Basic Investment Tools

Individuals with investable funds often have a desire to put those "extra" dollars to work to meet a specific purpose. For some, there may be a desire to accumulate funds for a future purchase, or a need to generate more income to pay current expenses. For others, it may be to put money aside for a "rainy day," or simply to "get rich." Whatever the investment goal, an investor should clearly understand both the role and the potential risks and rewards of each type of investment tool.

Stocks

The terms "stock" and "share" both refer to a fractional ownership interest in a corporation. As "owners," stockholders vote for the company's Board of Directors, and receive information on the firm's activities and business results. Stockholders may share in profits through "dividends" declared by the firm's Board.

When a corporate business is first organized, investors contribute money to fund the enterprise, and in return receive shares of stock representing their ownership in the company. If the business is successful, it will grow and have increasing profits, and the shares generally become more valuable. If the business is not successful, the value of the shares usually declines.

- **Uses:** Investors typically buy and hold stock for its long-term growth potential. Stocks with a history of regular dividends are often held for both income and growth.
- **Risks:** As the long-term growth of a company cannot be predicted, the short-term market value of the company's stock will fluctuate up and down. If the market price of the stock is higher than the purchase price when the stock is sold, a capital gain will result. If the market price of the stock is lower than the purchase price when the stock is sold, the result will be a capital loss.

Bonds

While stocks represent ownership in a business, bonds are debt. Issued by institutions such as the federal government, corporations, and state and local governments, a bond is evidence of money borrowed by the bond issuer. In return, bondholders receive interest and, at "maturity," the principal amount of the bond.

When first issued, a bond will have a specified rate of return, or "yield." For example, a 6.0% bond will pay $60.00 per year for each $1,000 invested. If a bond is traded on a public exchange, the market price will fluctuate, generally with changes in interest rates. Later investors will receive a yield that may be more, or less, than 6.0%, depending on the price paid for the bond in the open market.

- **Uses:** Bonds are typically bought by investors seeking current income. In some instances, bonds are also used for capital growth.
- **Risks:** Like stocks, the market price of bonds will fluctuate up and down. If an investor sells a bond before it matures, a capital gain or loss may result. Unless the issuer defaults, bonds held to maturity will recover the principal amount. Since a bond pays a fixed return, inflation risk can be a problem; over time, the dollars received will buy less and less. Also, the interest income received may be subject to current income taxation.

Savings Accounts

Most investors are familiar with a savings account at a bank, savings and loan, or credit union. For many, the generic term "savings account" includes both the traditional savings account (allowing for deposits and withdrawals of small amounts), as well as fixed-term certificates of deposit (CDs), for larger sums. Savings accounts are usually prized by investors for two primary characteristics: safety of principal, and liquidity. Such accounts are insured (against a failure of the savings institution) by agencies of the Federal government, such as the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA), for up to $250,000 per account.

- **Uses:** Savings accounts are often used as a reservoir for emergency funds, or as a "warehouse" for dollars ultimately earmarked for some other purpose. Some investors also use such accounts to generate current income.
- **Risks:** Because there is little risk of principal loss, savings accounts typically have a lower yield than other investments. One "risk" to such accounts is the potential additional interest income foregone in exchange for safety of principal. The relatively low yield can also be heavily impacted by inflation and current income taxes.

Life Insurance

The life insurance industry has developed a number of products that combine the protection of life insurance death benefits, with a significant cash value element. Policies such as universal life, indexed universal life, variable life, and variable universal life allow an individual to purchase a single financial instrument providing for both life insurance and long-term accumulation goals. Such policies may serve as a form of "forced investment" for those who find it difficult to put funds aside on a regular basis, but who routinely pay their bills. Additionally, life insurance company "annuities," either fixed annuities, variable annuities, or indexed annuities, offer a tax-deferred method of accumulating additional retirement funds.

- **Uses:** While life insurance products are primarily used for death benefit protection, they are also used for long-term accumulation goals. Available cash values may also serve as an "emergency reserve," if needed, or a source of loans, since life policies frequently include features permitting borrowing against these cash values.[1]
- **Risks:** Fixed contracts rely on the financial strength of the issuing life insurance company. Inflation may negatively impact a fixed return contract. Variable contracts share the risks of the underlying investments. Loans and withdrawals must be carefully structured to avoid negative income tax results.[1]

Real Estate

Real estate has long been a favored investment for those seeking tax benefits and a hedge against inflation. "Improved" real estate refers to land with apartments, a home, office, store, or other rentable enhancement. Rental income in excess of expenses may provide a "positive" cash flow. Additionally, depreciation may shelter a portion of the cash flow from current income tax. If all goes well, inflation will gradually increase rental income, thus raising the market value of the property.

Real estate investors may also choose to invest in "unimproved" or "raw" land. Typically such land generates no current cash flow, unless rented for agricultural purposes such as animal grazing or farming. Investors in raw land usually try to buy property in the path of expected, long-term growth, with the hope of selling the property at a gain when future demand pushes market prices up.

[1] A policy loan or withdrawal will generally reduce cash values and death benefits. If a policy lapses or is surrendered with a loan outstanding, the loan will be treated as taxable income in the current year, to the extent of gain in the policy. Policies considered to be modified endowment contracts (MECs) are subject to special rules.

- **Uses:** Investors in improved real estate typically seek tax-sheltered, current income along with long-term capital growth. Investors in unimproved real estate primarily seek long-term capital gains. Real estate serves as a hedge against inflation.

- **Risks:** An investor may find it difficult to keep a property rented, and thus not receive the expected cash flow. Deflation may decrease both rents and property values. Expected long-term growth in a geographical area may not occur. Real estate can be very illiquid; a quick sale may require a substantial reduction in price. Changes in tax law may reduce or eliminate anticipated tax benefits.