11-1 Low-Risk Investment Options

OBJECTIVES

- ***Discuss the importance of having liquid savings.***
- ***Give examples of savings options that are liquid.***
- ***Give examples of low-risk savings and investment options.***
- ***Explain how corporate bonds are different from government bonds.***
- ***Discuss how annuities can be used to provide for financial security.***

Chapter 11 presents savings and investing options that have low, medium, or high risk. Some of these investment options are more liquid than others. Some can be purchased for a small amount of money. Others can be bought only with larger investments. No one investment is likely to meet all your needs. You will learn to consider risk, liquidity, and rate of return as you choose investments for various purposes.

SAVINGS

Saving is setting aside money to meet future needs. Having savings to handle short-term needs is especially important. When you have enough savings, you will not need to borrow money to handle unexpected expenses. Savings should be in a form that is liquid. This means that savings should be in cash or in a savings or investment option that can quickly be changed into cash. A checking account or savings account in a bank that has no restrictions on withdrawals is an example of a safe, liquid savings option. Interest earned on the account may be very low. Low return is acceptable because the purpose of the account is to have funds available when needed. Keeping a certain minimum balance in a checking or savings account may have other advantages. For example, you may not have to pay bank service fees for the account. Some investments cannot be quickly changed into cash. Others can be changed quickly but require payment of a penalty for doing so. These investments are illiquid. Investors choose these options because they typically pay higher returns than those that are liquid. Many investors seek to balance their investments. They want to have some options that give high returns. They want to have other savings or investments that are liquid and that can be changed to cash quickly when needed.

SAVINGS ACCOUNTS

A savings account in a bank, credit union, or other insured financial institution is a good option to choose for meeting short-term needs. Savings accounts in banks are low-risk. They are insured by the FDIC up to the legal limit of $250,000 per depositor per bank. Savings accounts usually do not have withdrawal penalties. Some or all of the money can be withdrawn at any time. Thus, savings accounts are liquid. However, the account may have some restrictions. For example, the depositor may be able to write only a limited number of checks per month on the account. A savings account typically pays a low interest rate. The rate is usually higher, though, than for a checking account.

MONEY MARKET ACCOUNTS

A money market account is another good option to choose for liquid savings. This type of account pays the market rate of interest on the money deposited. A money market account is liquid. You can withdraw some or all of the money at any time. Money market accounts may have some restrictions. For example, the number of checks you can write in a month may be limited. A minimum balance, such as $1,000 or $5,000, may be required to open a money market account. Money market accounts are low-risk if they are insured. You can open an insured money market account at a bank or credit union. Because they are low-risk, these accounts pay a low rate of interest compared to some other investments. You can also open a money market account at a brokerage firm or other investment business. These accounts are not insured. They often pay a higher rate of interest than insured accounts. However, they carry a higher risk. When interest rates start rising in the economy, money market account rates will also rise. Thus, a money market account is a cushion against inflation.

CERTIFICATES OF DEPOSIT

A certificate of deposit, also called a CD, is a time deposit. This means that the money you deposit is set aside for a fixed amount of time at a set interest rate. A typical CD is not a liquid investment. You must pay a penalty if you withdraw the money before the stated time. CDs purchased at banks and credit unions are safe because they are insured by the FDIC. Thus, a CD is a low-risk investment, but it is not liquid. Interest rates paid on CDs are typically higher than rates paid for savings accounts or money market accounts. The higher rate is paid because you agreed to leave the money for a stated period of time. You may get a higher rate by agreeing to leave the money for a longer time period. For example, the interest rate for a CD with a term of 6 months may be 2.75 percent. The interest rate for a CD with a term of 36 months may be 4.25 percent.

- Withdrawal Penalties. If you redeem a CD early, you will typically pay a penalty. Be sure to ask about the penalty if you buy a CD. Early withdrawal penalties are meant to discourage depositors from withdrawing the money before the stated time period. The penalty may be 6 months' interest or more. In such cases, you can lose part of your principal if you withdraw money early.

- Special Features. CDs pay higher interest when money is set aside for a long period of time. They also pay higher interest for large amounts. A jumbo CD is a CD for a large sum of money, usually $100,000 or more, with a term of a year or longer. CDs that pay higher rates of interest often have higher withdrawal penalties. You can earn good interest on this type of CD if you are able to leave your money on deposit for the full term.

INVESTMENTS

Investments vary in term, risk, rate of return, and relative liquidity. Options that are low-risk typically pay a lower rate of return than those with higher risk. Options that are long-term typically pay higher rates than those that are short-term. To be liquid, an investment must be easily converted to cash. There should also be no significant loss of the amount invested. Whether or not an investment is liquid depends on several factors. If there are investors who are willing to buy when you wish to sell an investment, then the investment can be turned into cash quickly. However, there is no guarantee that the selling price will be higher than the price you paid for the investment. Thus, you could lose part of the amount invested. If there are no investors who are willing to buy the investment when you want to sell it, you will not be able to get cash quickly. Some investments are considered very safe because they are insured. Others that are not insured are also considered fairly safe. This is because the company or government body issuing them is financially sound.

SAVINGS BONDS

A bond is basically a loan that a buyer makes to a bond issuer. The bond issuer may be a government or a corporation. A U.S. savings bond is issued by the federal government. The bond is designed to be a long-term investment. Some U.S. savings bonds are issued at a discount. That means you pay less than face value. For example, you can purchase a $100 (face value) Series EE paper savings bond for $50. As interest is earned on the bond, it will grow to be worth $100 (the maturity value). Thus, when you redeem or cash in the bond, you will receive $100. Series EE Bonds pay a guaranteed rate if they are not redeemed early. When a savings bond reaches maturity, interest may continue to compound for several years. This type of bond is low-risk because it is guaranteed by the U.S. government. Because it is low-risk, however, the rate of return is lower than for some other investment options. While you can get your money quickly (cash the bonds when you want), you will forfeit the interest you would have earned if you cash the bond early. Thus, a savings bond is not considered a liquid investment. Some savings bonds can be a good way to save for a child's education. Interest is not taxable until the bond is cashed. If the bond is used for education expenses (for you or your children), then the interest may not be subject to federal taxes when the bond is cashed. U.S. savings bonds can be purchased through the TreasuryDirect Web site. This site also provides tools to help you create a savings plan using bonds.

CORPORATE AND GOVERNMENT BONDS

Bonds are issued by companies and governments. Some bonds are sold at face value. Others are sold at a discount or a premium. When you buy a bond at a discount, you pay less than face value for the bond. Bonds may be sold at a discount to increase the overall profit from the bond and make the bond more attractive to investors. Bonds sold at a premium sell for more than the face value. Some bonds are very attractive to investors, perhaps because they have a high coupon rate. These bonds may sell at a premium for more than the face value.

- You may receive regular interest payments from a bond. Many bonds pay interest twice a year (semiannually). The annual rate of interest paid on a bond is called the coupon rate. The rate is set at the time the bond is issued and typically does not change. When you redeem the bond, you exchange it for the face value. Bonds are redeemed when they mature.
- A callable bond has a clause that allows the issuer to repay the bond early (before the maturity date). The bond will be redeemed at a set amount. The amount is typically higher than the face value of the bond. However, the total amount of interest received will be less than if the bond was held until its maturity date. If interest rates have been falling, you may not be able to reinvest the money you receive from the bond at the same rate. Only investments at lower rates may be available. The amount you receive for the bond could also be less than the price for which you could sell the bond. Because of these risks, callable bonds typically pay a higher coupon rate than other similar bonds.
- A zero coupon bond does not pay yearly interest. The bond is sold at a deep discount and grows in value over time. You receive the face value of the bond at maturity. For example, you might buy a zero coupon bond for $12,000. In 10 years, at the maturity date, you might redeem the bond for $19,000. This type of bond can be a good way to invest for a particular long-term need, such as paying for a child's education.

Corporate Bonds. Corporate bonds are issued by corporations to raise money. Bonds are a form of borrowing for the company. The money is used for various purposes, such as building new factories or buying equipment. Corporate bonds pay a fixed coupon rate. The interest is subject to income tax. Any amount you gain when you redeem the bond is also taxed.

Corporate bonds are typically offered for sale in multiples of $1,000 or $5,000. They have various terms to maturity. Corporate bonds with terms of up to 2 or 3 years are short-term bonds. Bonds with terms of from 2 or 3 to 10 years are medium-term bonds. Bonds with terms of more than 10 years are long-term bonds. Some corporate bonds are considered low-risk investments; others are not. The risk depends on the issuing company's ability to make interest payments and repay the bond. Bond rating services study the financial health of bond issuers and assign bond ratings based on the risk of the bonds offered for sale. Investors can use these ratings to judge the risk of buying a bond. Standard & Poor's Corporation is an example of a company that provides ratings for bonds, as well as other services. Investment-grade bonds have high ratings and are considered fairly low-risk. Speculative-grade bonds have lower ratings. These bonds are sometimes called junk bonds or high-yield bonds. They are not considered low-risk. However, they are attractive to some investors because they pay higher rates than investment-grade bonds.

U.S. Government Bonds. Government bonds are issued by the U.S. Treasury or by U.S. government agencies. These bonds are low-risk when held to maturity. You do not have to pay state and local taxes on the income from some government bonds. These bonds make a good tax shelter. A tax shelter is an investment that allows you to legally avoid or reduce income taxes.

Municipal Bonds. Municipal bonds are issued by states, counties, cities, and towns. They are used to pay for projects such as roads or public buildings. You do not have to pay federal, state, or local taxes on the income from many municipal bonds. Municipal bonds are rated to help investors consider the risk involved. Many municipal bonds are considered low-risk. Although it is possible for a government unit to go bankrupt, it is not very likely. The tax shelter feature also makes these bonds attractive.

ANNUITIES

An annuity is a contract purchased from an insurance company. It guarantees a series of regular payments for a set time. To buy an annuity, you would pay a monthly payment into the account for a set number of years (such as 20). You could also invest a lump sum. Then, at the end of the set number of years, the annuity would start paying you monthly payments. Many people who buy annuities use them as a source of retirement income. They are fairly safe, but only as safe as the company you invest your money with. Annuities are not insured. When you pay into an annuity, the interest that is growing is not taxed. Annuities are tax-deferred, which means the interest will be taxed when you receive the monthly payments.

LIFE INSURANCE PLANS

When you buy a life insurance plan (other than term insurance), the policy gains in cash value. Life insurance provides a low rate of return on your money. However, it also provides death benefits. Many life insurance policies allow you to borrow money. If the loan is not repaid, the life insurance death benefit is reduced by the amount of the loan. This type of investment is illiquid. Some people think it is a good choice because it forces them to save while they also buy insurance. Like annuities, these investments are only as safe as the company from which you buy. The plans are not insured.

BROKERAGE ACCOUNTS

You can open an account at an investment company. This account may pay interest like a savings account, or it may be a clearing account. A clearing account is an account used to buy and sell investments. Money is taken from the account to buy them. When they are sold, money is put back into the account. Brokerage accounts are not insured. However, they are considered low-risk when placed with a reputable investment company. The accounts work a lot like a checking account. The account is liquid. However, there may be restrictions such as a limit to the number of checks you can write in a month or year. Interest earnings are usually higher than for checking or savings accounts in banks, but the risk is higher as well.

11-2 Medium-Risk Investment Options

OBJECTIVES

- ***List the various kinds of retirement plans that can be opened by an individual.***
- ***Describe retirement account options provided through employers.***
- ***Discuss the importance of portability for retirement plans.***
- ***Describe mutual fund investing and give advantages of investing in mutual funds.***

RETIREMENT ACCOUNTS

Some savings and investments are held in retirement accounts that are not taxed until the money is withdrawn. These accounts are tax shelters. This allows the money in the account to grow faster because earnings are computed on the entire balance. Retirement accounts are a good way to save for the future. Some types of accounts are insured and have very low risk. Other options are not insured and have higher risk and higher potential returns. You can choose the types of savings or investment options in some retirement accounts. For example, you could include CDs or stocks. If the plan is provided by an insured bank, a retirement account invested in CDs would be insured. Money invested in stocks and bonds is not insured even if the account is held in an insured bank. These accounts are not liquid but are long-term investments.

INDIVIDUAL PLANS

You can open retirement accounts as an individual. This means you must also manage them, or make choices about how to save or invest the money. Many individual plans allow you to deposit money pretax. This lowers your taxes now, while you are working. If money is withdrawn before age 59 ½, it is taxed at regular rates. Withdrawals are also subject to a 10 percent penalty. There are exceptions, such as withdrawals for medical expenses or education. Also, there comes a time when the money must be taken out of the account. Currently, money must be withdrawn from some retirement accounts at age 70 ½, even if you are not retired.

IRA Accounts. An IRA (individual retirement arrangement) allows individuals to deposit money into an account during their working years. The money deposited may be tax-deductible. Taxes are paid on the money and interest earned when the money is withdrawn during retirement. Money set aside for a traditional IRA can be deducted from gross income if you meet certain requirements. This lowers your income tax. IRAs are tax-deferred, which means you will not pay taxes on the money earned until it is withdrawn. IRA accounts can be set up at banks and other financial companies. You can choose the types of investments. If you choose a CD rather than stocks, you will take less risk, but you will also have lower returns. IRA accounts are managed by the investor. They are a good long-term plan for providing retirement income. Money must be taken from the accounts at age 70½, even if you are not retired. A Spousal IRA is set up to benefit a spouse who does not work outside the home. To qualify, you must file a joint tax return. The amount that can be set aside is limited, based on your income. The maximum IRA contribution per year is $5,000.

Roth IRA Accounts. With a Roth IRA, you cannot make pretax contributions. In other words, you cannot deduct the amount you contribute from your gross income. However, if you meet certain requirements, the earnings on a Roth IRA are tax-free. Thus, when you retire, the money you withdraw will not be taxable. You can choose the types of investments for a Roth IRA. No minimum distribution rules apply. You do not have to withdraw money from a Roth IRA at age 70 ½.

SEP Accounts. The SEP (simplified employer plan) is similar to an IRA. It is for self-employed small business owners and their employees. SEPs work like IRAs, except that the amount of money that can be set aside is higher. SEP contributions are deducted from gross earnings. This money is not taxed until it is withdrawn. As with an IRA, the investor chooses how the money is invested. Often called the SEP-IRA, the SEP is a simple plan for those who are fully or partly self-employed. There are no IRS filing or paperwork requirements. However, there is a limit as to how much can be set aside by small business owners.

Keogh Accounts. A Keogh account is similar to a SEP, but it has more complex filing rules. It also has higher limits and is available to self-employed professionals and their employees. Up to $40,000 can be deposited each year. Doctors, lawyers, accountants, and others set up these plans to provide for retirement. Contributions are deducted from taxable income. The money is not taxed until it is withdrawn. Like other retirement accounts, a Keogh account is managed by the investor. It can include low-risk or high-risk investments.

EMPLOYER-SPONSORED PLANS

Many employers provide some type of retirement plan for their employees. Often it is part of the employee's benefits package. These plans are sometimes very good options for workers. You can set aside money pretax. In some cases, the money you set aside may be matched by money contributed by the employer. Although you will pay taxes when you withdraw the money, the plan is a good option for providing retirement income.

401(k) Accounts. A 401(k) plan is a tax-deferred plan for employees. The employee sets aside money each month with a pretax payroll deduction. There is a limit to the amount the employee can contribute. In 2015, the amount was $18,000. The amount can change each year. These accounts and their earnings are not taxed until the money is withdrawn. At retirement, they are taxed as ordinary income. Employer contributions are optional. Sometimes companies match a certain percentage of employee deposits. The match may range from 25 to 100 percent. For example, suppose a company does a 30 percent match. For every dollar saved by the employee, 30 cents is added to that account by the company. Employers do a match in order to encourage employees to save for retirement. The 401(k) is also a part of benefits packages of many large companies. Employees can choose investments for their 401(k) fund, based on their willingness to take risk.

403(b) Accounts. A 403(b) account is a retirement plan for employees of nonprofit organizations or educational institutions. Teachers, school staff, nurses, doctors, professors, librarians, and ministers are examples of people who may qualify for a 403(b) plan. Some employers offer tax-sheltered annuities for their 403(b) retirement plans. Money is set aside by workers through payroll deduction. It is not matched by employers. The employee is allowed to choose investments for the money deposited. As in other retirement accounts, earnings and contributions are not taxed until the money is withdrawn.

Pension Plans. Some employers offer retirement accounts that are paid for entirely by the employer. These accounts are called defined benefit plans or simply pension plans. Pension plans provide payments to retired workers. Typically, employees must work for the company for a certain number of years to qualify. The payment amounts vary depending on the number of years worked, the worker's salary, and other factors. Pension plans are offered by fewer companies now than in the past. Employees do not make choices about investments. When the employees receive payments (at retirement), they must pay tax on the money.

PORTABILITY

Many retirement accounts are portable. This means you can take the account with you when you leave a job. Rollover is the process of moving an investment balance to another qualified account. For example, you may be working for a company that has a 401(k) or a 403(b) retirement account. If you leave your job at the company, you can take the money you contributed with you. Once the account is vested, you can also take with you money your employer contributed to the account. An account is vested when the employee has met certain requirements, such as time of employment. When you are vested, you have rights to the account. Vesting often occurs after 3 to 6 years of continuous employment. When you leave that job, you can roll over your 401(k) to an IRA account. You may also be able to roll over the account to an account provided by a new employer. Rollovers have a time limit and other rules.

INVESTMENTS WITH MEDIUM RISK

In order to earn a higher return, some people are willing to take some risk. Medium-risk investments will increase your return without raising the risk beyond reason. With many medium-risk choices, the investor can choose how much risk he or she is willing to take.

MUTUAL FUNDS

A mutual fund is operated by a professional investment firm. The firm sells shares in the mutual fund and invests the money in a variety of stocks, bonds, and other investments. Mutual funds are focused on a chosen investment strategy. Mutual fund companies manage many different types of mutual funds. If you invest with one of these companies, you can pick the type of investment strategy that appeals to you. If you choose a higher-risk fund, you might make more money. However, you could also lose money, including your principal. Mutual funds are often thought of as a good way to get started investing. Mutual fund companies sell shares to many investors. These investors are pooling their money with that of other investors to reduce risk. The mutual fund company is in the business of buying and selling. Its advisors are watching companies and markets. When you invest your money with a mutual fund company, you are paying for the firm's expertise. This allows you to spend your time doing other things. It also lowers your risk because your investment is diversified.

MUTUAL FUNDS

Fund Type	Description
Balanced funds	Invest in a diversified portfolio that includes some low-risk, some medium-risk, and some high-risk stocks. These funds strive for balance between growth and income. The objective is to reduce overall risk while maximizing return.
Bond funds	Invest primarily in bonds. If the bonds are tax-free, this advantage is passed along to investors.
Global funds	Invest in international companies, new industries in foreign countries, and companies in the world marketplace.
Growth funds	Invest in companies that will grow over the long run. Gains will be made when companies reach their potential. These are often considered high-risk investments in the short run.
Income funds	Invest in bonds and stocks that produce steady and reliable dividends. These dividends are passed along to investors.
Index funds	Invest in securities to match a market index with the goal of having returns similar to those of that index.
Money market funds	Invest in short-term securities that go up or down with current interest rates and the economy.
New venture funds	Invest in new and emerging businesses and industries. These are considered high-risk (but also high-return) choices.
Precious metal funds	Invest in companies that are associated with precious metals, such as gold, silver, and platinum.
Stock funds	Invest primarily in stocks. They could be categorized into types of stocks—blue-chip, technology, medical, etc.

Buying mutual funds is a form of indirect investing. With this indirect investment, you invest in the mutual fund company. The company makes the investment purchases and sales. You are investing indirectly in the choices of your mutual fund company. In other words, you own shares of the mutual fund company, not shares of stock in the companies in which it invests. When you choose a certain type of fund, the mutual fund company will select the combination of investments its analysts think is best to meet the fund's goals. The chart on the previous page shows various types of mutual funds. With mutual funds, the investor can also choose a combination of funds. This is called asset allocation. The investor could pick investments that have a variety of risks.

FAMILY HOME

Most financial experts believe that buying your own home is the best investment you will ever make. They also agree that home ownership is not always liquid. You must be willing to wait to sell when the market is rising. Because the costs of buying are so high, it usually takes several years to make a profit. When you own your own home, you should take good care of it to protect your investment. Over the long run, home ownership is a fairly safe investment, with value that often grows faster than the rate of inflation. Note: buying a family home is considered much less risky than investing in other types of real estate, such as rental properties, investment properties, or real estate investment trusts.

11-3 High-Risk Investment Options

OBJECTIVES

- ***Describe several high-risk investment options.***
- ***Compare common stock with preferred stock.***
- ***Describe direct investing and the risk it involves.***
- ***Discuss trading futures contracts for commodities.***
- ***Explain why indirect investing options reduce risk.***

STOCKS

When you buy stock in a corporation, you become a stockholder. A stockholder owns shares of the company. Stockholders make money in two ways. One way is by receiving dividends. The other way is by selling the stock at a price that is higher than the price paid for the stock. This increase in selling price is referred to as growth in value (or capital gains). A stock that pays annual dividends is attractive to an investor who needs the income, such as at retirement. Buying stocks and holding them for growth is a long-term strategy. You are betting that the value of the stock will go up over time.

The number of shares a stockholder owns may increase due to stock splits. In a stock split, the number of shares a company has sold is divided into a larger number. For example, in a two-for-one split, each person who owned 100 shares of stock will now own 200 shares. If the stock price before the split was $100, the price will now be $50. However, the stock may increase in price over a few years back to $100 per share. An investor who bought 100 shares at $75 per share would have 200 shares to sell at $100 per share.

Stocks are considered risky because an individual company could fail regardless of how big it is or how long it has been in business. There are many risks faced by businesses, from inflation risk to political risk. Stocks can be sold at any time as long as there is a buyer willing to purchase the stocks. However, if the stock price is low, the investor may want to hold the stock until the price rises. Otherwise, the investor will lose money on the investment.

COMMON STOCK

Many companies have two types of stock: common stock and preferred stock. Owners of common stock may share in the profits of the company through dividends. They have voting rights in decisions made by shareholders, such as who the company directors will be. They take a higher risk than owners of preferred stock. Common stock has no guaranteed dividends. If the company does well, the stockholder shares in the profit in the form of dividends. The directors of the corporation decide if a dividend payment is to be made. Stock dividends are taxable. There is no guarantee that the value of the stock will go up. Investors should review the selling prices of stocks they own often to see whether the prices are going up or down. If the price of a stock keeps going down over time, the investor may want to sell the stock and invest in another option.

PREFERRED STOCK

In many companies, owners of preferred stock have a guaranteed dividend rate. This rate is paid before common stockholders get paid a dividend. Because there is less risk, preferred stock costs more than common stock. Preferred stockholders do not have voting rights. If the company goes bankrupt, they get paid before common stockholders.

Buying investments directly from companies and holding them individually is known as direct investing. If you buy the stock of a company and hold that stock, you are taking a high risk. That is because you have a lot of money in one place. This plan does not spread risk. You can, however, lower your risk by buying many different types of stocks and other direct investment options.

BUSINESS VENTURES

You may decide to start a small business. You could also loan money to someone so that person can start a business. More than half of all small businesses fail each year, making this a very risky investment. If the business succeeds, however, it can be a profitable investment. A business plan is a document that outlines how a business plans to succeed. It includes the company mission, the financing needs, the marketing plan, the management plan, and the operating plans for the company. The plan attempts to show how the business will make a profit. Before you invest in a business venture, be sure to read and understand the business plan. You could make a lot of money, or you could lose your investment.

COLLECTIBLES

Collectibles are art objects, coins, decorative plates, books, baseball cards, or other items bought for their investment value. Some collectible items will go up in value over time. Others will not. The investor must decide which items she or he thinks will go up in value. Coins are a commonly collected item. When coins are rare, they gain in value. Buying collectibles is a very risky investment choice. When collecting, have a clear goal in mind. Decide whether you are collecting items as an investment or whether you are simply buying items that you like for your own enjoyment. If you are buying items as an investment, do market research to learn which items may increase in value. Also, do research to learn about the items so you can tell whether an item is authentic or a replica. Being able to prove that an item is authentic is especially important for art objects and sports memorabilia.

RENTAL/INVESTMENT PROPERTY

Individuals can buy real estate beyond a family home. If you buy a house and rent it to tenants, you will receive rent for income. Buying rental real estate has risks and responsibilities. The tenant (renter) takes possession of a valuable piece of property. The tenant must take reasonable care of it. You, the owner, are responsible for repairs and maintenance. This may mean fixing or replacing the roof, painting, and other upkeep. The property may increase in value over time. Thus, an investment in rental property can provide current income and long-term growth. Other forms of rental property besides a single-family home include duplexes, apartment complexes, and vacation property.

REAL ESTATE INVESTMENT TRUSTS

REITs (real estate investment trusts) are also known as real estate stocks. A REIT is a corporation. It may own and operate income-producing property. An apartment building that rents to families and a factory building that rents to a business are examples of income-producing properties. A REIT may lend money to real estate developers. It may also invest in securities backed by real estate mortgages. Buying shares in a REIT is a form of indirect investing, similar to buying shares in a mutual fund. When REITs make profits, the profits are distributed to shareholders. You own shares of stock in the REIT. You do not own the individual pieces of property purchased by the REIT. Your money is invested indirectly in the real estate market. Many REITS are publicly traded. You can buy shares of these REITs on the stock exchanges. Because of the nature of real estate, REITs outperform many other investment funds over the long run.

FUTURES CONTRACTS AND COMMODITIES

Futures contracts are another type of high-risk investment. A futures contract is an agreement to buy or sell a specific commodity or currency at a set price on a set date in the future. A commodity is a specific item of value that is bought and sold in a marketplace. It could be soybeans, silver, live cattle, coffee, or other items. Buying and selling a futures contract does not transfer ownership. It spells out the terms under which the commodity or currency will be bought or sold at a later date. Futures contracts are often used by sellers and buyers as a way to hedge, or reduce the likelihood of losing money in the future. For example, suppose a company has agreed to buy fuel in the future at a set price. The company might also want to buy some fuel futures contracts. If the price of the fuel rises, then the company may make enough money on the futures contracts to pay for the increased price of the fuel itself.

As you have probably guessed, investing in this category is very risky. You will have no control over what happens to prices for commodities. For example, the weather during the growing season may have a big effect on the price for products such as corn or orange juice. Investors who have an in-depth knowledge of how the market for a particular product fluctuates may be able to do well trading commodities. For example, suppose a farmer has grown corn for 20 years. This farmer has studied the conditions that affect corn prices, such as weather and the amount of corn already in storage from previous years. This farmer may have the knowledge needed to do well trading futures contracts for corn. However, the same farmer might know little about currency markets and might not do well trading currency. Investors in futures contracts should realize that you could make—or lose—a lot of money in a short time.

INVESTMENT CLUBS

An investment club is a group of people who pool their money together to buy and sell investments. The group may be small—just a few people who work together to buy something they could not afford as individuals. For example, three or four couples may jointly buy a vacation home and share the time using it. The group may also be hundreds of people who do not know each other. Investment clubs may buy stocks, bonds, or other investments. Clubs may take part in direct investing, as in buying stocks, or indirect investing, as in buying mutual funds. An investment club usually has stated goals and buys certain kinds of investments to reach those goals.

FOCUS ON: Day Traders

Day traders are individuals who attempt to make money by buying and selling stocks and bonds. These investments are not held for long-term growth. They are held just long enough to make a profit. When the day trader sees a stock's price rising, the stock is sold for a quick profit. When the day trader sees prices dropping for stocks that are good values, the trader buys. As soon as prices come up again, the trader takes the profit by selling. If the price does not rise again, the trader takes a loss. Day traders must be aware of general market conditions. They also must be familiar with companies, products, and industries in which they trade. By carefully watching the market and keeping track of trends, day traders can make considerable profits over time. Of course, they are bound to make mistakes at times. They might sell before the stock hits its peak price or select a stock that loses value. Because they trade so often, day traders must also consider trading fees and expenses when calculating actual profits.

Chapter Summary

- ***Investors should consider risk, return, and liquidity when making savings and investing choices.***
- ***Savings accounts are low-risk and liquid, but the return is low.***
- ***A money market account is a good option to choose for liquid savings.***
- ***A certificate of deposit is a low-risk investment, but it is not liquid.***
- ***Withdrawal penalties may apply if you withdraw money from a CD before the set time period.***
- ***A U.S. savings bond is designed to be a long-term investment.***
- ***Bonds can be purchased through the TreasuryDirect Web site.***
- ***Bonds are issued by companies and governments. Government bonds and investment-grade corporate bonds are considered low-risk.***
- ***Annuities are low-risk, illiquid investments. Some people purchase them to provide retirement income.***
- ***Individual retirement plans include IRAs, SEPs, and Keoghs. Some of these plans are tax shelters because they lower tax liability.***
- ***Employer-sponsored retirement accounts include 401(k), 403(b), and employer-provided pension plans. These are often part of an employee's benefit package.***
- ***When you are vested, you can take your retirement account with you when you leave a job. A rollover is the process of moving an investment balance to another qualified account such as an IRA account.***
- ***Mutual funds are a form of indirect investment with medium risk.***
- ***You choose the types of funds to increase or reduce risk through asset allocation.***
- ***Buying a home has risks but can provide good returns when home values rise faster than inflation.***
- ***Buying individual stocks is a high-risk investment choice. Common stock is more risky than preferred stock.***
- ***Business ventures, collectibles, and rental property have high risk, but they also have the potential for high returns.***
- ***Futures contracts for commodities are considered speculative, or at the highest level of risk.***
- ***Buying shares in a REIT is a form of indirect investing, similar to buying shares in a mutual fund. When REITs make profits, the profits are distributed to shareholders.***
- ***An investment club is a group of people who pool their money together to buy and sell investments.***