Common Types of Investments

1. Introduction

When you invest, you buy something that you expect will grow in value and provide a profit, either in the short term or over an extended period. You can choose among a vast universe of investment alternatives, from art to real estate. When it comes to financial investments, most people concentrate on three core categories: stocks, bonds, and cash equivalents. You can invest in these asset classes directly or through mutual funds and exchange-traded funds (ETFs).

Many financial investments—including stocks, bonds, and mutual funds and ETFs that invest in these assets—are legally considered to be securities under the federal securities laws. Securities tend to be widely available, easily bought and sold, and subject to federal, state, and private-sector regulation. However, investing in securities carries certain risks. That's because the value of your investment fluctuates as the market price of the security changes in response to investor demand. As a result, you can make money, but you can also lose some or all of your original investment.

Some cash equivalents, which you can exchange for cash with little or no loss of value, may be securities, as U.S. Treasury bills and money market mutual funds are—or they may be insured bank products, such as certificates of deposit (CDs). Cash equivalent securities expose you to less risk of losing money than stocks or bonds do, in part because they tend to be very short-term investments whose values tend to remain stable.

Issuing Stocks and Bonds

When corporations want to raise money, called capital, to expand their businesses or provide additional services, they may issue, or offer, stocks, bonds, or both stocks and bonds for public sale. A stock offering invites investors to buy an ownership position in the company while a bond offering invites them to make a loan in exchange for the promise of repayment in full plus a certain rate of interest for the use of the money.

Similarly, federal, state, and local governments may issue bonds if they want to raise money to pay for new projects or supplement their tax revenues to pay for day-to-day operations.

When a company sells stock for the first time, it's called an initial public offering or IPO. A company may also make a secondary or follow-on offering to sell additional shares of its stock to the pubic. In the case of bonds, each time bonds

are sold to the public to raise money they're called new issues. Once these public offerings take place, the capital raising is complete and the stocks and bonds trade in their respective secondary markets. The issuing organization does not receive any additional money from secondary transactions.

Public offerings in the U.S. must comply with the federal securities laws and the rules of the Securities and Exchange Commission (SEC). In addition, there are often additional state laws that apply to public offerings, as well as rules imposed by the market in which the offering ultimately trades.

2. Stock

When you invest in stock, you buy ownership shares in a company—also known as equity shares. Your return on investment, or what you get back in relation to what you put in, depends on the success or failure of that company. If the company does well and makes money from the products or services it sells, you expect to benefit from that success.

There are two main ways to make money with stocks:

1. **Dividends**. When publicly owned companies are profitable, they can choose to distribute some of those earnings to shareholders by paying a dividend. You can either take the dividends in cash or reinvest them to purchase more shares in the company. Many retired investors focus on stocks that generate regular dividend income to replace income they no longer receive from their jobs. Stocks that pay a higher than average dividend are sometimes referred to as "income stocks."

2. **Capital gains**. Stocks are bought and sold constantly throughout each trading day, and their prices change all the time. When a stock price goes higher than what you paid to buy it, you can sell your shares at a profit. These profits are known as capital gains. In contrast, if you sell your stock for a lower price than you paid to buy it, you've incurred a capital loss.

Both dividends and capital gains depend on the fortunes of the company—dividends as a result of the company's earnings and capital gains based on investor demand for the stock. Demand normally reflects the prospects for the company's future performance. Strong demand—the result of many investors wanting to buy a particular stock—tends to result in an increase in the stock's share price. On the other hand, if the company isn't profitable or if investors are selling rather than buying its stock, your shares may be worth less than you paid for them.

The performance of an individual stock is also affected by what's happening in the stock market in general, which is in turn affected by the economy as a whole. For example, if interest rates go up and you think you can make more money with bonds than you can with stock, you might sell off stock and use that money to buy bonds. If many investors feel the same way, the stock market as a whole is likely to drop in value, which in turn may affect the value of the investments you hold. Other factors, such as political uncertainty at home or abroad, energy or weather problems, or soaring corporate profits, also influence market

performance.

However—and this is an important element of investing—at a certain point, stock prices will be low enough to attract investors again. If you and others begin to buy, stock prices tend to rise, offering the potential for making a profit. That expectation may breathe new life into the stock market as more people invest.

This cyclical pattern—specifically, the pattern of strength and weakness in the stock market and the majority of stocks that trade in the stock market—recurs continually, though the schedule isn't predictable. Sometimes, the market moves from strength to weakness and back to strength in only a few months. Other times, this movement, which is known as a full market cycle, takes years.

At the same time that the stock market is experiencing ups and downs, the bond market is fluctuating as well. That's why asset allocation, or including different types of investments in your portfolio, is such an important strategy: In many cases, the bond market is up when the stock market is down and vice versa. Your goal as an investor is to be invested in several categories of investments at the same time, so that some of your money will be in the category that's doing well at any given time.

Common and Preferred Stock

You can buy two kinds of stock. All publicly traded companies issue common stock. Some companies also issue preferred stock, which exposes you to somewhat less risk of losing money, but also provides less potential for total return. Your total return includes any income you receive from an investment plus any change in its value.

If you hold common stock you're in a position to share in the company's success or feel the lack of it. The share price rises and falls all the time—sometimes by just a few cents and sometimes by several dollars—reflecting investor demand and the state of the markets. There are no price ceilings, so it's possible for shares to double or triple or more over time—though they could also lose value. The issuing company may pay dividends, but it isn't required to do so. If it does, the amount of the dividend isn't guaranteed, and it could be cut or eliminated altogether—though companies may be reluctant to do either if they believe it will send a bad message about the company's financial health.

Holders of preferred stock, on the other hand, are usually guaranteed a dividend payment and their dividends are always paid out before dividends on common stock. So if you're investing mostly for income—in this case, dividends—preferred stock may be attractive. But, unlike common stock dividends, which

may increase if the company's profit rises, preferred dividends are fixed. In addition, the price of preferred stock doesn't move as much as common stock prices. This means that while preferred stock doesn't lose much value even during a downturn in the stock market, it doesn't increase much either, even if the price of the common stock soars. So if you're looking for capital gains, owning preferred stock may limit your potential profit.

Another point of difference between common stock and preferred stock has to do with what happens if the company fails. In that event, there's a priority list for a company's obligations, and obligations to preferred stockholders must be met before those to common stockholders. On the other hand, preferred stockholders are lower on the list of investors to be reimbursed than bondholders are.

Classes of Stock

In addition to the choice of common or preferred stock, certain companies may offer a choice of publicly traded share classes, typically designated by letters of the alphabet—often A and B. For example, a company may offer a separate class of stock for one of its divisions which itself was perhaps a well-known, formerly independent company that has been acquired. In other cases, a company may issue different share classes that trade at different prices and have different dividend policies.

When a company has dual share classes, though, it's more common for one share class to be publicly traded and the other to be nontraded. Nontraded shares are generally reserved for company founders or current management. There are often restrictions on selling these shares, and they tend to have what's known as super voting power. This makes it possible for insiders to own less than half of the total shares of a company but control the outcome of issues that are put to a shareholder vote, such as a decision to sell the company.

Understanding Various Ways Stocks Are Described

In addition to the distinctions a company might establish for its shares—such as common or preferred—industry experts often group stocks generally into categories, sometimes called subclasses. Common subclasses, explained in greater detail below, focus on the company's size, type, performance during market cycles, and potential for short- and long-term growth.

Each subclass has its own characteristics and is subject to specific external pressures that affect the performance of the stocks within that subclass at any given time. Since each individual stock fits into one or more subclasses, its behavior is subject to a variety of factors.

1. Market Capitalization

You'll frequently hear companies referred to as large-cap, mid-cap, and small-cap. These descriptors refer to market capitalization, also known as market cap and sometimes shortened to just capitalization. Market cap is one measure of a company's size. More specifically, it's the dollar value of the company, calculated by multiplying the number of outstanding shares by the current market price.

There are no fixed cutoff points for large-, mid-, or small-cap companies, but you may see a small-cap company valued at less than $1 billion, mid-cap companies between $1 billion and $5 billion, and large-cap companies over $5 billion—or the numbers may be twice those amounts. You might also hear about micro-cap companies, which are even smaller than other small-cap companies.

Larger companies tend to be less vulnerable to the ups and downs of the economy than smaller ones—but even the most venerable company can fail. Larger companies typically have larger financial reserves, and can therefore absorb losses more easily and bounce back more quickly from a bad year. At the same time, smaller companies may have greater potential for fast growth in economic boom times than larger companies. Even so, this generalization is no guarantee that any particular large-cap company will weather a downturn well, or that any particular small-cap company will or won't thrive.

2. Industry and Sector

Companies are subdivided by industry or sector. A sector is a large section of the economy, such as industrial companies, utility companies, or financial companies. Industries, which are more numerous, are part of a specific sector. For example, banks are an industry within the financial sector.

Frequently, events in the economy or the business environment can affect an entire industry. For example, it's possible that high gas prices could lower the profits of transportation and delivery companies. A new rule changing the review process for prescription drugs could affect the profitability of all pharmaceutical companies.

Sometimes an entire industry might be in the midst of an exciting period of innovation and expansion, and becomes popular with investors. Other times that same industry could be stagnant and have little investor appeal. Like the stock market as a whole, sectors and industries tend to go through cycles, providing strong performance in some periods and disappointing performance in others.

Part of creating and maintaining a strong stock portfolio is evaluating which sectors and industries you should be invested in at any given time. Having made that decision, you should always evaluate individual companies within a sector or industry you've identified to focus on the ones that seem to be the best investment choices.

3. Defensive and Cyclical

Stocks can also be subdivided into defensive and cyclical stocks. The difference is in the way their profits, and therefore their stock prices, tend to respond to the relative strength or weakness of the economy as a whole.

Defensive stocks are in industries that offer products and services that people need, regardless of how well the overall economy is doing. For example, most people, even in hard times, will continue filling their medical prescriptions, using electricity, and buying groceries. The continuing demand for these necessities can keep certain industries strong even during a weak economic cycle.

In contrast, some industries, such as travel and luxury goods, are very sensitive to economic up-and-downs. The stock of companies in these industries, known as cyclicals, may suffer decreased profits and tend to lose market value in times of economic hardship, as people try to cut down on unnecessary expenses. But their share prices can rebound sharply when the economy gains strength, people have more discretionary income to spend, and their profits rise enough to create renewed investor interest.

4. Growth and Value

A common investment strategy for picking stocks is to focus on either growth or value stocks, or to seek a mixture of the two since their returns tend to follow a cycle of strength and weakness.

Growth stocks, as the name implies, are issued by companies that are expanding, sometimes quite quickly but in other cases over a longer period of time. Typically, these are young companies in fairly new industries that are rapidly expanding.

Growth stocks aren't always new companies, though. They can also be companies that have been around for some time but are poised for expansion, which could be due to any number of things, such as technological advances, a shift in strategy, movement into new markets, acquisitions, and so on.

Because growth companies often receive intense media and investor attention,

their stock prices may be higher than their current profits seem to warrant. That's because investors are buying the stock based on potential for future earnings, not on a history of past results. If the stock fulfills expectations, even investors who pay high prices may realize a profit. Since companies may take big risks to expand, however, growth stocks may be very volatile, or subject to rapid price swings. For example, a company's new products may not be a hit, there may be unforeseen difficulty doing business in new countries, or the company may find itself saddled with major debt in a period of rising interest rates. As always with investing, the greater the potential for an outstanding return, the higher the risk of loss.

When a growth stock investment provides a positive return, it's usually as a result of price improvement—the stock price moves up from where the investor originally bought it—not because of dividends. Indeed, a key feature of most growth stocks is an absence of dividend payments to investors. Instead, company managers tend to plow gains directly back into the company.

Value stocks, in contrast, are solid investments selling at what seem to be low prices given their history and market share. If you buy a value stock, it's because you believe that it's worth more than its current price. You might look for value in older, more established industries, which tend not to get as much press as newer industries. One of the big risks in buying value stocks, also known as undervalued stocks, is that it's possible that investors are avoiding a company and its stock for good reasons, and that the price is a fairer reflection of its value than you think.

On the other hand, if you deliberately buy stocks that are out of fashion and sell stocks that other investors are buying—in other words, you invest against the prevailing opinion—you're considered a contrarian investor. There can be rewards to this style of investing, since by definition a contrarian investor buys stocks at low prices and sells them at high ones. However, contrarian investing requires considerable experience and a strong tolerance for risk, since it may involve buying the stocks of companies that are in trouble and selling stocks of companies that other investors are favoring. Being a contrarian also takes patience, since the turnaround you expect may take a long time.

Volatility

If you've seen the jagged lines on charts tracking stock prices, you know that prices fluctuate throughout the day, week, month, and year, as demand goes up and down in the markets. You'll see short-term fluctuations as the stock's price moves within a certain price range, and longer-term trends over months and years, in which that short-term price range itself moves up or down. The size and

frequency of these short-term fluctuations are known as the stock's volatility.

If a stock has a relatively large price range over a short time period, it is considered highly volatile and may expose you to increased risk of loss, especially if you sell for any reason when the price is down. Though there are exceptions, growth stocks tend to be more volatile than value stocks.

In contrast, if the range of prices is relatively narrow over a short time period, a stock is considered less volatile and normally exposes you to less investment risk. But reduced risk also means reduced potential for substantial short-term return since the stock price is unlikely to increase very much in that time frame.

Stocks may become more or less volatile over time. One example might be a newer stock that had formerly seen big price swings, but becomes less volatile as the company grows and establishes a track record. Another example might be a stock with a traditionally stable price that becomes extremely volatile following unfavorable or favorable news reports, which trigger a rash of buying and selling.

Stock Splits

When a stock price gets very high, companies may decide to split the stock to bring its price down. One reason to do this is that a very high stock price can intimidate investors who fear there is little room for growth, or what is known as price appreciation.

Here's how a stock split works: Suppose a stock trading at $150 a share is split 3-for-1. If you owned 100 shares worth $15,000 before the split, you would hold 300 shares valued at $50 each after the split, so that your investment would still worth $15,000. More investors may become interested in the stock at the lower price, so there's always the possibility that your newly split shares will rise again in price due to increased demand. In fact, it may move back toward the pre-split price—though, of course, there's no guarantee that it will.

You may also own stock that goes through a reverse split, though this type of split is less common especially among seasoned companies that trade on one of the major U.S. stock markets, including the NYSE, The NASDAQ Stock Market, or the Amex. In this case, a company with very low-priced stock reduces the total number of shares to increase the per-share price.

For example, in a reverse split you might receive one new share for every five old shares. If the price-per-share had been $1, each new share would be worth $5. Companies may do reverse splits to maintain their listing on a stock market that has a minimum per-share price, or to appeal to certain institutional investors who

may not buy stock priced below a certain amount. In either of those cases—indeed if reverse splits are announced or actually occur—you'll want to proceed with caution. Reverse splits tend to go hand in hand with low priced, high risk stocks.

Evaluating a Stock

When you buy a stock, you're buying part ownership of a company, so the questions to ask as you select among the stocks you're considering are the same questions you'd ask if you were buying the whole company:

- What are the company's products?
- Are they in demand and of high quality?
- Is the industry as a whole doing well?
- How has the company performed in the past?
- Are talented, experienced managers in charge?
- Are operating costs low or too high?
- Is the company in heavy debt?
- What are the obstacles and challenges the company faces?
- Is the stock worth the current price?

Because each company is a different size and has issued a different number of shares, you need a way to compare the value of different stocks. A common and quick way to do this is to look at the stock's earnings. All publicly traded companies report earnings to the Securities and Exchange Commission on a quarterly basis in an unaudited filing known as the 10-Q, and annually in an audited filing known as the 10-K.

If you check those reports, the company's annual report, or its Web site, you'll find its current earnings-per-share, or EPS. That ratio is calculated by dividing the company's total earnings by the number of shares. You can then use this per-share number to compare the results of companies of different sizes. EPS is one indication of a company's current strength.

You can divide the current price of a stock by its EPS to get the price-to-earnings ratio, or P/E multiple, the most commonly quoted measure of stock value. In a nutshell, P/E tells you how much investors are paying for a dollar of a company's earnings. For example, if Company A has a P/E of 25, and Company B has a P/E of 20, investors are paying more for each dollar earned by Company A than for each dollar earned by Company B.

There's no perfect P/E, though there is a market average at any given time. Over the long term that number has been about 15, though higher in some periods and lower in others. Value investors tend look for stocks with relatively low P/E ratios—below the current average—while growth investors often buy stocks with higher than average P/E ratios.

While P/E can be a revealing indicator, it shouldn't be your only measure for

evaluating a stock. For example, there are times you might consider a stock with a P/E that's higher than average for its industry if you have reason to be optimistic about its future prospects. Remember, though, that when a stock has an unusually high P/E, the company will have to generate substantially higher earnings in the future to make it worth the price. At the other end of the scale, a low P/E may be a sign that significant price appreciation is possible or that a company is in serious financial trouble. That's one of the determinations you'll want to make before you buy.

A P/E ratio can only be as useful as the earnings numbers it's based on. While there are standards for reporting earnings, and a company's financial reports are audited, there may still be a lack of consistency across earnings reports. You've probably seen stories in the financial press about companies restating earnings. This happens when an accounting error or other discrepancy comes to light, and a company must reissue reports for past periods. Inaccurate or inconsistent earnings statements may make P/E a less reliable measure of stock value.

Even though P/E is the most widely quoted measure of stock value, it's not the only one. You'll also see stock analysts discussing measures such as ROA (return on assets), ROE (return on equity), and so on. While all of these acronyms may seem confusing at first, you may find, as you get to know them, that they can help answer some of your questions about a company, such as how efficient it is, how much debt it's carrying, and so on.

One way to learn more about individual stocks is through professional stock research. The brokerage firm where you have your account may provide research from its own analysts and perhaps from outside sources. You can also find independent research from analysts who aren't affiliated with a brokerage firm, as well as consensus reports that bring together opinions from a variety of analysts. Some of this research is free, while other research comes with a price tag.

In the past, there have been conflicts of interest at brokerage firms that provide investment banking services to public companies, since analysts may sometimes have felt pressure to review those stocks positively. However, brokerage firms are required to establish strict separations between their investment banking and stock analysis departments to comply with regulations designed to minimize any such potential conflicts of interests.

Buying and Selling Stock

To buy and sell stock, you usually need to have an account at a brokerage firm, also known as a broker-dealer, and give orders to a stockbroker at the firm who

will execute those instructions on your behalf, or online, where the firm's technology systems route your order to the appropriate market or system for execution. The kind of firm you use will determine how you convey your orders, what types of services you have access to, and what fees you pay to trade your stocks. In general, the more services the firm offers, the more you'll pay for each transaction. Brokerage firms may also charge fees to maintain your account.

Full-service brokerage firms provide research as well as trade executions and may offer customized portfolio management, investment advice, financial planning, banking privileges, and other services. Discount firms offer fewer services but, as their name implies, generally charge less to execute the orders you place. The trick is to find the balance that's right for you. On the one hand, you don't want fees to cut into your returns, but on the other hand, you may benefit from more guidance. You'll want to check what effect the amount you have to invest—or what are known as your investable assets—will have on the level of service you receive and the prices you pay.

You can place buy and sell orders over the phone with your broker or you can trade stocks online. Many firms offer full account access and trading through their Web sites at lower prices than they charge for phone orders. If you do trade online, it's important to be wary of trading too much, simply because it's so easy to place the trade. You should consider your decisions carefully, taking into account the fees and taxes as well as the impact on the balance of assets in your portfolio, before you place an order.

There are ways to buy stock directly through certain companies without using a broker. For example, if you used a broker to purchase a share of stock in a company that offers a dividend reinvestment plan, or DRIP, you can choose to buy additional shares through that plan. DRIPs allow you to automatically reinvest your dividends and periodically write checks to buy more stock. Some companies also offer direct purchase plans, or DPPs, that allow you to buy shares directly from the issuer at any time.

DRIPs and DPPs are usually administered for the company by a third party known as a shareholder services company or stock transfer agent that can also handle the sale of your shares. Transaction fees for DRIP and DPP orders tend to be substantially less than brokerage fees.

Trading vs. Buy-and-Hold

The goal of most investors generally is to buy low and sell high. This can result in two quite different approaches to equity investing.

One approach is described as “trading.” Trading involves following the short-term price fluctuations of different stocks closely and then trying to buy low and sell high. Traders usually decide ahead of time the percentage increase they’re looking for before you sell (or decrease before they buy).

While trading has tremendous potential for immediate rewards, it also involves a fair share of risk because a stock may not recover from a downswing within the time frame you’d like—and may in fact drop further in price. In addition, frequent trading can be expensive, since every time you buy and sell, you may pay broker’s fees for the transaction. Also, if you sell a stock that you haven’t held for a year or more, any profits you make are taxed at the same rate as your regular income, not at your lower tax rate for long-term capital gains.

Be aware that trading should not be confused with “day trading,” which is the rapid buying and selling of stock to capitalize on small price changes. Day trading can be extremely risky, especially if you attempt to day trade using borrowed money. Individual investors frequently lose money by trying to use this approach.

A very different investing strategy—called buy-and-hold—involves keeping an investment over an extended period, anticipating that the price will rise over time. While buy-and-hold reduces the money you pay in transaction fees and short-term capital gains taxes, it requires patience and careful decision-making. As a buy-and-hold investor, you generally choose stocks based on a company’s long-term business prospects. Increases in the stock price over years tend to be based less on the volatile nature of the market’s changing demands and more on what’s known as the company’s fundamentals, such as its earnings and sales, the expertise and vision of its management, the fortunes of its industry, and its position in that industry.

Buy-and-hold investors still need to take price fluctuations into account, and they must pay attention to the stock’s ongoing performance. Naturally, the price at which you buy a stock directly affects the potential profits you’ll make from its sale. So it makes sense to buy the stock at a price you believe is reasonable. While you hold the stock, it’s also important to watch for signs that your investment isn’t going the direction you planned—for example, if the company regularly misses its earnings targets, or if developments in the industry turn bleaker.

Sometimes you’ll decide, after reviewing the company’s fundamentals, that it’s worthwhile to ride out a slump in price and wait for a stock to recover. Other times, you may decide you’ll have better returns if you sell your holding and invest elsewhere. Either way, it’s important to stay on top of the stocks you own by paying attention to news that could affect their value.

Advanced Short-Term Trading

There are a number of ways that some experienced investors seek increased returns by taking on more risk.

- **Buying on Margin**. When you buy stocks on margin, you borrow part of the cost of the investment from your broker, in the hopes of increasing your potential returns. To use this approach, you set up what's known as a margin account, which typically requires you to deposit cash or qualified investments worth at least $2,000. Then when you invest, you borrow up to half the cost of the stock from your broker and you pay for the rest. In this way, you can buy and sell more stock than you could without borrowing, which is a way to leverage your investment.

  If the price goes up and you sell the stock, you pay your broker back, plus interest, and you get to keep the profits. However, if the price drops, you may have to wait to sell the stock at the price you want, and in the meantime, you're paying interest on the amount you've borrowed. If the price drops far enough, your broker will require you to add money or securities to your margin account to bring it up to the required level. The required level is based on the ratio of your cash and qualified investments to the amount you borrowed from your broker in your account. If you can't add enough money, your broker can sell off the investments in that account to repay what you've borrowed, which invariably means that you'll lose money on the deal.

- **Short Selling.** Short selling is a way to profit from a price drop in a company's stock. However, it involves more risk than just buying a stock, which is sometimes described as having a long position, or owning the stock long. To sell a stock short, you borrow shares from your broker and sell them at their current market price. If that price falls, as you expect it to, you buy an equal number of shares at a new, lower price to return to your broker. If the price has dropped enough to offset transaction fees and the interest you paid on the borrowed shares, you may pocket a profit. This is a risky strategy, however, because you must still re-buy the shares and return them to your broker. If you must re-buy the shares at a price that's the same as or higher than the price at which you sold the borrowed shares, after accounting for transaction costs and interest, you will lose money.

  Because short selling is in essence the sale of stocks you don't own, there

are strict margin requirements associated with this strategy, and you must set up a margin account to conduct these transactions. The margin money is used as collateral for the short sale, helping to insure that the borrowed shares will be returned to the lender down the road.

3. Bonds

Bonds are debt investments. They represent a loan you make to an institution—a corporation, government, or government agency—in exchange for interest payments during a specific term plus the repayment of your principal when the bond comes due. Because the income you receive from a bond is generally fixed at the time the bond is created, bonds are often considered fixed-income investments.

Bonds are usually described based on these key characteristics:

- **Par value or face value:** the amount you're lending and expect to be paid back, usually $1,000 per bond, but sometimes in multiples of $1,000
- **Term**: the length of time until the bond matures
- **Maturity date**: the date on which the principal is to paid in full to you
- **Interest**: the percentage of the loan amount the borrower will pay you for the use of your money over the term

Making Money with Bonds

You can make money with bonds in two ways:

1. **Interest**. The interest payments from the bond normally provide you with a fixed source of income for the bond's term. In most cases, the rate is fixed at the time the bond is issued.

2. **Capital gains**. You might also make a profit by selling a bond before maturity at a higher price than you paid for it.

The interest rate is part of the contractual relationship you have with the borrower. It's determined by a number of factors, including the bond's term, current market rates, and the creditworthiness of its issuer, which depends on the risk associated with the likelihood of the issuer's repaying the bond. In general, longer-term bonds pay higher rates to reward you for committing your money for an extended period, but that's not always the case. It's also typical for a low-rated issuer to have to offer higher rates to attract interest in its bonds.

Types of Bonds

There are several major categories of bonds that are available in the bond marketplace, which you may own either directly or through bond mutual funds or

exchange traded funds.

- **Corporate bonds** are issued by companies to raise capital for their business activities. A company may have a host of reasons for choosing to issue bonds rather than sell stock. Some companies are concerned about watering down, or diluting, the value of existing stock by issuing new shares. Others might want to raise money while remaining privately owned. Still others might find it less costly to issue bonds, given prevailing market conditions.

- **Municipal bonds**, also known as munis, are issued by municipalities—local governments at the state, county, or city level—either to supplement tax revenues or to pay for public projects, such as building a new hospital or maintaining roads or bridges. A muni is repaid either from tax revenues or from fees collected by the government that issues the bond. One major appeal of munis is that the interest they pay is usually free of federal income tax, and may also be free of state or local income taxes in the jurisdictions where they are issued. Investors in the highest tax brackets, however, should take into account that interest on some munis may be subject to the alternative minimum tax (AMT). In addition, any capital gains are taxable at all levels of government.

- **Agency bonds** are issued both by government agencies and by government-sponsored enterprises (GSEs), which are entities like the Tennessee Valley Authority, a power utility owned by the federal government, that operate like corporations but have charters from the government to provide some public service. The largest GSEs in the U.S. include the Federal Home Loan Bank (FHLB), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

- **Treasury securities**, also known as Treasuries, are debt offerings from the United States Treasury Department. They're backed by the full faith and credit of the U.S. government and are considered to have essentially perfect credit. Treasuries come as short-term Treasury bills, mid-term Treasury notes, and long-term Treasury bonds. While you do have to pay federal income tax on the interest from Treasuries, you do not pay state and local taxes on that income.

- **Asset-backed securities** are loans, accounts receivables or other assets that are securitized, or packaged into bond offerings, by investment banks and mortgage corporations. These securities make it possible for you to invest in these debt markets by buying the bonds, while making the money

you lend available to borrowers who want to finance their purchases. For instance, mortgage-backed securities, such as those offered by mortgage corporations Fannie Mae and Freddie Mac, make the money collected from selling bonds available to lenders and ultimately to borrowers who want to buy a home. Asset-backed bonds are called pass-through securities because the payments of interest and return of principal that these borrowers make are returned to the bondholders.

Credit Risk

Because bonds are loans, investing in bonds involves credit risk—that is to say, the risk that the borrower won't pay you back as promised. Because of credit risk, whenever you lend money, you need to evaluate whether the borrower has the financial ability to make interest payments and repay your principal according to your agreement. For example, on a personal level, someone with $1 million in his or her bank account is probably a better credit risk than someone with $100 in the bank. The same is true with corporations, and, in a slightly different way, with municipal governments.

Other things to take into account are how much debt the borrower already has, whether the borrower seems financially solid, and how the borrower has paid back debt in the past. The situation is somewhat different with mortgage-backed securities, since in that case the repayment is from thousands of individual borrowers repaying their mortgages rather than a single corporation or government entity.

You would find it difficult to gather sufficient information to gauge a bond issuer's credit risk on your own. Fortunately, there are several companies, known as Nationally Recognized Statistical Rating Organizations (NRSROs), which do this for you. They are A.M. Best Company, Inc., Dominion Bond Rating Service Ltd. (also known as DBRS Ltd.), Fitch, Inc., Japan Credit Rating Agency, Ltd., Moody's Investors Service, Rating and Investment Information, Inc., and Standard & Poor's Ratings Services. Their bond analysts rate bond issuers' credit on a scale ranging from the highest quality, meaning the lowest credit risk, to the poorest quality, which may mean the company is in default and is no longer able to pay its debt obligations. Corporations and municipal governments that receive the top ratings issue what's called investment grade debt. Debt of the U.S. government is not rated because it is considered free of default risk.

Bond issuers with high credit ratings can borrow money from investors at lower rates. In contrast, for lower-quality bonds to be attractive to investors, they have to offer higher interest rates. The riskiest bonds offer very high rates of interest but involve a higher chance of default. If the risk pays off, investors could collect more money than they could with safer bonds, but if it doesn't, they could end up losing principal as well as interest. In this sense, high-risk bonds—also known as junk bonds and sometimes referred to as high-yield bonds—are more speculative, and investors who purchase them tend to trade them like stocks rather than hold on to them for the income.

Coupon and Yield

Bond interest payments are also called the bond's coupon, since in the past, paper bond certificates came with coupons you cut off, or clipped, and exchanged for interest payments. Today, you no longer need to turn in a coupon to collect your interest payments. They simply arrive on schedule, typically twice a year. The payment and schedule are set in the bond agreement, usually at a fixed rate but sometimes not. For example, a stepped-coupon bond will change interest rates at certain dates—going from 3% to 5%, for example. A floating-rate bond will adjust the interest rate periodically, according to a specific measure of current rates, to keep your coupon payments in line with payments made by new bonds.

Your interest rate is sometimes, but not always, the same as your yield. Yield is a measure of how much an investment is paying per dollar invested, calculated by dividing the annual interest by the price. A bond with a higher yield is more profitable. When you shop for bonds, you'll find that brokers and online comparison tables will quote yields, and the financial press often discusses yields rather than coupon rates in its bond coverage.

There are several ways to calculate a bond's yield, so it's important to know which yield you're dealing with when you read about bonds or compare them.

The simplest yield calculation—coupon yield—is exactly the same as the bond's interest rate. You calculate coupon yield by dividing the amount the bond pays you per year by the bond's par value. For example, if par value were $1,000 and each year you received two coupon payments of $25 each, you would divide $50 (the year's total) by $1,000 to get a 5% coupon yield.

If you buy the bond at issue for par value and hold it to maturity, coupon yield is what you'll be concerned about. But if you buy a bond on the secondary market, the price will probably have moved higher or lower than par. In that case, you'll want to look at a number called current yield, which you calculate by dividing the interest by the actual market price.

Let's say you were thinking of buying a bond paying 5%, or $50 a year, but that it's selling at a discount for $925. The bond's current yield in this case would be 5.4% ($50 divided by $925), which is slightly higher than its coupon yield. Likewise, if the bond were selling at a premium, meaning a price higher than par, its current yield would be slightly lower than its coupon yield.

The yield that brokers and bond tables tend to provide is the bond's yield-to-maturity (YTM). YTM is a more complicated calculation that's designed to give you a better idea of the bond's total earning power over its whole term. It factors in all the remaining coupon payments, but it also includes any profit or loss you'd

realize when full par value was repaid, as compared to what you paid to buy the bond. YTM also includes the effect of compounding, by assuming that every coupon payment is reinvested at the same coupon rate as the original bond.

Interest rates change all the time, of course, and when you receive a coupon payment, it's more likely than not that the rate you'll get by reinvesting it will differ from the rate of the original bond. Still, YTM is a more comprehensive measure of a bond's true earnings potential over its entire term, especially if you plan to reinvest your coupon payments rather than use them as income.

Interest Rate Risk

Even U.S. Treasury notes and bonds, which are considered to have zero credit risk, are not risk free. Like all bonds, they're subject to interest rate risk, or the consequences of changes in the rate that borrowers are paying. This risk affects you if you're reinvesting a maturing bond and the current rates are lower than the rate you were earning. It means your yield will be less.

Interest rate risk also affects you if you want to sell an older bond before it matures. The reason is that bond prices and rates move in opposite directions. When interest rates go up, prices of existing bonds go down because they are paying the older, lower rate and so providing a smaller yield. When rates go down, prices of existing bonds go up because they are paying a higher rate.

For example, if your bond has a coupon yield of 5% but new bonds of the same type offer a coupon yield of 6%, no investor will pay the same price for your bond as for the new one because it would mean less income. They'll be willing to pay only a lower, or discount, price to bring the yield closer to the yield from the newer bond.

Of course, interest rate changes can also work in your favor. If you own a bond paying 5% interest, but new bonds of the same type are paying only 4%, you can probably sell your on the secondary market for a higher price, or at a premium.

In addition, changes in interest rates mean that there's an opportunity cost to committing your money to a bond at the current rate. If rates should go up after you buy a bond, your money will be locked in at the old rate. To invest at the new rate, you'd either have to sell your bond at a discount or come up with investment money somewhere else. In addition, interest rate changes affect your actual YTM because you'll be reinvesting your coupon payments at the going rate, which is different from your original rate.

Longer-term bonds are more susceptible to interest rate risk than shorter-term

bonds, since they lock your money in for a longer time and because interest rates can change much more over extended periods. That's why the debt securities with the lowest risk of all are U.S. Treasury bills because their terms are so short—4, 13, or 26 weeks. With such as short time frame, rates typically change very little before maturity. That's a primary reason that T-bills are described as cash equivalent investments.

In addition to being vulnerable to interest rate risk, longer-term bonds are also more susceptible to inflation risk, which is the erosion of the buying power of your money due to rising prices over time. Because of all these added risks, longer terms bonds usually must pay higher interest rates to attract investors.

One popular way to manage one aspect of interest rate risk—the risk that your bond will mature when rates are low and you'll have to buy new bonds paying a lower yield—is to stagger the maturity dates of your bonds, so they don't all mature at once. Using this technique, known as laddering, you purchase bonds that mature at regular intervals, such as one or two years apart, so that the evenly spaced maturities resemble the rungs of a ladder. If you receive repayments of principal at different times, rather than having all your bonds repaid at once, you may be able to avoid having to reinvest all your money at an unattractive rate and missing out on more attractive rates at other times.

Some bonds, known as put bonds, give you the option to redeem your bond, or exchange it for par value, before the scheduled maturity date. While put bonds leave you less vulnerable to interest rate risk, since you won't risk having to sell your bond in the secondary market at a discount, they also offer lower coupon rates in exchange for this lower risk.

Zero-Coupon Bonds

Bonds usually make coupon payments twice a year, but zero-coupon bonds, also known as zeros, pay interest all at once, at maturity, along with the repayment of principal.

If you're investing for a future goal when you'll need a sum of money at a particular time, a zero-coupon bond may be a useful investment. One way zeroes can be handy is that they pay you interest on the interest that you've earned but haven't received, at the YTM rate. This eliminates the possibility that you might have to reinvest your coupon payments at a lower rate than the bond itself is paying. However, the market price of zeros can be extremely volatile in the secondary market, so they may be a good investment choice only if you are fairly certain you will hold them to maturity.

Because zeroes are priced differently from coupon-paying bonds, you need less up front to make a substantial investment. Instead of paying par value, you buy them at a deep discount, or much less than par value, and you're repaid par value at maturity. The discount represents your total income from the bond.

One catch with zeroes, however, is that you may still owe income taxes on the coupon payments during the term of the loan even though you haven't received them. For this reason, it may make sense, if you plan on investing in zeroes, to do so through a tax-deferred account or to purchase tax-free municipal zeros issued in the state where you live.

Callable Bonds

A bond issuer may choose to call a bond—repay the principal to a bond's investors before its maturity date—if the bond allows it. These callable bonds specify the times at which the issuer may call the bond, either in the form of a call schedule, with specific dates on which the bond may be called, or as a single date, beyond which the bond may be called at any time.

The risk that your bond will be called makes it more vulnerable to reinvestment risk, or the risk that you'll find yourself forced to reinvest your principal at a lower interest rate than you were receiving on the called bond. That's especially likely to occur because issuers generally call bonds when interest rates drop. By paying back their high-interest debt and borrowing at lower rates with a new bond issue, issuers can finance their activities more cheaply. However, it leaves you holding cash to reinvest when interest rates are low.

Issuers may sometimes choose to pay back, or redeem, only part of a total bond issue. In that case, investors to be repaid may be chosen by lottery. In addition, some bonds have a series of calls built in, with a feature known as a sinking fund—money that the issuer sets aside specifically to pay back a certain chunk of the total debt in stages.

Because calls can make a bond less attractive to investors, issuers may specify that the bond will be redeemed at higher than par, giving you the chance to realize a profit if your bond is called. If you want to consider how much you'll make on your investment if the bond is called versus how much you'll make if it matures on schedule, you can ask your broker for a yield figure known as yield-to-call, or yield-to-first-call. This number tells you what your yield would be if your bond were called at the earliest possible date.

Buying and Selling Bonds

Investing in bonds can require a relatively large outlay of principal. Although par value is usually $1,000, many bonds are not available individually and are sold only in lots of five or more. Agency bonds in particular may have a minimum investment of $10,000.

Because of this high initial investment, it's more typical for institutions, such as mutual funds and pension funds, to own corporate and agency bonds than it is for individual investors. Some of the same issues exist with municipal bonds, but certain issuers may market to individuals in part to build community support for expensive projects.

Treasury securities, however, are the exception. New issues are sold by the Treasury directly to the public on the TreasuryDirect Web site at www.treasurydirect.gov, and you may buy bills, notes, and bonds individually with a minimum investment of $1,000.

To buy or sell all other bonds, you usually need to work with a broker, who matches you with sellers and buyers through a bond dealer. Sometimes the broker's own firm has bonds in their own inventory to sell, and these may be priced better than bonds the broker must buy from another firm. Bond prices are not as transparent at stock prices, in part because the commissions you pay when you buy or sell them are not reported separately, as stock commissions are.

While some bonds trade on the major exchanges, the majority of corporate bonds trade over-the-counter and, until recently, it was difficult for individuals to find current prices. Today, extensive real-time trade information and end-of-day index information on corporate bonds is displayed without charge in the Market Data section of FINRA's Web site at www.finra.org/marketdata.

4. Mutual Funds

Mutual funds are a popular way to invest in securities. Because mutual funds can offer built-in diversification and professional management, they offer certain advantages over purchasing individual stocks and bonds. But, like investing in any security, investing in a mutual fund involves certain risks, including the possibility that you may lose money.

Technically known as an “open-end company,” a mutual fund is an investment company that pools money from many investors and invests it based on specific investment goals. The mutual fund raises money by selling its own shares to investors. The money is used to purchase a portfolio of stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. Each share represents an ownership slice of the fund and gives the investor a proportional right, based on the number of shares he or she owns, to income and capital gains that the fund generates from its investments.

The particular investments a fund makes are determined by its objectives and, in the case of an actively managed fund, by the investment style and skill of the fund’s professional manager or managers. The holdings of the mutual fund are known as its underlying investments, and the performance of those investments, minus fund fees, determine the fund’s investment return

While there are literally thousands of individual mutual funds, there are only a handful of major fund categories:

- Stock funds invest in stocks
- Bond funds invest in bonds
- Balanced funds invest in a combination of stocks and bonds
- Money market funds invest in very short-term investments and are sometimes described as cash equivalents

Most fund companies also offer one or more money market funds, which make very short-term investments and are sometimes described as cash equivalents.

You can find all of the details about a mutual fund—including its investment strategy, risk profile, performance history, management, and fees—in a document called the prospectus. You should always read the prospectus before investing in a fund.

Mutual funds are equity investments, as individual stocks are. When you buy

shares of a fund you become a part owner of the fund. This is true of bond funds as well as stock funds, which means there is an important distinction between owning an individual bond and owning a fund that owns the bond. When you buy a bond, you are promised a specific rate of interest and return of your principal. That's not the case with a bond fund, which owns a number of bonds with different rates and maturities. What your equity ownership of the fund provides is the right to a share of what the fund collects in interest, realizes in capital gains, and receives back if it holds a bond to maturity.

Making Money with Mutual Funds

If you own shares in a mutual fund you share in its profits. For example, when the fund's underlying stocks or bonds pay income from dividends or interest, the fund pays those profits, after expenses, to its shareholders in payments known as income distributions. Also, when the fund has capital gains from selling investments in its portfolio at a profit, it passes on those after-expense profits to shareholders as capital gains distributions. You generally have the option of receiving these distributions in cash or having them automatically reinvested in the fund to increase the number of shares you own.

Of course, you have to pay taxes on the fund's income distributions, and usually on its capital gains, if you own the fund in a taxable account. When you invest in a mutual fund you may have short-term capital gains, which are taxed at the same rate as your ordinary income—something you may try to avoid when you sell your individual securities. You may also owe capital gains taxes if the fund sells some investments for more than it paid to buy them, even if the overall return on the fund is down for the year or if you became an investor of the fund after the fund bought those investments in question.

However, if you own the mutual fund in a tax-deferred or tax-free account, such as an individual retirement account, no tax is due on any of these distributions when you receive them. But you will owe tax at your regular rate on all withdrawals from a tax-deferred account.

You may also make money from your fund shares by selling them back to the fund, or redeeming them, if the underlying investments in the fund have increased in value since the time you purchased shares in the funds. In that case, your profit will be the increase in the fund's per-share value, also known as its net asset value or NAV. Here, too, taxes are due the year you realize gains in a taxable account, but not in a tax-deferred or tax-free account. Capital gains for mutual funds are calculated somewhat differently than gains for individual investments, and the fund will let you know each year your taxable share of the fund's gains.

Active vs. Passive Management

When a fund is actively managed, it employs a professional portfolio manager, or team of managers, to decide which underlying investments to choose for its portfolio. In fact, one reason you might choose a specific fund is to benefit from the expertise of its professional managers. A successful fund manager has the experience, the knowledge, and the time to seek and track investments—key attributes that you may lack.

The goal of an active fund manager is to beat the market—to get better returns by choosing investments he or she believes to be top-performing selections. While there is a range of ways to measure market performance, each fund is measured against the appropriate market index, or benchmark, based on its stated investment strategy and the types of investments it makes.

For instance, many large-cap stock funds typically use the Standard & Poor's 500 Index as the benchmark for their performance. A fund that invests in stocks across market capitalizations might use the Dow Jones Wilshire 5000 Total Stock Market Index, which despite its name measures more than 5,000 stocks, including small-, mid-, and large-company stocks. Other indexes that track only stocks issued by companies of a certain size, or that follow stocks in a particular industry, are the benchmarks for mutual funds investing in those segments of the market. Similarly, bond funds measure their performance against a standard, such as the yield from the 10-year Treasury bond, or against a broad bond index that tracks the yields of many bonds.

One of the challenges that portfolio managers face in providing stronger-than-benchmark returns is that their funds' performance needs to compensate for their operating costs. The returns of actively managed funds are reduced first by the cost of hiring a professional fund manager and second by the cost of buying and selling investments in the fund. Suppose, for example, that the management and administrative fees of an actively managed fund are 1.5% of the fund's total assets and the fund's benchmark provided a 9% return. To beat that benchmark, the portfolio manager would need to assemble a fund portfolio that returned better than 10.5% before fees were taken out. Anything less, and the fund's returns would lag its benchmark.

In any given year, most actively managed funds do not beat the market. In fact, studies show that very few actively managed funds provide stronger-than-benchmark returns over long periods of time, including those with impressive short term performance records. That's why many individuals invest in funds that don't try to beat the market at all. These are passively managed funds, otherwise

known as index funds.

Passive funds seek to replicate the performance of their benchmarks instead of outperforming them. For instance, the manager of an index fund that tracks the performance of the S&P 500 typically buys a portfolio that includes all of the stocks in that index in the same proportions as they are represented in the index. If the S&P 500 were to drop a company from the list, the fund would sell it, and if the S&P 500 were to add a company, the fund would buy it. Because index funds don't need to retain active professional managers, and because their holdings aren't as frequently traded, they normally have lower operating costs than actively managed funds. However, the fees vary from index fund to index fund, which means the return on these funds varies as well.

Some index funds, which go by names such as enhanced index funds, are hybrids. Their managers pick and choose among the investments tracked by the benchmark index in order to provide a superior return. In bad years, this hybrid approach may produce positive returns, or returns that are slightly better than the overall index. Of course, it's always possible that this type of hybrid fund will not do as well as the overall index. In addition, the fees for these enhanced funds may be higher than the average for index funds.

Fund Objectives

Within the major categories of mutual funds, there are individual funds with a variety of investment objectives, or goals the fund wants to meet on behalf of its shareholders. Here is just a sampling of the many you'll find:

Stock funds:

- **Growth funds** invest in stocks that the fund's portfolio manager believes have potential for significant price appreciation.
- **Value funds** invest in stocks that the fund's portfolio manager believes are underpriced in the secondary market.
- **Equity income funds** invest in stocks that regularly pay dividends.
- **Stock index funds** are passively managed funds, which attempt to replicate the performance of a specific stock market index by investing in the stocks held by that index.
- **Small-cap, mid-cap, or large-cap stock funds** stick to companies within a certain size range. Economic cycles tend to favor different sized companies at different times, so, for example, a small-cap fund may be doing very well at a time when large-cap funds are stagnant, and vice versa.

- **Socially responsible funds** invest according to political, social, religious, or ethical guidelines, which you'll find described in the fund's prospectus. Many socially responsible funds also take an activist role in the companies where they invest by representing their shareholders' ethical concerns at meetings with company management.
- **Sector funds** specialize in stocks of particular segments of the economy. For example, you may find funds that specialize solely in technology stocks, in healthcare stocks, and so on. Sector funds tend to be less diversified than funds that invest across sectors, but they do provide a way to participate in a profitable segment of the economy without having to identify specific companies.
- **International, global, regional, country-specific, or emerging markets funds** extend their reach beyond the United States. International funds invest exclusively in non-U.S. companies. Global funds may invest in stocks of companies all over the world, including U.S. companies with global businesses. Regional funds focus on stocks of companies in a particular region, such as Europe, Asia, or Latin America, while country-specific funds narrow their range to stocks from a single country. Funds that invest in emerging markets look for stocks in developing countries.

Bond funds:

- **Corporate, agency, or municipal bond funds** focus on bonds from a single type of issuer, across a range of different maturities.
- **Short-term or intermediate-term bond funds** focus on short- or intermediate-term bonds from a wide variety of issuers.
- **Treasury bond funds** invest in Treasury issues.
- **High-yield bond funds** invest in lower-rated bonds with higher coupon rates.

Other funds:

- **Balanced funds** invest in a mixture of stocks and bonds to build a portfolio diversified across both asset classes. The target percentages for each type of investment are stated in the prospectus. Because stocks and bonds tend to do well during different phases of an economic cycle, balanced funds may be less volatile than pure stock or bond funds.
- **Funds of funds** are mutual funds that invest in other mutual funds. While these funds can achieve much greater

diversification than any single fund, their returns are affected by the fees of both the fund itself and the underlying funds. There may also be redundancy, which can cut down on diversification, since several of the underlying funds may hold the same investments.

- **Target-date funds**, sometimes called lifecycle funds, are funds of funds that change their investments over time to meet goals you plan to reach at a specific time, such as retirement. Typically, target-date funds are sold by date, such as a 2025 fund. The farther away the date is, the greater the risks the fund usually takes. As the target date approaches, the fund changes its balance of investments to emphasize conserving the value it has built up and to shift toward income-producing investments.
- **Money market funds** invest in short-term debt, such as Treasury bills and the very short-term corporate debt known as commercial paper. These investments are considered cash equivalents. Money market funds invest with the goal of maintaining a share price of $1. They are sometimes considered an alternative to a bank savings account although they aren't insured by the FDIC. Some funds have private insurance.

It's important to keep in mind that funds don't always invest 100% of their assets in line with the strategy implied by their stated objectives. Some funds undergo what's called style drift when the fund manager invests a portion of assets in a category that the fund would typically exclude—for example, the manager of large-company fund may invest in some mid-sized or small companies. Fund managers may make this type of adjustment to compensate for lagging performance, but it may expose you to risks you weren't prepared for.

The SEC has issued rules that require a mutual fund to invest at least 80% of its assets in the type of investment suggested by its name. But funds can still invest up to one-fifth of their holdings in other types of securities—including securities that you might consider too risky or perhaps not aggressive enough. You might want to check the latest quarterly report showing the fund's major investment holdings to see how closely the fund manager is sticking to the strategy described in the prospectus, which is presumably why you invested in the fund.

Understanding Fees

All mutual funds charge fees. Because small percentage differences can add up to a big dollar difference in the returns on your mutual funds, it's important to be aware of all the fees associated with any fund you invest in. Some fees are charged at specific times, based on actions you take, and some are charged on an ongoing basis. Fees are described in detail in each fund's prospectus, which you should be sure to read before investing in any fund.

Here are types of fees that may be charged on an ongoing basis:

- **Management fees.** These fees pay the fund's portfolio manager.
- **12b-1 fees.** These fees, capped at 1% of your assets in the fund, are taken out of the fund's assets to pay for the cost of marketing and selling the fund, for some shareholder services, and sometimes to pay employee bonuses.
- **Other expenses.** This miscellaneous category includes the costs of providing services to shareholders outside of the expenses covered by 12b-1 fees or portfolio management fees. You also pay transaction fees for the trades the fund makes, though this amount is not reported separately as the other fees are.

The following fees are based on actions you may take, so may or may not be amounts you pay:

- **Account fees.** Funds may charge you a separate fee to maintain your account, especially if your investment falls below a set dollar amount.
- **Redemption fees.** To discourage very short-term trading, funds often charge a redemption fee to investors who sell shares shortly after buying them. Redemption fees may be charged anywhere from a few days to over a year. So it's important to understand if and how your fund assesses redemption fees before you buy, especially if you think you might need to sell your shares shortly after purchasing them.
- **Exchange fees.** Some funds also charge exchange fees for moving your money from one fund to another fund offered by the same investment company.
- **Purchase fees.** Whether or not a fund charges a front-end sales charge, it may assess a purchase fee at the time you buy shares of the fund.

One easy way to compare mutual funds fees is to look for a number called the fund's Total Annual Fund Operating Expenses, otherwise known as the fund's expense ratio. This percentage, which you can find in a fund's prospectus, on the fund's Web site, or in financial publications, will tell you the percentage of the fund's total assets that goes toward paying its recurring fees every year. The higher the fund's fees, the greater its handicap in terms of doing better than the overall market as measured by the appropriate benchmark.

For example, if you were considering two similar funds, Fund ABC and Fund XYZ, you might want to look at their expense ratios. Suppose Fund ABC had an expense ratio of 0.75% of assets, while Fund XYZ had an expense ratio of 1.85%. For Fund XYZ to match Fund ABC in annual returns, it would need a portfolio that outperformed Fund ABC by more than a full percentage point. Remember, though, that the expense ratio does not include loads, which are fees you may pay when you buy or sell your fund.

FINRA provides an easy-to-use, online Mutual Fund Expense Analyzer at www.finra.org that allows you to compare expenses among funds—or among different share classes of the same fund. Using a live data feed that captures expense information for thousands of funds, the analyzer can help you understand the impact fees have on your investment over time. Once you select up to three funds, type in the amount you plan to invest and how long you plan to keep the fund, the analyzer does the rest.

You should also be aware of transaction fees, which the mutual fund pays to a brokerage firm to execute its buy and sell orders. Those fees are not included in the expense ratio, but are subtracted before the fund's return is calculated. The more the fund buys and sells in its portfolio, which is reported as its turnover rate, the higher its transaction costs may be.

Understanding Loads

When you buy mutual fund shares from a stockbroker or other investment professional, you might have to pay sales charges, called loads, which are calculated as a percentage of the amount you invest. Like commissions on stock or bond transactions, these charges compensate the broker for the time and effort of working with you to select an appropriate investment.

The rate at which you're charged varies from fund company to fund company. In addition, companies may offer different classes of shares, which assess the charge at different times. You'll want to be sure you understand the financial consequences of choosing a specific share class before you purchase a fund.

You can use the FINRA Mutual Fund Expense Analyzer to compare share classes.

Class A shares have a front-end load, which is a commission you pay at the time you buy the shares. The average range is between 2% and 5%, though it varies. This amount is subtracted from the total you're investing in the fund. For example, if you invest $1,000 in a fund with a 5% front-end load, $950 of your investment would buy fund shares, and $50 would go to your broker.

Class B shares have a back-end load, which you don't pay unless you sell your shares during the period the charge applies, which is usually up to seven years after purchase, though it could be longer or shorter. The load tends to drop, perhaps by a percentage point each year, and then disappears altogether. However, the annual fees that the fund charges on Class B shares are higher than the fees on Class A shares. Back-end loads are also known as contingent deferred sales charges (CDSC).

Class C shares may carry a level load, which a fund collects every year you hold the fund, or they may have a back-end load or CDSC, similar to B shares. Class C shares also tend to have higher annual fees than Class A shares, typically on a par with those that apply to Class B shares. In addition, C shares do not convert to another share class.

As their name implies, no-load funds do not impose sales charges and you typically buy shares directly from the investment company that offers these funds. The same funds may be available, with a load, from investment professionals. Remember, though, that while no-load funds have no sales charges, they may still charge 12b-1 fees, purchase fees, redemption fees, exchange fees, and account fees in addition to the operating fees that all funds charge.

Breakpoints

Sometimes load funds offer volume discounts for higher investment amounts, in much the way that supermarkets sometimes offer economy bargains for buying certain things in bulk. In the case of funds, your front-end load, or Class A share sales charges, may be reduced if you invest a certain amount. The amounts at which your sales charges drop are called breakpoints. The breakpoints are different for each fund, and your broker must tell you what they are and must apply breakpoints if your investment qualifies.

Breakpoint rules vary, but some funds let you qualify for breakpoints if all your investments within the same fund family—funds offered by the same fund company—add up to the breakpoint level. Some funds let the total investments made by all the members of your household count toward the breakpoint. In addition, some funds let you qualify for a breakpoint over time, instead of with a single investment, by adding your past investments to your new ones. You might even qualify for a breakpoint if you write a letter of intent, informing the fund that you're planning to invest enough to qualify for the breakpoint in the future.

In short, funds can offer breakpoints any number of ways, or they may not offer them at all. Whenever you're entitled to breakpoints, however, the fund is required to apply them to your investment. To find out whether a fund offers breakpoints, use FINRA's Breakpoint Search Tool at http://tools1.finra.org/nbst/.

Open-End vs. Closed-End Funds

One of key distinguishing features of a mutual fund, or open-end fund, is that investors can buy and sell shares at any time. Funds create new shares to meet demand for increased sales and buy back shares from investors who want to sell. Sometimes, open-end funds get so large that they are closed to new investors. Even if an open-end fund is closed, however, it still remains an open-end fund since existing shareholders can continue to buy and sell fund shares.

Open-end funds calculate the value of one share, known as the net asset value (NAV), only once a day, when the investment markets close. All purchase and sales for the day are recorded at that NAV. To figure its NAV, a fund adds up the total value of its investment holdings, subtracts the fund's fees and expenses, and divides that amount by the number of fund shares that investors are currently holding.

NAV isn't necessarily a measure of a fund's success, as stock prices are, however. Since open-end funds can issue new shares and buy back old ones all

the time, the number of shares and the dollars invested in the fund are constantly changing. That's why in comparing two funds it makes more sense to look at their total return over time rather than to compare their NAVs.

Closed-end funds differ from open-end funds because they raise money only once in a single offering, much the way a stock issue raises money for the company only once, at its initial public offering, or IPO. After the shares are sold, the closed-end fund uses the money to buy a portfolio of underlying investments, and any further growth in the size of the fund depends on the return on its investments, not new investment dollars. The fund is then listed on an exchange, the way an individual stock is, and shares trade throughout the day.

You buy or sell shares of a closed-end fund by placing the order with your stockbroker. The price for closed-end funds rises and falls in response to investor demand, and may be higher or lower than its NAV, or the actual per-share value of the fund's underlying investments.

5. Exchange Traded Funds

Exchange traded funds, or ETFs, are pooled investments that combine aspects of mutual funds with those of individual stocks. Like a mutual fund, each ETF owns a group of investments, sometimes described as a basket, which reflects the composition of the index that the ETF tracks. But like a stock, an ETF is listed on an exchange and trades throughout the day, so that an order you place to buy or sell is executed at the current trading price.

You buy ETFs for the same reason you buy mutual funds—to achieve a level of diversification in an asset subclass that‘s difficult to accomplish on your own with a portfolio of individual securities. In addition, because there are so many ETFs tracking both broad and narrow segments of the market, you can use ETFs, or a combination of ETFs and individual securities and mutual funds to add asset classes to your portfolio that you might not be able to invest in otherwise. But ETFs, despite the word "fund" in their names, are not—and are not allowed to call themselves—mutual funds.

Using ETFs

Net asset value (NAV) is calculated in the same way a mutual fund's is, by dividing the combined value of the basket of securities the ETF holds by the number of shares that have been created. The market price is not identical to the NAV, as is the case with open-end mutual funds because it is affected by investor demand—or lack of it—for shares. But unlike closed-end funds, which they resemble in certain ways, ETFs are constructed so that the trading price rarely moves much above or below the NAV. This means there's little risk of having to pay a premium or sell at a discount.

Like other investments, your ETF may increase in value, and, if you wish you can sell at a profit. Of course, if the NAV falls and you sell, you may have a loss. You also benefit if the securities an ETF holds pay interest or dividends. That income may either be reinvested or paid to shareholders quarterly or annually, depending on the way the ETF is structured.

You can own ETFs in taxable, tax-deferred, or tax-free accounts. In taxable accounts, any capital gains the fund realizes from selling shares are taxed in the year you realize them, though the rate that applies may be your long-term capital gains rate. However, ETFs that track traditional indexes tend to have fairly modest turnover and so are fairly tax efficient.

In contrast, in a tax-deferred account, gains become part of the total assets in the account and are taxed at your ordinary rate when you withdraw at some point in

the future. In a tax-free account, any gains or income escape tax if you follow the rules for withdrawal.

Buying and Selling ETFs

You buy ETFs through your brokerage account, as you do individual stocks, and pay a commission on each transaction. In addition, ETFs have expense ratios, as mutual funds do, calculated as a percentage of the assets you have invested. However, ETF expense ratios tend to be closer to the fees on index funds than to those on actively traded funds—and in many cases are lower than comparable index funds.

Unlike mutual funds, it is also possible to buy ETFs on margin and sell them short. These advanced investment strategies may be useful for some experienced investors.

Because of the commission you pay on each transaction, ETFs, like individual stocks, are generally not recommended for incremental investing strategies such as dollar cost averaging because the sales charges could erode investment return. However, the same caution applies to load mutual funds.

Comparing ETFs and Mutual Funds

When you're considering an index investment, you'll want to think about some of the ways in which ETFs and mutual funds differ.

ETFs don't need to hold much of their portfolio in cash as mutual funds do, because they don't have to buy back shares that investors want to redeem. Instead shares are bought and sold among investors at the market price. Cash assets rarely provide the same level of return as assets fully invested in securities. For the same reason, ETFs don't have to sell investments to raise cash when investors are selling shares. This reduces transaction costs and short-term capital gains, both of which can reduce your overall return on a mutual fund.

On the other hand, ETFs that track smaller or nontraditional indexes may be thinly traded, which could make it difficult for you to sell at a price you want. In addition, if the compositions of nontraditional indexes change frequently, as is sometimes the case, the ETF will be less tax efficient than you might have anticipated.

6. Real Estate Investment Trusts

Real estate investment trusts, commonly known as REITs, are corporations that sell shares to raise money for investments in real estate or, less often, a portfolio of real estate mortgages. Equity REITs offer you a way to invest in real estate indirectly, without the responsibility for identifying the properties to be included in the portfolio, or for raising the capital to buy them, or ensuring the portfolio is diversified.

One of the advantages of owning real estate is that it adds to your investment mix an asset with a low correlation to stocks, bonds, and the funds that invest in them. That's important, because when the return on securities is disappointing, the return on real estate may be much stronger. Of course, the opposite is true as well. Real estate returns may drop in periods when stocks or bonds are doing well.

How REITs Work

Each REIT has a management team that buys and manages the REIT's properties and distributes income to shareholders. REITs collect rental income from tenants of the properties it owns and realize capital gains when it sells properties that have appreciated in value. A key distinction between REITs and individual real estate companies is that a REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than to resell them once they are developed.

REITs can be publicly held or privately owned. Public REITs must register their securities with the SEC. You can buy and sell shares of public REITs that are listed on a stock exchange in the same way you buy individual securities, closed-end funds, or ETFs. Some REITs are also sold over-the-counter (OTC), as some stocks are. REITs typically trade at prices above or below their net asset value, or what the properties are worth. Investors can also invest indirectly in REITs through mutual funds and ETFs.

Making Money with REITS

Most people who buy REITs do so primarily for the dividend income they distribute to investors, which by law must be at least 90% of the corporation's taxable income. Unlike stock dividends, REIT dividend income is taxable at your ordinary income tax rate. While REIT income can increase when rents are rising and real estate is gaining value, there is always the risk that income can fall if space goes unrented or costs rise. The return on a REIT also depends on the skill of the management team and their choice of properties.

Evaluating REITs

While REITs resemble funds in some ways, the evaluation process for REITS is closer to the process you would use to evaluate an individual stock. Before investing in a REIT, you'll want to research a number of factors that can affect REIT performance, such as:

- Management quality and corporate structure
- Anticipated total return from the REIT, estimated from the expected price change and the prevailing dividend yield
- Current dividend yields relative to other income-generating investments such as bonds or utility stocks
- Anticipated growth in earnings per share
- Underlying asset values of the real estate and/or mortgages, and other assets

It is also valuable to be knowledgeable about the factors that impact earnings growth, or lack of it, in real estate investments generally. These include an understanding of revenue sources generally based on occupancy rates and rent prices, cost-efficiencies that may arise, and new business opportunities.