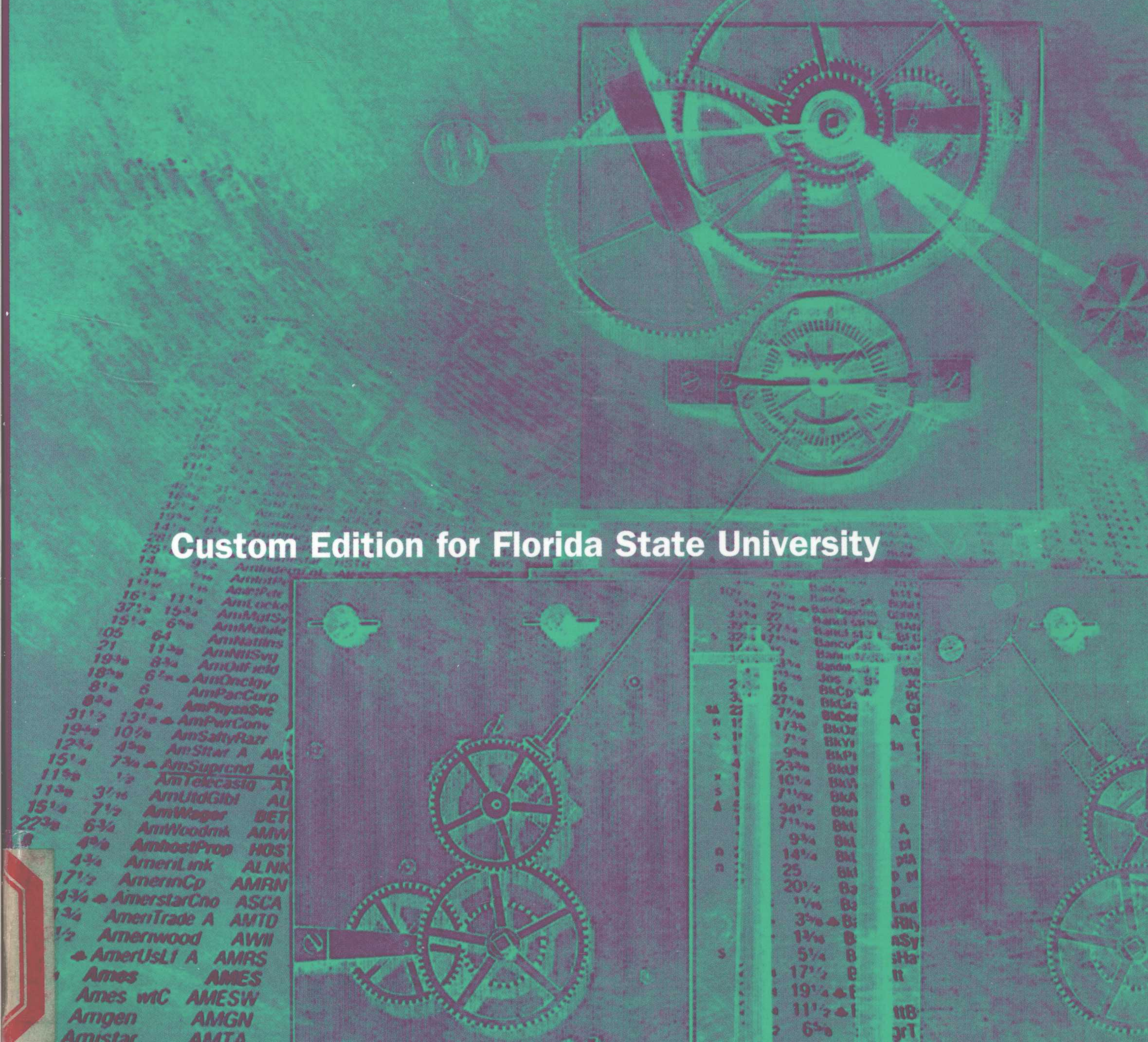
FUNDAMENTALS OF INVESTING, THE FINANCIAL SYSTEM, AND FINANCIAL MARKETS



Custom Edition for Florida State University

FUNDAMENTALS OF INVESTING, THE FINANCIAL SYSTEM, AND FINANCIAL MARKETS

Material taken from:

Fundamentals of Investing, Eighth Edition
Lawrence J. Gitman
Michael D. Joehnk

Money, the Financial System and the Economy, Fourth Edition
R. Glenn Hubbard

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Fundamentals of Investing

Eighth Edition

Lawrence J. Gitman
Michael D. Joehnk

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THE INVESTMENT ENVIRONMENT

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CHAPTER 1

THE ROLE AND SCOPE OF INVESTMENTS

Learning Goals

After studying this chapter, you should be able to:

LG 1 Understand the meaning of the term *investment* and the factors commonly used to differentiate among types of investments.

LG 2 Describe the *investment* process and types of investors.

LG 3 Discuss the principal types of investment vehicles.

LG 4 Describe the steps in investing, particularly establishing investment goals, and cite fundamental personal tax considerations.

LG 5 Discuss investing over the life cycle and investing in different economic environments.

LG 6 Understand the popular types of short-term investment vehicles.

In just a few years, the world of investments has moved to center stage in American life. Twenty years ago, most people's only exposure to investment news was a 10-second announcement on the evening news about the change in the Dow Jones Industrial Average that day.

Today, about half of all Americans own stocks, and 20% of them only began investing after 1996. Cable TV stations such as CNNfn and CNBC specialize in business and financial news. You can't pass a newsstand without seeing headlines that scream, "Ten Stocks to Buy Now!" or "The Hottest Mutual Funds." Besides the *Wall Street Journal*, you can subscribe to *Investor's Business Daily, Financial Times, Barron's, Kiplinger's Personal Finance Magazine, Money, Smart Money*, and dozens more publications that focus on investing.

The Internet has played a large role in opening the world of investing to individual investors. By giving them access to tools formerly restricted to investment professionals, it creates a more level playing field. The Internet also places enormous amounts of information and a means of trading securities just a few mouse clicks away. In short, technology makes investing much easier, but it can also increase the risks for inexperienced investors.

Regardless of whether you make transactions online or use a traditional broker, the same investment fundamentals presented in this textbook apply. The first chapter introduces you to the types of investments, the investment process, key investment vehicles, the role of investment plans, and the importance of meeting liquidity needs. Becoming familiar with investment alternatives and developing realistic investment plans should greatly increase your chance of financial success.

Investments and the Investment Process

LG 1 LG 2

Note: The Learning Goals shown at the beginning of the chapter are keyed to text discussions using these icons.

If you have money in a savings account, you already have at least one investment to your name. An **investment** is simply any vehicle into which funds can be placed with the expectation that it will generate positive income and/or that its value will be preserved or increased. The rewards, or **returns,** from investing are received in two basic forms: current income and increased value. For example, money invested in a savings account provides current income in the form of periodic interest payments. A share of common stock purchased as an investment is expected to increase in value between the time it is purchased and the time it is sold.

Is cash placed in a simple (no-interest) checking account an investment? No, because it fails both tests of the definition. It does not provide added income, nor does its value increase. (In fact, the value of the cash in a checking account is likely to decrease, because it is eroded over time by inflation.)

We begin our study of investments by looking at types of investments and at the structure of the investment process.

investment
any vehicle into which funds can be placed with the expectation that it will generate positive income and/or preserve or increase its value.

returns
the rewards from investing, received as current income and/or increased value.

Types of Investments

When you invest, the organization in which you invest—whether it is a company or a government entity—offers you an expected future benefit in exchange for the current use of your funds. Organizations compete for the use of your funds. The one that will get your investment dollars is the one that offers a benefit you judge to be better than any competitor offers. But, different investors judge benefits differently. As a result, investments of every type are available, from "sure things" such as earning 3% interest on your bank savings account, to the possibility of tripling your money fast by investing in a newly issued dot-com stock. The investments you choose will depend on your resources, your goals, and your personality. We can differentiate types of investments on the basis of a number of factors.

securities
investments that represent evidence of debt or ownership or the legal right to acquire or sell an ownership interest.

property
investments in real property or in tangible personal property.

Securities or Property Investments that represent debt or ownership or the legal right to acquire or sell an ownership interest are called **securities.** The most common types of securities are stocks, bonds, and options. The focus of this book is primarily on securities.

Property, on the other hand, consists of investments in real property or tangible personal property. *Real property* is land, buildings, and that which is permanently affixed to the land. *Tangible personal property* includes items such as gold, artwork, antiques, and other collectibles.

direct investment
investment in which an investor directly acquires a claim on a security or property.

indirect investment
investment made in a *portfolio,* or collection of securities or properties.

portfolio
collection of securities or properties, typically constructed to meet one or more investment goals.

Direct or Indirect A **direct investment** is one in which an investor directly acquires a claim on a security or property. If you buy a stock or bond in order to earn income or preserve value, you have made a direct investment.

An **indirect investment** is an investment made in a **portfolio,** or collection of securities or properties, typically constructed to meet one or more investment goals. For example, you may purchase a share of a *mutual fund.* This share gives you a claim on a fraction of the entire portfolio rather than on the security of a single firm.

debt
funds lent in exchange for interest income and the promised repayment of the loan at a given future date.

Debt, Equity, or Derivative Securities Usually, an investment represents either a debt or an equity interest. **Debt** represents funds lent in exchange for interest income and the promised repayment of the loan at a given future date.

When you buy a debt instrument like a *bond,* in effect you lend money to the issuer. The issuer agrees to pay you a stated rate of interest over a specified period of time, at the end of which the original sum will be returned.

equity
ongoing ownership in a business or property.

Equity represents ongoing ownership in a business or property. An equity investment may be held as a security or by title to a specific property. The most popular type of equity security is *common stock.*

derivative securities
securities that are structured to exhibit characteristics similar to those of an underlying security or asset and that derive their value from the underlying security or asset.

Derivative securities are neither debt nor equity. They derive their value from, and have characteristics similar to those of, an underlying security or asset. *Options* are an example: An investor essentially buys the opportunity to sell or buy another security or asset at a specified price during a given period of time. Options and other derivative security investments, though not so common as debt and equity investments, have grown rapidly in popularity in recent years.

risk
the chance that actual investment returns will differ from those expected.

Low- or High-Risk Investments are sometimes differentiated on the basis of risk. As used in finance, **risk** is the chance that actual investment returns will differ from those expected. The broader the range of possible values or returns associated with an investment, the greater its risk.

Investors are confronted with a continuum of investments that range from low to high risk. Although each type of investment vehicle has a basic risk characteristic, the actual level of risk depends on the specific vehicle. For example, stocks are generally believed to be more risky than bonds. However, it is not difficult to find high-risk bonds that are more risky than the stock of a financially sound firm such as IBM or McDonald's.

speculation
the purchase of high-risk investment vehicles that offer highly uncertain returns and future value.

Low-risk investments are those considered safe with regard to the receipt of a positive return. *High-risk investments* are considered speculative: Their levels of return are highly uncertain. **Speculation** offers highly uncertain returns and future value, so it is high-risk investment. Because of this greater risk, the returns associated with speculation are expected to be greater. Both investment and speculation differ from gambling, which involves playing games of chance. In this book we will use the term *investment* for both investment and speculation.

short-term investments
investments that typically mature within one year.

long-term investments
investments with maturities of longer than a year or with no maturity at all.

Short- or Long-Term The life of an investment can be described as either short- or long-term. **Short-term investments** typically mature within one year. **Long-term investments** are those with longer maturities or, like common stock, with no maturity at all. It is not unusual to find investors matching the maturity of an investment to the period of time over which they wish to invest their funds.

Note: Discussions of international investing are highlighted by this icon.

domestic investments
debt, equity, and derivative securities of U.S.-based companies.

foreign investments
debt, equity, and derivative securities of foreign-based companies.

Domestic or Foreign As recently as 10 to 15 years ago, individuals invested almost exclusively in purely **domestic investments**: the debt, equity, and derivative securities of U.S.-based companies. Today, these same investors routinely also look for **foreign investments** (both direct and indirect) that might offer more attractive returns or lower risk than purely domestic investments. Information on foreign companies is now readily available, and it is now relatively easy to make foreign investments. As a result, many individuals now actively invest in foreign securities. All aspects of foreign investing are therefore routinely considered throughout this book.

The Structure of the Investment Process

The investment process brings together *suppliers* of extra funds with *demanders* who need funds. Suppliers and demanders of funds are most often brought together through a financial institution or a financial market. (Occasionally, especially in property transactions, buyers and sellers deal directly with one another.) **Financial institutions** are organizations that channel the savings of governments, businesses, and individuals into loans or investments. Banks and insurance companies are financial institutions. **Financial markets** are forums in which suppliers and demanders of funds make financial transactions, often through intermediaries. They include securities, commodities, and foreign exchange markets.

financial institutions
organizations that channel the savings of governments, businesses, and individuals into loans or investments.

financial markets
forums in which suppliers and demanders of funds make financial transactions.

The dominant financial market in the United States is the *securities market.* It includes stock markets, bond markets, and options markets. Similar markets exist in most major economies throughout the world. Their common feature is that the price of an investment vehicle at any point in time results from an equilibrium between the forces of supply and demand. As new information about returns and risk becomes available, the changes in supply and demand may result in a new equilibrium or *market price.* Financial markets streamline the process of bringing together suppliers and demanders of funds, and they allow transactions to be made quickly and at a fair price. They also publicize security prices.

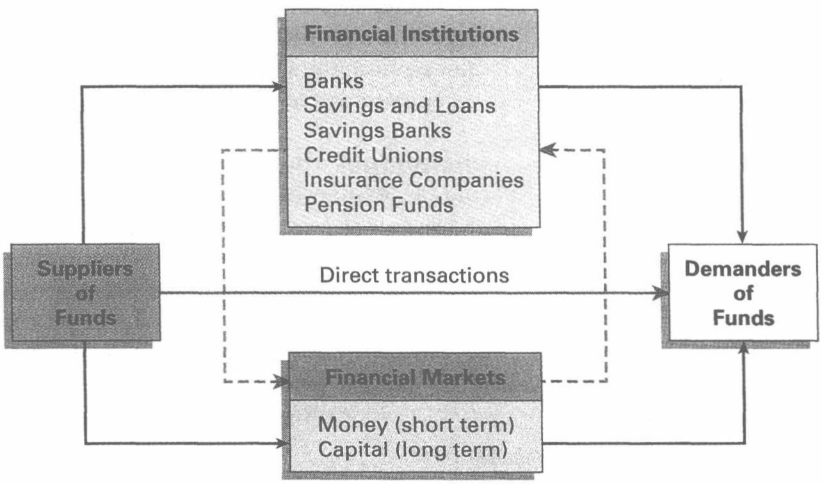
Figure 1.1 diagrams the investment process. Note that the suppliers of funds may transfer their resources to the demanders through financial institutions, through financial markets, or in direct transactions. As the broken lines show, financial institutions can participate in financial markets as either suppliers or demanders of funds.

Participants in the Investment Process Government, business, and individuals are the three key participants in the investment process. Each may act as a supplier and a demander of funds. For the economy to grow and prosper, funds must be available to qualified individuals and to government and business. If

FIGURE 1.1

The Investment Process

Note that financial institutions participate in the financial markets as well as transfer funds between suppliers and demanders. Although the arrows go only from suppliers to demanders, for some transactions (e.g., the sale of a bond), the principal amount borrowed by the demander from the supplier (the lender) is eventually returned.



individuals began suddenly hiding their excess funds under floorboards rather than putting them in financial institutions or investing them in the financial markets, then government, business, and individuals in need of funds would have difficulty obtaining them. As a result, government spending, business expansion, and consumer purchases would decline, and economic activity would slow.

Note: Investor Facts offer interesting or entertaining tidbits of information.

INVESTOR FACTS

AMERICANS LOVE STOCKS— A recent survey showed that 48% of Americans now own stocks or stock mutual funds, compared to just 19% in 1983. Stocks and stock mutual funds account for about 36% of total household financial assets, up from 28% in 1995. As the rising equity markets made stocks more popular, holdings of other financial assets—particularly checking, savings, and money market accounts; money market mutual funds; and bonds—declined.

Source: Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin,* Board of Governors of the Federal Reserve System, Washington, DC, January 2000, pp. 8–9.

Government All levels of government—federal, state, and local—require vast sums of money. Some goes to finance *capital expenditures:* long-term projects related to the construction of public facilities such as schools, hospitals, public housing, and highways. Usually the financing for such projects is obtained by issuing various types of long-term debt securities. Another demand for funds comes from *operating needs*—the money required to keep the government running. At the federal level, for example, these funds are used to pay employee and other costs associated with national defense, education, public works, welfare, Social Security, Medicare, and so on, as well as interest on the national debt. These operating costs are usually paid from tax revenue and fee collections. However, when operating expenditures exceed government revenues or when there is a timing mismatch between government receipts and payments, the government borrows funds—typically by issuing short-term debt securities.

Occasionally, governments are also suppliers of funds. If a state has temporarily idle cash, it may make a short-term investment to earn a positive return. In general, though, government is a *net demander of funds.* That is, it demands more funds than it supplies. The financial activities of governments, both as demanders and suppliers of funds, significantly affect the behavior of financial institutions and financial markets.

Business Most business firms require large sums of money to support operations. Like government, business has both long- and short-term financial needs. On the long-term side, businesses seek funds to build plants, acquire equipment and facilities, and develop products. Their short-term needs center on obtaining funds to finance inventory and accounts receivable and to meet other operating costs. Businesses issue a wide variety of debt and equity securities to finance these needs.

Businesses also supply funds when they have excess cash. In fact, many large business firms have sophisticated cash-management operations and are major purchasers of short-term securities. But like government, business firms in general are *net demanders of funds.*

Note: Addresses of additional information sources that can be found on the Internet are interspersed throughout the chapter.

Individuals You might be surprised to learn that the individual investor's role in the investment process is significant. Most individuals are more aware of their need to borrow than they are of the ways in which they put money into the financial system. They frequently demand funds in the form of loans to finance the acquisition of property—typically automobiles and houses. Yet, in fact, the activities of individual investors help to satisfy the net demands of government and business for funds in a variety of ways: Individual investors place funds in savings accounts, buy debt or equity instruments, buy insurance, make retirement plan contributions, and purchase various types of property. Although the individual demand for funds seems great, individuals as a group are *net suppliers of funds:* They put more funds into the financial system than they take out.

HOT

An Investing in Action box at the text's Web site discusses the saving and investing habits of "Generation Xers."

www.awl.com/gitman_joehnk

HOT

Getting investment information is now only a few "mouse clicks" away. Everything from stock quotations, to news articles, to Wall Street research is available on the Web. There are many Web sites that provide tutorials on financial information.

CyberInvest.com contains contains free investing guides. Check out [Guides]. Guides compare resources and features at hundreds of the best investing sites on the Web. The guides can save you time—and thus money—by revealing at a glance how investing Web sites stack up against each other. Then you can jump to the site of your choice by clicking on its name. Especially check the *Investing 101* guide under [Education Center].

www.cyberinvest.com

Types of Investors When we refer to individuals in the investment process, we do so to differentiate households from government and business. We can further characterize the participation of individuals in the investment process in terms of who manages the funds. **Individual investors** manage their personal funds in order to achieve their financial goals. The individual investor usually concentrates on earning a return on idle funds, building a source of retirement income, and providing security for his or her family. The accompanying *Investing in Action* box on page 8 offers a quiz to determine a baseline on your investing "know-how."

Individuals who lack the time or expertise to make investment decisions often employ **institutional investors**—investment professionals who are paid to manage other people's money. These professionals trade large volumes of securities for individuals, businesses, and governments. Institutional investors include financial institutions (banks, life insurance companies, mutual funds, and pension funds). Financial institutions invest large sums in order to earn a significant return for their customers. For example, a life insurance company invests its premium receipts to earn returns that will permit payments to policyholders or beneficiaries.

Both individual and institutional investors apply similar fundamental principles. However, institutional investors generally invest larger sums of money on behalf of others and therefore are often more sophisticated in investment knowledge and methods. The information presented in this textbook is aimed primarily at individual investors; it represents only the first step toward developing the expertise needed to qualify as an institutional investor.

Note: Two *Investing in Action* boxes per chapter describe real-life investing situations or elaborate on innovative investment vehicles. These high-interest boxes have been written for this textbook, with student readers in mind. Some of the concept review questions in the chapter are related to material in these boxes.

individual investors
investors who manage their own funds.

institutional investors
investment professionals paid to manage other people's money.

CONCEPTS IN REVIEW

1.1 Define the term *investment,* and explain why individuals invest.

1.2 Differentiate among the following types of investments, and cite an example of each: (a) securities and property investments; (b) direct and indirect investments; (c) debt, equity, and derivative securities; and (d) short-term and long-term investments.

1.3 Define the term *risk,* and explain how risk is used to differentiate among investments.

1.4 What are *foreign investments,* and what role do they play today for the individual investor?

1.5 Describe the structure of the overall investment process. Explain the role played by *financial institutions* and *financial markets.*

1.6 Classify the role of (a) government, (b) business, and (c) individuals as net suppliers or net demanders of funds.

1.7 Differentiate between *individual investors* and *institutional investors.*

1.8 How high is your investment IQ, as measured by the quiz in the *Investing in Action* box on page 8? Make a note of your score so that you can impress yourself at the end of the course with how much you've learned.

Note: The concepts in review questions at the end of each text section encourage you, before you move on, to test your understanding of the material you've just read.

INVESTING in action

Test Your Investment IQ

How much do you know about investing? Take this investor literacy quiz, developed by *Money* magazine and the Vanguard Group to test the investment savvy of 1,500 mutual fund investors.

The average score (for the full 20-question quiz) was only 37%. But don't despair if you, too, don't score well. You'll learn the answers to these and many other questions from this book.

1. Which type of investment has offered the best protection against inflation over long periods of time?
   a. Money market funds and bank accounts.
   b. Government National Mortgage Association securities (also known as Ginnie Maes or GNMAs).
   c. Stocks.
   d. Corporate bonds.
2. Common stocks always provide higher returns than bonds or money market investments.
   a. True.
   b. False.
3. As an individual, the most you can contribute to an IRA each year is:
   a. $1,000.
   b. $2,000.
   c. $5,000.
   d. $10,000.
4. Interest earned by municipal bonds is exempt from federal income tax.
   a. True.
   b. False.
5. If interest rates declined, the price of a bond or bond fund generally would:
   a. Increase.
   b. Decrease.
   c. Stay about the same.
   d. It is impossible to predict.
6. If you own only U.S. stocks in your investment portfolio, you will reduce your overall risk by adding international stocks.
   a. True.
   b. False.
7. Which market benchmark or stock exchange is the best gauge of the performance of the entire U.S. stock market?
   a. S&P 500 Index.
   b. Wilshire 5000 Total Market Index.
   c. Dow Jones Industrial Average.
   d. Nasdaq Composite Index.
8. If you invest in a 401(k) plan at work, you are not eligible to contribute to an IRA.
   a. True.
   b. False.
9. From 1926 to 1999, the return on U.S. stocks has averaged:
   a. 5% per year.
   b. 11% per year.
   c. 19% per year.
   d. 28% per year.
10. Which of the following is not an attribute of mutual funds?
    a. Diversification.
    b. Professional management.
    c. Guaranteed return.
    d. None of the above.
11. If your investment returned 10% last year and inflation was 3%, your "real" (i.e., adjusted for inflation) return was:
    a. 3.3%.
    b. 7%.
    c. 13%.
    d. 30%.
12. A mutual fund that invests in government securities is guaranteed not to lose money.
    a. True.
    b. False.

Answers: 1 (c); 2 (b); 3 (b); 4 (a); 5 (a); 6 (a); 7 (b); 8 (b); 9 (b); 10 (c); 11 (b); 12 (b).

Sources: Laura Lallos, "What's Your Investing IQ?" *Money,* August 2000, pp. 91–92; quiz downloaded from **cgi.money.com/cgi-bin/money/polls/vanguard/vanguard.plx**

Investment Vehicles

LG 3

A wide variety of investment vehicles are available to individual investors. Vehicles differ in terms of maturities or lives, costs, return and risk characteristics, and tax considerations. We devote the bulk of this book—Chapters 6 through 15—to describing the characteristics, special features, returns and risks, and possible investment strategies that can be used with vehicles available to the individual investor. Here we will introduce these investment vehicles. Table 1.1 summarizes the information presented in this section.

Short-Term Vehicles

short-term vehicles
savings instruments that usually have lives of 1 year or less.

liquidity
the ability of an investment to be converted into cash quickly and with little or no loss in value.

Short-term vehicles include savings instruments that usually have lives of 1 year or less. Short-term vehicles generally carry little or no risk. Often such instruments are used to "warehouse" idle funds and earn a return while long-term vehicles are being evaluated. They are also popular among conservative investors, who may use short-term vehicles as a primary investment outlet. Short-term vehicles also provide **liquidity.** That is, they can be converted into cash quickly and with little or no loss in value. Provision for liquidity is an important part of any financial plan. The role of short-term vehicles in financial planning and the key features of the most popular short-term vehicles are discussed later in this chapter.

TABLE 1.1 Overview of Investment Vehicles

Type	Description	Examples	Where Covered in This Book
Short-term vehicles	Savings instruments with lives of 1 year or less. Used to warehouse idle funds and to provide liquidity.	Deposit accounts	Ch. 1
		Series EE savings bonds	Ch. 1
		U.S. Treasury bills (T-bills)	Ch. 1
		Certificates of deposit (CDs)	Ch. 1
		Commercial paper	Ch. 1
		Banker's acceptances	Ch. 1
		Money market mutual funds	Ch. 1
Common stock	Equity investment vehicles that represent ownership in a corporation.		Chs. 6–8
Fixed-income securities	Investment vehicles that offer a fixed periodic return.	Bonds	Chs. 9, 10
		Preferred stock	Ch. 11
		Convertible securities	Ch. 11
Mutual funds	Companies that raise money from sale of shares and invest in and professionally manage a diversified portfolio of securities.		Ch. 12
Derivative securities	Securities that are neither debt nor equity but are structured to exhibit the characteristics of the underlying securities or assets from which they derive their value.	Options	Ch. 14
		Futures	Ch. 15
Other popular investment vehicles	Various other investment vehicles that are widely used by investors.	Real estate Tangibles Tax-advantaged investments	On text's Web site, www.awl.com/gitman_joehnk

Common Stock

common stock
equity investment that represents ownership in a corporation; each share represents a fractional ownership interest in the firm.

Common stock is an equity investment that represents ownership in a corporation. Each share of common stock represents a fractional ownership interest in the firm. For example, one share of common stock in a corporation that has 10,000 shares outstanding would represent 1/10,000 ownership interest. Next to short-term vehicles and home ownership, common stock is the most popular form of investment vehicle.

dividends
periodic payments made by firms to their shareholders.

capital gains
the amount by which the sale price of an asset *exceeds* its original purchase price.

fixed-income securities
investment vehicles that offer a fixed periodic return.

The return on investment in common stock comes from either of two sources: dividends or capital gains. **Dividends** are periodic payments made by the corporation to its shareholders from its current and past earnings. **Capital gains** result from selling the stock (or any asset) at a price that *exceeds* its original purchase price. For example, say you purchased a single share of One Tech Industries common stock for $40 per share. During the first year you owned it, you received $2.50 per share in cash dividends. At the end of the year, you sold the stock for $44 per share. If we ignore the costs associated with buying and selling the stock, you earned $2.50 in dividends and $4 in capital gains ($44 sale price—$40 purchase price).

bonds
long-term debt instruments (IOUs), issued by corporations and governments, that offer a known interest return plus return of the bond's *face value* at maturity.

Fixed-Income Securities

Fixed-income securities are investment vehicles that offer a fixed periodic return. Some forms offer contractually guaranteed returns. Others have specified, but not guaranteed, returns. Because of their fixed returns, fixed-income securities tend to be popular during periods of high interest rates, when investors seek to "lock in" high returns. The key forms of fixed-income securities are bonds, preferred stock, and convertible securities.

preferred stock
ownership interest in a corporation; has a stated dividend rate, payment of which is given preference over common stock dividends of the same firm.

convertible security
a fixed-income obligation (bond or preferred stock) with a feature permitting conversion into a specified number of shares of common stock.

Bonds **Bonds** are the long-term debt instruments (IOUs) issued by corporations and governments. A bondholder has a contractual right to receive a known interest return, plus return of the bond's *face value* (the stated value given on the certificate) at maturity (typically 20 to 40 years). If you purchased a $1,000 bond paying 9% interest in semiannual installments, you would expect to be paid $45 (9% × ½ year × $1,000) every 6 months. At maturity you would receive the $1,000 face value of the bond. An investor may be able to buy or sell a bond prior to maturity.

Preferred Stock Like common stock, **preferred stock** represents an ownership interest in a corporation. Unlike common stock, preferred stock has a stated dividend rate. Payment of this dividend is given preference over common stock dividends of the same firm. Preferred stock has no maturity date. Investors typically purchase it for the dividends it pays, but it may also provide capital gains.

HOT

Successful investing can be surprisingly simple and straightforward. There are many baseline investing sites. Log on to SmartMoney.com. Scroll down the homepage to Smart Money University and read the sections on Investing 101 and Strategic Investing that explain the fundamentals of stocks, bonds, and mutual funds.

www.smartmoney.com

Convertible Securities A **convertible security** is a special type of fixed-income obligation (bond or preferred stock). It has a feature permitting the investor to convert it into a specified number of shares of common stock. Convertible bonds

INVESTOR FACTS

THE FEELING'S MUTUAL!— Investors have put more than $7.1 trillion of investment assets into the almost 8,000 mutual funds in the United States. The 4,140 stock funds led the way with $4.2 trillion (60%) of the total, followed by 700 taxable money market funds with $1.5 trillion (21%).

Source: "Trends in Mutual Fund Investing, July 2000," Investment Company Institute, Washington, DC, August 30, 2000, downloaded from www.ici.org

and convertible preferreds provide the fixed-income benefit of a bond (interest) or preferred stock (dividends) while offering the price-appreciation (capital gain) potential of common stock.

Mutual Funds

A company that raises money from sale of its shares and invests in and professionally manages a diversified portfolio of securities is called a **mutual fund.** Investors in the fund own an interest in the fund's portfolio of securities. All mutual funds issue and repurchase shares of the fund at a price that reflects the value of the portfolio at the time the transaction is made. **Money market mutual funds** are mutual funds that invest solely in short-term investment vehicles.

mutual fund
a company that raises money from sale of its shares and invests in and professionally manages a diversified portfolio of securities.

money market mutual funds
mutual funds that invest solely in short-term investment vehicles.

Derivative Securities

As noted earlier, *derivative securities* derive their value from that of an underlying security or asset. They typically possess high levels of risk, because they usually have uncertain returns or unstable market values. But, because of their above-average risk, these vehicles also have high levels of expected return. The key derivative securities are options and futures.

Options **Options** are securities that give the investor an opportunity to sell or buy another security at a specified price over a given period of time. Most often, options are purchased in order to take advantage of an anticipated change in the price of common stock. However, the purchaser of an option is not guaranteed any return and could even lose the entire amount invested because the option does not become attractive enough to use. Aside from their speculative use, options are sometimes used to protect existing investment positions against losses. Three common types of options are *puts, calls,* and *warrants,* which we will discuss in detail in Chapter 14.

options
securities that give the investor an opportunity to sell or buy another security at a specified price over a given period of time.

Futures **Futures** are legally binding obligations stipulating that the sellers of such contracts will make delivery and the buyers of the contracts will take delivery of a specified commodity or financial instrument at some specific date, at a price agreed on at the time the contract is sold. Examples of commodities sold by contract include soybeans, pork bellies, platinum, and cocoa. Examples of financial futures are contracts for Japanese yen, U.S. Treasury securities, interest rates, and stock indexes. Trading in commodity and financial futures is generally a highly specialized, high-risk proposition.

futures
legally binding obligations stipulating that the sellers of such contracts will make delivery and the buyers of the contracts will take delivery of a specified commodity or financial instrument at some specific date, at a price agreed on at the time the contract is sold.

Other Popular Investment Vehicles

Various other investment vehicles are also used by investors. The most common are real estate, tangibles, and tax-advantaged investments.

Real estate consists of entities such as residential homes, raw land, and a variety of forms of income property, including warehouses, office and apartment buildings, and condominiums. The appeal of real estate investment is the potential returns in the form of rental income, tax write-offs, and capital gains. **Tangibles** are investment assets, other than real estate, that can be seen

real estate
entities such as residential homes, raw land, and income property.

tangibles
investment assets, other than real estate, that can be seen or touched.

HOT

Real estate, tangibles, and tax-advantaged investments are discussed on the text's Web site. Click on the Web chapter titled Real Estate and Other Tangible Investments.

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or touched. They include gold and other precious metals, gemstones, and collectibles such as coins, stamps, artwork, and antiques. These assets are purchased as investments in anticipation of price increases. Because the federal income tax rate for an individual can be as high as 39.6%, many investors look for **tax-advantaged investments.** These are investment vehicles and strategies for legally reducing one's tax liability. With them, investors find that their after-tax rates of return can be far higher than with conventional investments.

tax-advantaged investments investment vehicles and strategies for legally reducing one's tax liability.

CONCEPTS IN REVIEW

1.9 What are *short-term vehicles?* How do they provide *liquidity?*

1.10 What is *common stock* and what are its two sources of potential return?

1.11 Briefly define and differentiate among the following investment vehicles. Which offer fixed returns? Which are derivative securities? Which offer professional investment management?

a. Bonds
b. Preferred stock
c. Convertible securities
d. Mutual funds
e. Options
f. Futures

Making Investment Plans

LG 4 LG 5

The process of investing can be carried out by following a logical progression of steps. It is important that your investment plans take into account the impact of taxes. Your plans also should be responsive to your stage in the life cycle and to the changing economic environment.

Steps in Investing

Investing can be conducted on a strictly intuitive basis or on the basis of plans carefully developed to achieve specific goals. Evidence favors the more logical approach that begins with establishing a set of overall financial goals and then developing and executing an investment program consistent with those goals. The following brief overview of the steps in investing provides a framework for discussion of the concepts, tools, and techniques presented throughout the book.

Step 1: Meeting Investment Prerequisites Before investing, you must make certain that the *necessities of life* are adequately provided for. This category includes funds for housing, food, transportation, taxes, and clothing. In addition, a pool of easily accessible funds should be established for meeting emergency cash needs. (Meeting liquidity needs is discussed later in this chapter.)

Another prerequisite is adequate protection against the losses that could result from death, illness or disability, damage to property, or a negligent act. Protection against such risks can be acquired through life, health, property, and liability insurance.

HOT

Detailed information on meeting life insurance needs is available on this text's Web site. Click on the Web chapter titled Tax-Advantaged Investments and then on Deferred Annuities and Single-Premium Life Insurance.

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investment goals
the financial objectives that one wishes to achieve by investing.

Step 2: Establishing Investment Goals Once you have satisfied the prerequisites and set clearly defined financial goals, the next step is to establish *investment goals*. **Investment goals** are the financial objectives you wish to achieve by investing. Clearly, your investment goals will determine the types of investments you will make. Common investment goals include:

1. *Accumulating Retirement Funds*. Accumulating funds for retirement is the *single most important reason for investing*. Too often, people tend to rely heavily on Social Security and employers for retirement funds. It is of the utmost importance to review the amounts that can realistically be expected from these sources. You can then decide, on the basis of your retirement goals, *whether they will be adequate to meet your needs*. If they are not, they must be supplemented through your own investment program. The earlier in life you assess your retirement needs, the greater your chance of accumulating sufficient funds to meet them.

2. *Enhancing Current Income*. Investments enhance current income by earning dividends or interest. Retirees frequently choose investments offering *high current income at low risk*. The idea of a retired person "clipping coupons"—collecting interest—from high-grade bonds is a fair description of what most senior citizens should be doing at that point in their lives.

HOT

Tax-advantaged investments are discussed on the text's Web site. Click on the Web chapter titled Tax-Advantaged Investments.

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3. *Saving for Major Expenditures*. Families often put aside money over the years to accumulate the funds needed to make major expenditures. The most common of these are the down payment on a home, education, vacation travel, and capital to start a business. The appropriate types of investment vehicles depend on the purpose and the amount of money needed. For purposes such as the down payment on a home or a child's education, for example, much less risk should be tolerated than for other goals. The attainment of such basic goals should not, if possible, be placed in jeopardy.

4. *Sheltering Income from Taxes*. Federal income tax law allows certain noncash charges to be deducted from specified sources of income. Such deductions reduce the amount of final taxable income. Obviously, if a person can avoid (or defer) paying taxes on the income from an investment, he or she will have more funds left for reinvestment.

investment plan
a written document describing how funds will be invested and specifying the target date for achieving each investment goal and the amount of tolerable risk.

Step 3: Adopting an Investment Plan Once your general goals have been established, you should adopt an **investment plan**—a written document describing how funds will be invested. A series of supporting investment goals can be developed for each long-term goal. For each goal, specify the target date for achieving it and the amount of tolerable risk.

Generally, the more important the financial objective, the lower the risk that should be assumed. Suppose, for example, one long-run goal is to accumulate $80,000 in cash by the end of 10 years. That goal could be spelled out as a plan to accumulate $80,000 in cash by investing in a portfolio evenly divided between low-risk and speculative stocks providing a total return of 10% per year. The more specific you can be in your statement of investment goals, the easier it will be to establish an investment plan consistent with your goals.