable taking.** Even if you expect to work 30 more years before retiring, you may not be able to stomach the risk of losing money, which can happen with any type of investment at certain times. "Sleeping well" was the investment criterion of the late Paul Samuelson, American's first Nobel laureate in economics.

Making Investments

Investing Sooner

The sooner you start to invest, the more time your money has to grow. But investing at any age, if you have the resources to do so, helps you financially.

- **Other investments or expected sources of income.** This includes Social Security, which provides lifetime benefits and therefore represents a significant financial asset for most Americans. You may also have earned a pension, or have a small business or income from family business interests. The amount of these assets can greatly influence the amount of risk you feel comfortable taking and the type of investments you make.

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Investing Timeframes

If you're rattled by the thought of losing money in a short period of time—with investing, five years is fairly short—then you may not be ready to invest.

But keep in mind that it's entirely possible—though not guaranteed—that an investment that loses value at some point will regain its value over time and be worth substantially more than you invested. The longer you can hold onto your investments, the better your chances for success.

TYPES OF INVESTMENTS

Every investment belongs to what is known as an asset class—a group of investments that have important features in common. Generally, each asset class:

- Puts your money to work in different ways
- Provides a different level of long-term return
- Exposes you to different types of risk
- Reacts differently from the other classes to what's happening in the financial markets and the economy in general

The major asset classes are equities, fixed income, cash and its equivalents, and real estate.

Equities

You make an equity investment when you buy shares of stock in an individual corporation or shares in a mutual fund or exchange traded fund (ETF) that owns stock in a number of corporations.

There are two ways to make money with equity investments—by selling at a profit or by sharing in the corporation's earnings, typically through dividends the corporation may issue.

The risk with equity investments is that the prices may be volatile—they can change significantly in a short period of time—and neither their market price nor the income they may provide is guaranteed. This means you could lose some or all of your money in an equity investment, especially if its price dropped suddenly and you sold your shares.

Fixed Income

When you buy a bond, you are effectively lending money to the bond issuer, such as a corporation, a government, or government agency. The issuer pays you a pre-determined amount of interest on a scheduled basis—hence, fixed income. When the bond comes due, or matures, the lender pays you back the face value of the bond.

Bonds are often bought and sold before they mature. If interest rates rise, the value of bonds you own will fall since newer bonds will pay a higher rate. Just the opposite happens if interest rates drop—the bonds you hold increase in value.

Making Investments

One of the major risks of bond investing is inflation, which eats into the value of the fixed payments the bond makes over time. To mitigate this risk, you might consider two types of government bonds that are designed to protect investors from the effects of inflation:

- **I-Bonds**, which are inflation-adjusted U.S. Savings Bonds, that pay interest based on both a fixed rate and inflation rate that is adjusted twice a year.
- **TIPS**, which are Treasury Inflation-Protected Securities, that pay principal-based interest that is adjusted for inflation. So as inflation increases, so do the interest payments.

You can also invest in fixed income by buying bond mutual funds or ETFs that invest in a portfolio of bonds. While the return is based on the performance of the portfolio—not on a specific interest rate—these funds can provide a diversity of fixed income holdings that mitigates the risk of owning just a handful of bonds.

Cash and Its Equivalents

Cash is the money you hold in your wallet, and your savings and checking accounts. Cash equivalents, which are highly liquid, include short-term CDs (certificates of deposit), U.S. Treasury Bills, and money market mutual funds. Bank savings accounts and CDs are insured up to certain limits and Treasury Bills are backed by the full faith and credit of the U.S. government.

While cash equivalents typically pay low interest rates that won't protect you against inflation, there are good reasons to keep part of your portfolio in cash—for example, as a reserve for emergencies or as a pool of funds you can draw upon when you need the money but don't want to sell off other investments at a loss.

Real Estate

You can invest in commercial real estate, such as office buildings, apartment complexes, and shopping malls, by buying shares of a publicly traded Real Estate Investment Trust (REIT).

The more varied a REIT's properties are, either by type or geography, the greater the protection it has against downturns in the real estate market. Typically, a REIT must distribute at least 90% of its taxable income to shareholders, so investors may be attracted to REITs' stream of income. But, remember, income from REITs is taxed at a higher rate than the rate that applies to dividend income from stocks.

MUTUAL FUNDS AND ETFs

Mutual funds and ETFs are similar in that they both invest in a basket of underlying investments. As a result, they provide an opportunity to invest more widely than you could otherwise do by buying individual securities.

Mutual Funds

A mutual fund is formed when an investment company creates a group, or family, of mutual funds. Each fund has a specific objective, such as providing long-term growth, current income, or sometimes a combination of the two.

Each fund pools the money it raises from its shareholders to make its investments. The more shares the fund sells, the more money it has to build a broadly diversified portfolio. This makes funds less risky than individual stocks and bonds.

Mutual funds also make it easy to invest. Initial minimum investments are relatively low and you can make additional investments of $50 or $100 on a regular basis—or any time you want. A mutual fund will also buy back any shares you want to sell based on the fund's price—called the net asset value, or NAV—at the close of the business day, so it's easy to liquidate your shares.

Exchange Traded Funds (ETFs)

ETFs combine attributes of mutual funds and stocks. Like an index mutual fund, an ETF holds a portfolio of underlying securities determined by an index to which the ETF is linked. And like stocks, ETFs are traded on the exchange where they are listed throughout the day.

ETFs offer several advantages. Specifically, ETFs:

- Allow you to diversify into different investment niches
- Make asset allocation easy
- Are relatively inexpensive to buy and own
- Provide transparency, so you always know what securities the ETF is holding
- May be structured to limit the distribution of taxable gains to shareholders

The NAV for each ETF is calculated daily based on the changing value of the securities it owns. But its market price, like the price of a stock, is determined by supply and demand and other market forces

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Mutual Fund Diversity

The varied portfolio of some mutual funds makes them less risky than buying individual stocks and bonds.

Uses of Target Date Funds

Target date funds can also be used for IRAs, college savings accounts, and taxable investment accounts.

Since they automatically reallocate their holdings, it makes things a lot simpler for investors, who would otherwise need to do the reallocation themselves or with the help of a financial professional.

Target Date Funds

If you contribute to a retirement plan at work, you probably have the option of investing in a target date fund. Generally, you pick the fund pegged to your expected year of retirement. For example, if you expect to retire in 2040, you would select a 2040 target date fund.

Typically, these funds start with a portfolio mostly in stocks and then shift over time to increase the percentage of fixed income. This shift, in theory, makes the fund less risky as the target date approaches. The pace and timing of this reallocation is known as the fund's glide path.

Remember, however, that target date funds pose the same risk as other mutual funds and they do not guarantee that you'll have the money you're anticipating for retirement. You should also check if the fund's allocation of holdings is appropriate for your individual goals and risk tolerance.

Making Investments

Active vs. Passing Investing

A big debate in mutual fund investing is about the relative merits of actively managed mutual funds and passively managed, or index, funds.

Actively Managed Funds. An actively managed fund tries to provide a stronger return than the benchmark index for the type of investments it makes. For example, a fund that invests in large-company stocks typically wants to outperform the S&P 500 Index.

The fund's manager and his or her team research companies, choose investments, and trade stocks to achieve high returns. That increases the fund's costs, which are passed on to shareholders as fees.

One of the traps investors fall into is picking an actively managed fund based on its recent track record. While an actively managed fund might do significantly better than its benchmark over one year or even several years, it almost never does so consistently.

Index Funds. An index fund invests to replicate the performance of the index it tracks, not to beat it. If the fund tracks the S&P 500, for instance, it owns the 500 stocks in that index, so it does not have to pay a manager to choose investments. And there are few trading costs because the portfolio changes only when the index changes. The result is much lower fees for the fund's shareholders.

MANAGING RISK

Risk is the potential for losing money instead of making it, or making less than you had expected. Risk is also the possibility that the value of your return—what you earn plus the change in value of your investment—will be undermined by inflation, reducing your buying power.

Understanding the risk/return relationship is essential to making rational investment decisions. The more risk you're willing to take, the greater the potential for a substantial return, but also for experiencing a loss. On the other hand, if you take no risk, you'll have minimal return, if any.

While certain investments provide minimal return, the tradeoff is that they keep your principal safe. You can be confident that you'll be able to withdraw your $1,000 investment in a CD at the end of the term. In contrast, at any point, your mutual fund could be worth far less than $1,000. And if you sold it once it declined, you'd have a loss.

Market and Investment Risk

The risk associated with investing typically fits into one of two categories:

- Market risk that results from what's happening in the financial markets as a whole—for example, the extraordinarily weak economy in 2008 and 2009.
- Investment risk that occurs when an individual investment loses value for reasons directly related to the investment itself—for example, poor management or overly strong competition.

Strategies to Manage Risk

While all investments carry some risk, there are three ways to mitigate that risk: asset allocation, diversification, and cost control. While these strategies don't guarantee success or protect you from losses,they can help to manage risk while maintaining the potential for a strong return.

Asset Allocation

Using asset allocation, you divide your investment principal among several different types of investments, or asset classes, on a percentage basis, rather than putting all your proverbial eggs into one basket.

Different asset classes—equities, fixed income, cash equivalents, and real estate—generally react differently to what's happening in the economy at any given time. Asset allocation lets you offset losses in one class with gains in another and also helps you take advantage of the ever-changing markets by having some investments in every asset class every year.

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Allocation with Mutual Funds

There's no allocation that's right for everyone or that works perfectly in every market environment. But a handful of mutual funds that invest in different asset classes provide adequate diversification so that when one part of your portfolio falls in value it doesn't sink the ship.

Diversification

Asset allocation helps you manage market risk. You can help manage investment risk by diversifying, or investing in several investments within each subclass of an asset class.

For example, a large-company stock and a small-company stock are both equities, but belong to different subclasses. Asset subclasses tend to differ from each other in some important ways—for example, a large-company stock and a small-company stock tend to increase in value at different rates, react differently to changes in the economy, and expose you to different levels of investment risk.

Your equity portfolio is diversified if you own three or four mutual funds that make different types of investments—for example, an index fund that tracks large-company stocks, a second index fund that tracks small-company stocks, and a third that tracks international stocks in developed countries. And your fixed income portfolio is diversified if you own some corporate bonds, some municipal bonds, and some Treasuries.

You're not diversified if you own just a handful of stocks, or shares of a mutual fund that is concentrated in one financial sector, or if the bonds you own are all issued by the state in which you live.

ALLOCATING AN INVESTMENT PORTFOLIO

How you allocate the investments in your portfolio among the different asset classes will depend on several factors: your age, your family and financial situation, your tolerance for risk, and investments you hold elsewhere, such as in an employer retirement account.

While no two situations are exactly alike, there are some basic allocation models to use as starting points—for example:

- 60% in the U.S. stock market and 40% in the U.S. bond market
- 40% in the stock market, 20% in international stock, and 40% in the total bond market
- 25% in large company stocks, 25% in small company stocks, 25% in international companies, and 25% in short-term Treasuries.

Whatever asset allocation you decide on initially, you should periodically review the portfolio to make sure the balance is consistent with your investment goals and life circumstances.

Reallocation

When you reallocate your portfolio, you adjust your asset allocation as your circumstances change. The allocation you picked as a single 25-year-old is likely too aggressive when you're 50 and facing the prospect of sending a child to college. You may want to trim the amount you have in equities and other more risky investments, and beef up on safer fixed income and cash equivalents.

If you invest in a target date fund for your employer-sponsored retirement plan or other account, the fund automatically reallocates the holdings, shifting to more conservative investments as the target date approaches.

Rebalancing

Even when you are investing for the long term, you should periodically adjust your portfolio to account for swings in the financial markets. For example, if equities did extremely well, and fixed income did poorly, you may find that your portfolio has skewed from your preferred allocations.

One approach is to sell off the asset class that has performed well, locking in a profit, and buy securities in the asset class that has underperformed when those prices tend to be lower. Alternatively, you can designate your new investment money to the asset class that has done poorly until the balance is restored.

When to Rebalance Your Portfolio

In general, you should consider rebalancing your portfolio when your allocation drifts 10% or more from the targets you've set.

Rebalancing also restores your investment portfolio to the level of risk you were comfortable with when you first established your asset allocation.

Sample Portfolio

There is no ideal or "right" portfolio allocation, since everyone's situation is somewhat different. The following examples show different allocations for people of different ages with different lifestyle and financial circumstances.

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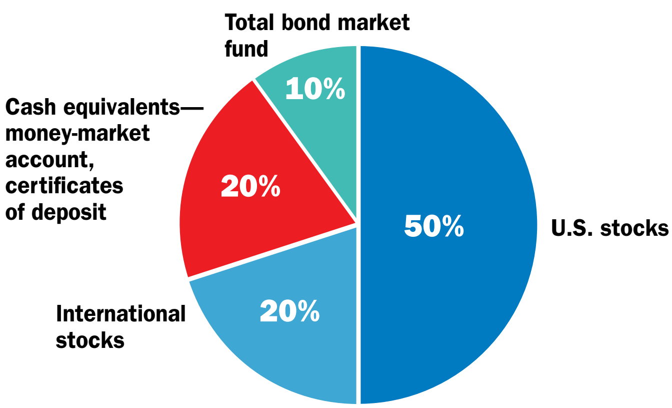
Hannah, Single 28

Hannah saves regularly when she can, and wants to invest money for a potentially higher rate of return.

Since she is relatively young, and has time to ride out market downturns, she chooses a relatively aggressive allocation, with 50% of her assets in domestic stock, 20% in international stock, and 10% in bonds.

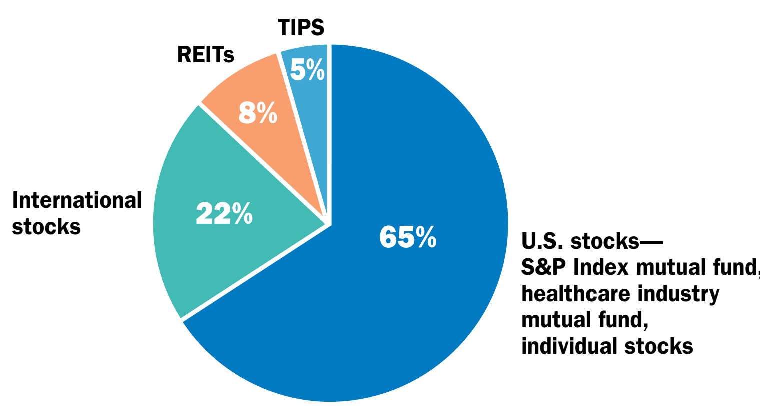
To maintain an emergency cushion, Hannah decides to keep 20% of her assets in money markets and certificates of deposit.



Rich and Elizabeth, Married, Late 30s

Since both Rich and Elizabeth believe they have steady jobs—and, combined, a healthy income —, they have opted for a particularly aggressive asset allocation. That includes 65% in U.S. stocks, 22% in international stocks, and 8% in real estate investment trusts. A tiny percentage, 5%, is allocated to Treasuries.

The question is how they will fare in a market downturn, if they need cash and have to sell off stock when prices are low. They may also face some difficulty if one of them loses his or her job.

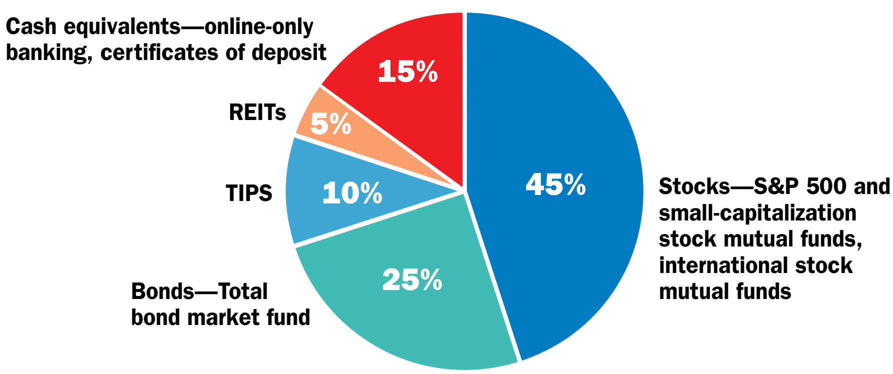


Don and Rosa, Married, Early 50s

Don and Rosa are helping foot the bill for two children in college, are worried about increasing healthcare expenses, and face another 10 years of mortgage payments on their house.

They need their portfolio to generate current income, while recognizing the importance of saving for their retirement. So they've allocated 25% of their portfolio to bonds, yet are keeping 5% in REITs and a healthy 45% percentage in equities, which they anticipate could boost their returns to provide adequate retirement income.

They also have 15% in cash equivalents and 10% in TIPS to provide a hedge against inflation.



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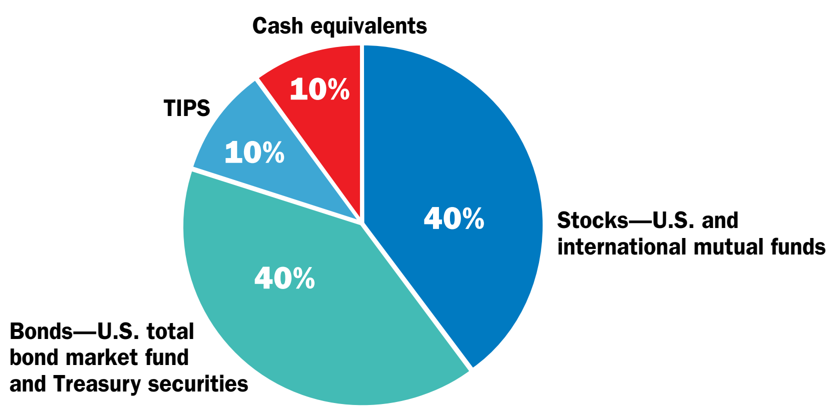
Juan, Single, 70

Juan is retired and is collecting a pension and Social Security. He prefers financial safety over potential gains and so he allocates 40% of his portfolio to bonds, 10% to tips, and 10% to cash equivalents.

Yet, Juan keeps 40% of his allocation in mutual funds in U.S. and international stocks to seek a higher return over time, which he may need if he lives many years in retirement, than he would receive from fixed income and cash equivalents.



INVESTMENT COSTS

In addition to market risk and investment risk, you have to consider what you pay to buy and own investments, since these costs directly reduce your investment return.

Some investment costs are unavoidable. It costs money to handle transactions. It costs mutual funds money to manage their funds. It costs brokers to maintain their offices and websites and provide research about investments.

Lower Your Investment Expenses

There are ways you can avoid paying more than necessary:

- When investing in a mutual fund, always check its expense ratio. To pay for its operating and marketing expenses, a fund annually charges a percentage of your account balance. If the expense ratio is 1%, for example, you will pay $150 on an account value of $15,000.

  The fund may also impose sales charges, called loads, which aren't included in the expense ratio. Both are published in a fund's prospectus and on the fund company's website. Many fund companies will sell you shares in their funds directly, with no sales charge. The point is to choose the least expensive of comparably rated funds.

- Choose lower-cost investment accounts. You might open an online brokerage account, where commissions can run less than $10 per transaction. With this type of account, though, you may have to do more work on your own to identify investments and choose the right times to buy and sell since your broker will not be making suggestions.

Other Costs to Keep an Eye On

If you invest in mutual funds and stocks through a brokerage account, you will likely pay commissions for trading securities and you could pay additional fees for account maintenance or failing to keep a minimum balance.

You have no control over many investment variables—the direction of the market, the rate of inflation, or the tax rate on your earnings. But you do have control over one of the most critical variables—what you pay to buy and own your investments.

The Impact of Fees

Assume you invest $10,000 in a tax-deferred account, make monthly contributions of $250 for 25 years, and realize an annual 6% rate of return. (Also assume for this example that no taxes are being paid.)

In the following example, if you invested in Fund 1 you would end up with $205,955. But if you had invested in Fund 3, you'd have only $173,645. That's a difference of $32,310—a tidy amount that's better in your pocket than adding to a fund's revenues.

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	Fund 1	**Fund 2**	**Fund 3**
Value before fees and expenses	$212,813	$212,813	$212,813
Expense ratio	0.2%	0.8%	1.2%
Upfront sales charge	None	None	4.75%
Effect of fees and expenses	–$6,858	–$25,993	–$39,168
Actual value	**$205,955**	**$186,820**	**$173,645**