



Wise Women

*Investments:
Understanding the Basics*

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Wise Women

Investments: Understanding the Basics

Part 1: Bonds (Fixed Income)

Part 2: Stocks (Equities)

Part 3: Mutual Funds and Exchange Traded Funds (ETFs)

Part 4: Building Portfolios



Part 1: Bonds (Fixed Income)

- What is a Bond
- Types of Bonds
- Bond Maturity
- Risks of Bonds



Many Different Kinds of Bonds

Bonds are **loans** to governments or corporations

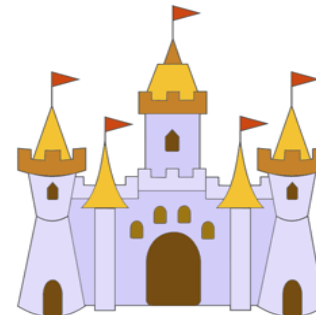
Government
Bonds



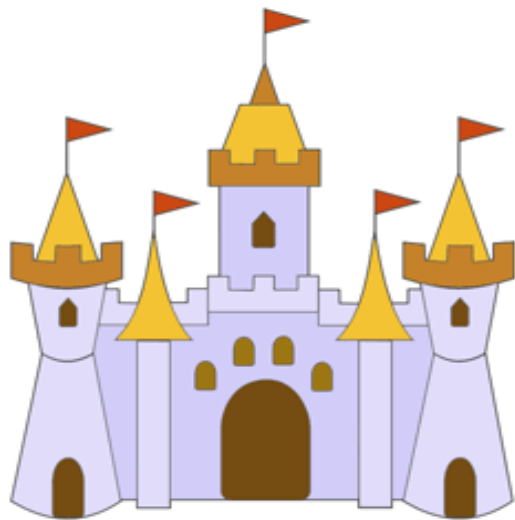
Mortgage
Backed
Bonds



Corporate
Bonds

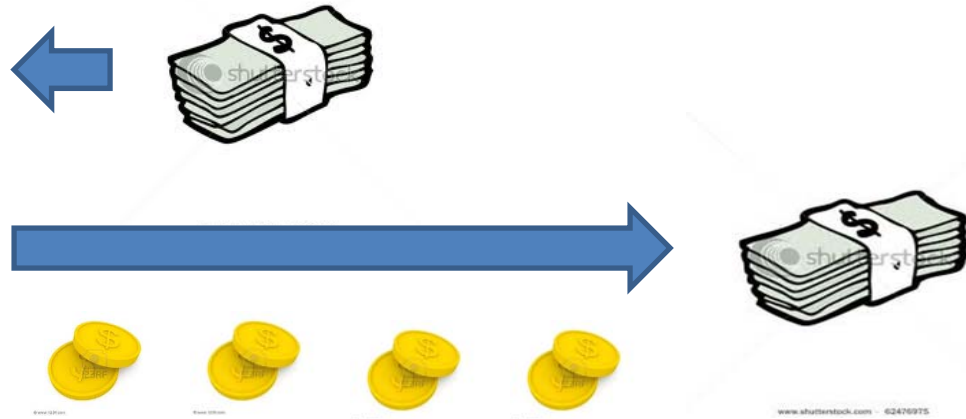


If you purchase a 2 year Disney Bond that pays 4% annually...



At Disney, they are using the money you lent them to grow their business.

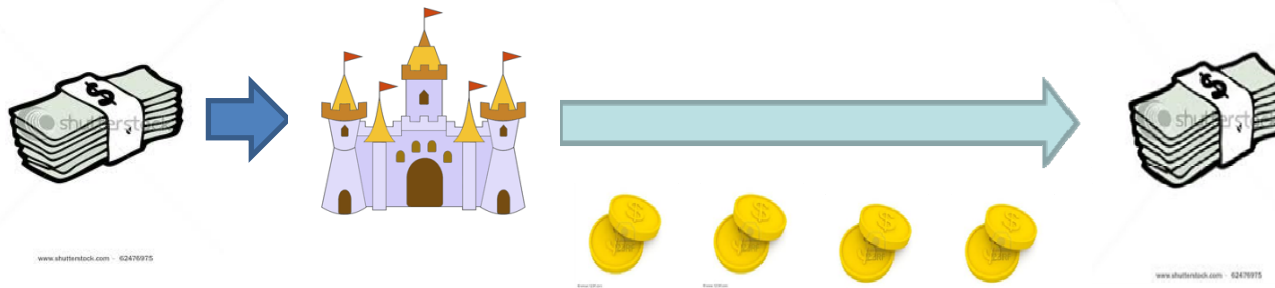
Lent Disney \$10,000



Disney pays you 4% interest a year. So you receive \$200 every 6 months. At the end of 2 years, you receive the \$10,000 back.

Bond Maturity

2 Year Disney Bond



5 Year Disney Bond



- Short Term Bonds: 1-3 Years
- Intermediate Term Bonds: 3-10 Years
- Long Term Bonds: 10+ Years

Are Bonds Risky?

- Default Risk
- Maturity Risk
- Interest Risk
- Inflation Risk



Default Risk: What Happens When...

The government or company you lent money to cannot pay:

- the interest they owe you
- or even worse, the original amount you lent them!



Defaults are more likely to happen to companies and countries with:

- Large amount of existing debt
- Poor cash flow
- No or limited cash reserves
- Poor business model

Default Risk of Bonds

US
Government
Bonds



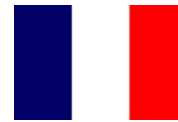
Mortgage
Backed
Bonds



US
Investment
Grade
Corporate
Bonds



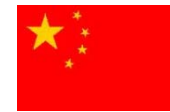
Developed
Nations
Government
Bonds



US High
Yield
Corporate
Bonds



Emerging
Nations
Government
Bonds



Low Default Risk

High Default Risk

Credit Ratings

A credit rating is a grade given to bonds that indicates the quality of the bond.

- Provided by various services such as Standard & Poor's, Moody's and Fitch
- Expressed in letters from AAA (best) to D (default)

Maturity Risk - Why are 2 year bonds less risky than 5 year bonds?

2 Year 4% Interest Disney Bond



Reinvested at 6% Interest in 3 Year Disney Bond



Total Interest Earned on \$10,000 is \$2,600.

5 Year 5% Disney Bond

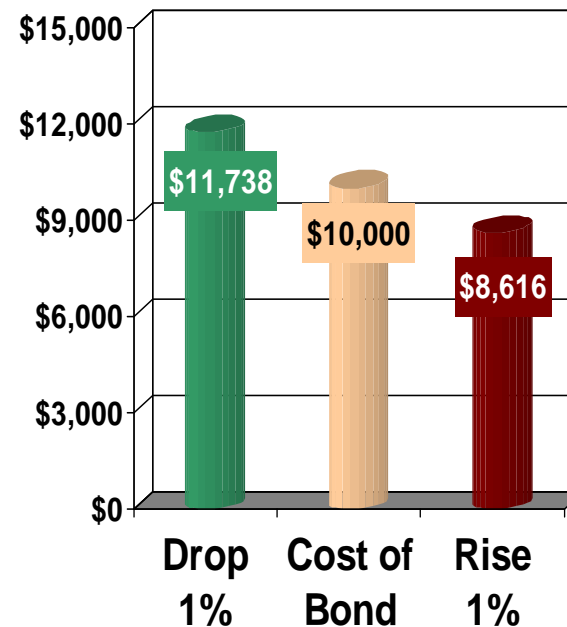


Total Interest Earned on \$10,000 is \$2,500.

***If you try to sell the bond between years 3 and 5, you will receive less than \$10,000 because the interest rate on your bond is lower than the current market rate.**

Interest Rate Risk - What Happens When...

- You purchase a \$10,000 **30-year bond** which pays interest of 5% annually.
- What happens to the value of your bond if interest rates change tomorrow?
- But if you hold on to the bond for 30 years, you will receive the \$10,000 back as long as the bond does not default.



Inflation Risk

Over time, inflation can erode the value of your money

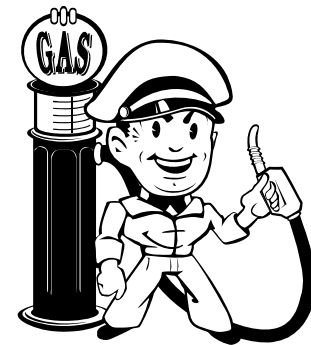
Example:

Cost of gasoline in 2002 - \$1.36 per gallon

\$1,000 could buy 735 gallons of gas

Cost of gasoline today - \$3.00 per gallon

\$1,000 can buy 333 gallons of gas

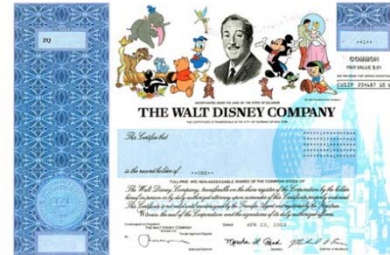


Bonds Summary

- Loans to governments or corporations
- Pre-determined interest paid periodically in return for the use of money
- Range from minimal risks (US Treasury bonds) to substantial risks (high yield or “junk” bonds)
- Historically more stable than stocks but generally does not provide as much earnings

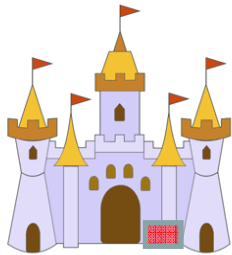
Part 2: Stocks (Equities)

- What is a Stock
- Types of Stocks
- Risks of Stocks
- Importance of Stocks in Long Term Portfolios

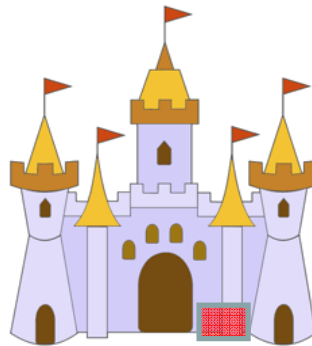


If You Purchase Disney Stock...

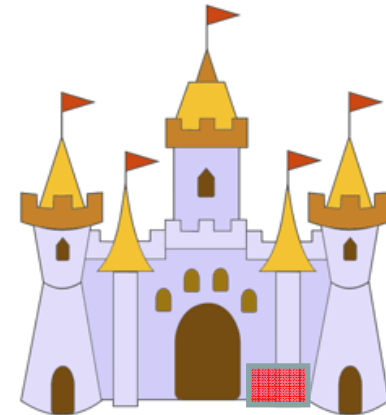
\$20 per share



\$40 per share












\$60 per share



Your piece of the magic increases or decreases in size depending on how well the company does.

Types of Stocks

		<u>Stock Style</u>		
		Value	Blend	Growth
<u>Company Size</u>	Large			
	Medium			
	Small			

Difference Between a Good Stock and a Good Buy

Good Stock:

- Strong management
- Quality products or services
- Strong competitive advantages
- Strong financial strength

Good Buy:

- Quality stock with **attractive valuation**: where the stock price is lower than its estimated value.

Risks of Stocks

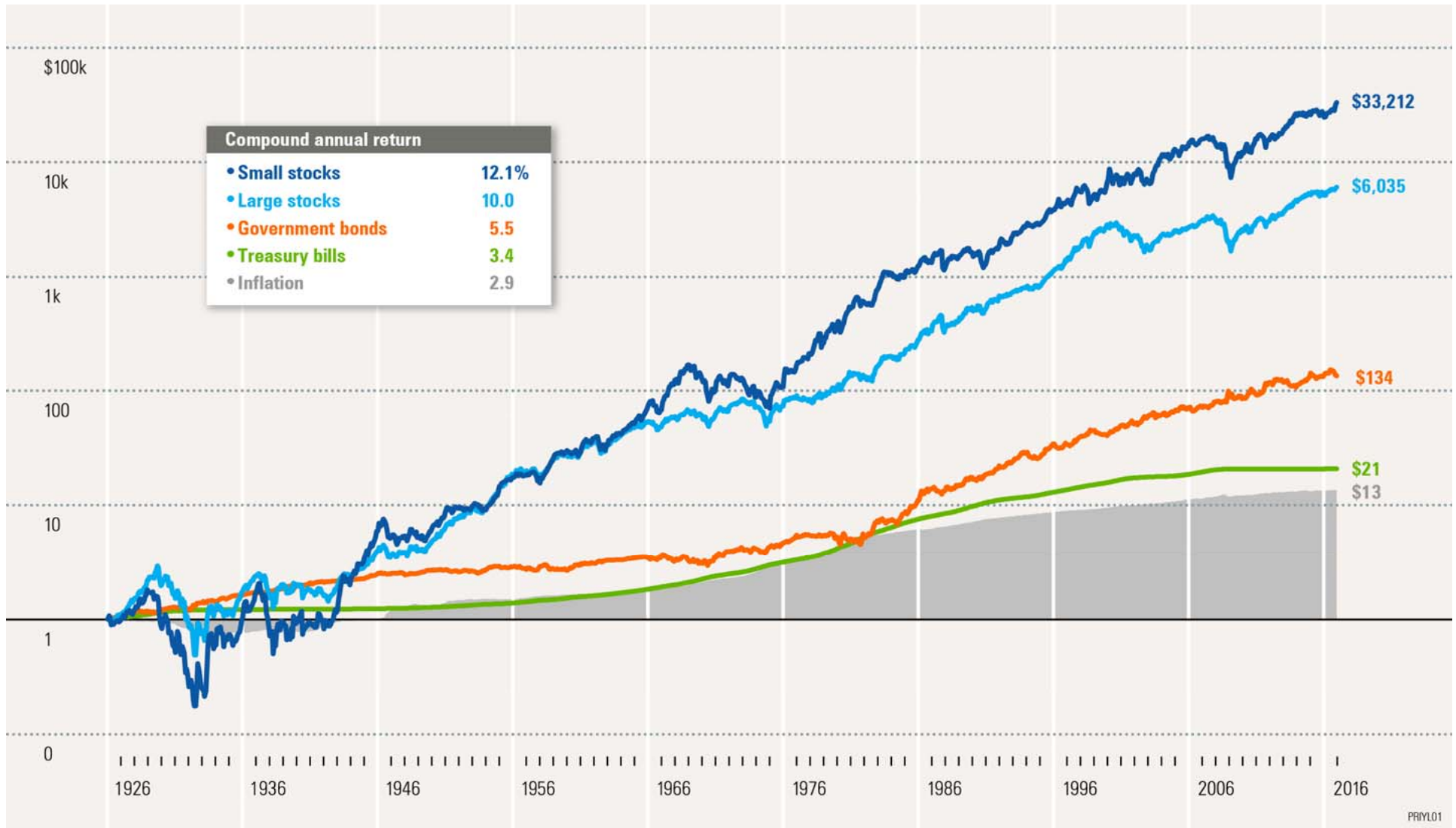
- **Significant decrease in stock price**
 - Why?
 - Business risk – company specific issues
 - Market risk – economic downturn
- **Forced to sell risk**
 - Significant risk of large short term losses



Stocks as Long Term Investments

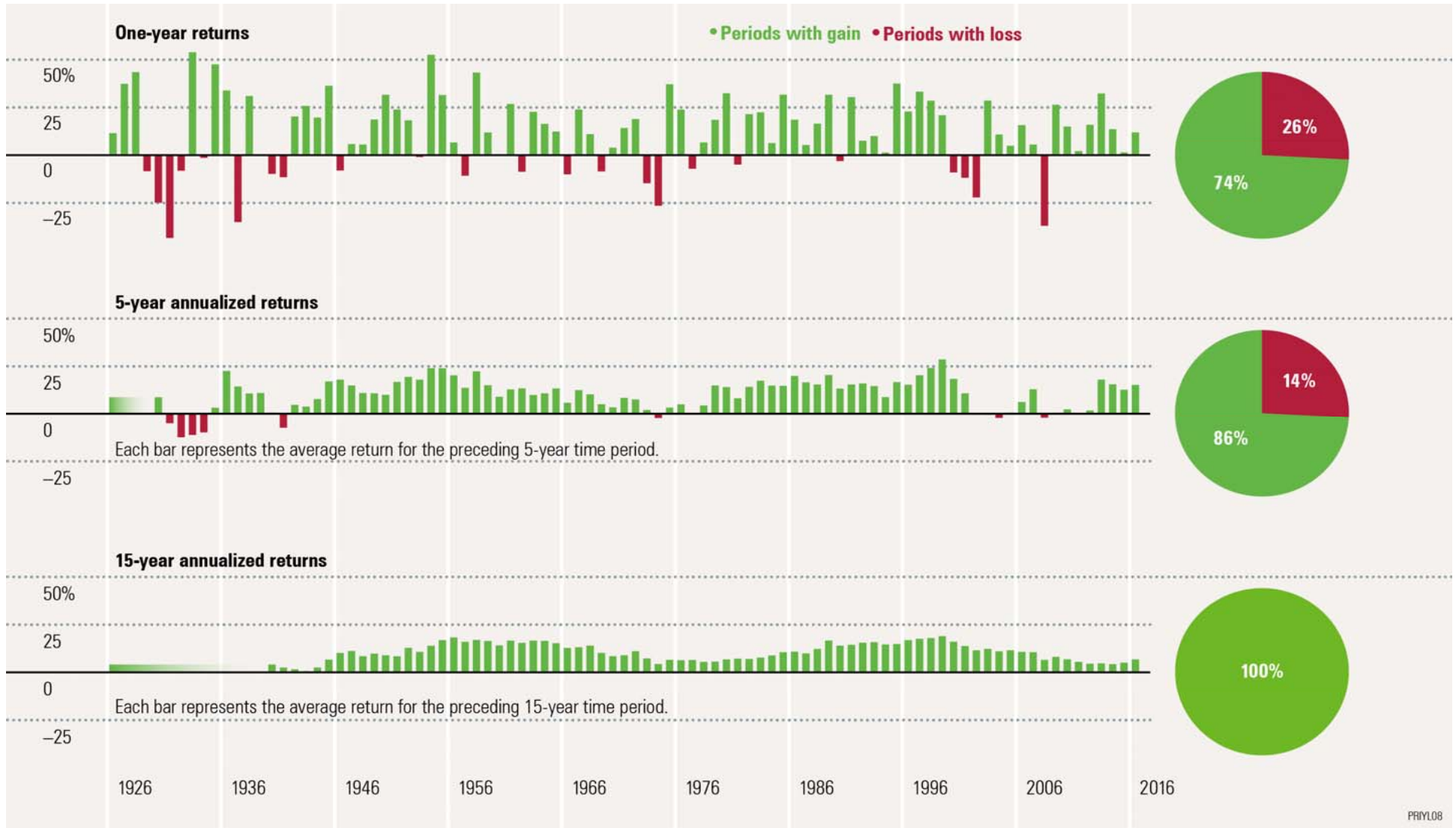
Stocks have been historically, the best investment to outpace inflation over long investment horizons.

Return of Stocks, Bonds, Bills, and Inflation 1926–2016



Past performance is no guarantee of future results. Hypothetical value of \$1 invested at the beginning of 1926. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. © Morningstar. All Rights Reserved.

Risk of Stock Market Loss Over Time (1926–2016)



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Stocks Summary

- Equity ownership in companies
- As many different types of stocks as there are different types of companies
- Historically more risky than bonds but generally outpace inflation over long investment periods.

Part 3: Mutual Funds

A mutual fund is

- a company that brings together a group of people and invests their money in stocks, bonds, or other securities.

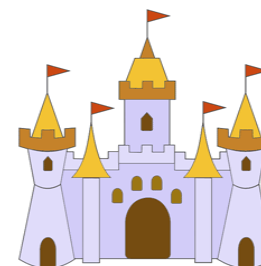
Each investor owns shares, which represent a portion of the holdings of the fund.

Individual Bonds vs Bond Mutual Funds

US
Government
Bond



US High
Quality
Corporate
Bond












US
Government
**Bond Mutual
Fund**



US
Corporate
**Bond Mutual
Fund**



Individual Stocks vs Stock Mutual Funds

	Value	Blend	Growth	
Large				Large Company Mutual Fund
Medium				
Small				

Small Value Company Mutual Fund

Exchange Traded Funds (ETFs)



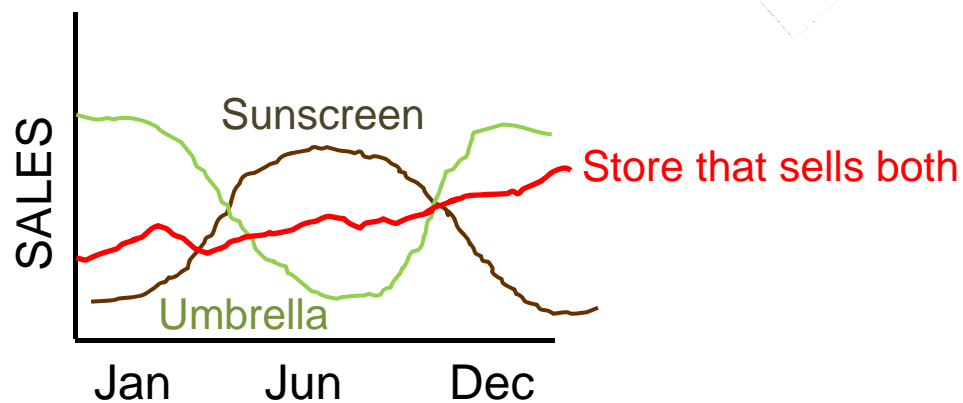
- Like mutual funds, ETFs are baskets of securities
- Like stocks, ETF can be bought and sold on a stock exchange and their prices fluctuate real-time throughout the day
- Many ETFs have low operating costs and high tax efficiency
- Many ETFs track indices.* For example a popular ETF, "Spiders" (SPY), tracks the Standard and Poor's 500 index of large-cap stocks

Part 4: Building Portfolios

In the dry season, sunscreen sells well



In the wet season, umbrellas sell well



Return of Different Investments Over Time

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Highest return	33.4	28.6	29.8	21.5	22.8	17.8	60.7	20.7	14.0	26.9	11.6	25.9	32.5	31.3	27.1	18.2	45.1	24.7	1.4	25.6
	22.8	20.3	27.3	5.9	3.8	1.6	39.2	18.4	7.8	16.2	9.9	1.6	28.1	15.1	2.9	17.9	32.4	13.7	0.0	12.0
	15.9	13.1	21.0	0.1	3.7	-6.3	28.7	11.9	7.1	15.8	5.5	-17.9	26.5	13.0	2.1	16.0	23.3	7.4	-0.4	8.2
	15.9	11.9	14.8	-3.6	-0.6	-13.3	26.2	10.9	5.7	13.0	5.3	-36.7	14.4	10.1	0.0	11.1	17.6	2.9	-0.6	1.8
	5.3	4.9	4.7	-9.1	-11.9	-15.7	1.4	8.5	4.9	4.8	4.7	-37.0	0.1	8.2	-3.3	3.4	0.0	0.0	-0.7	1.5
Lowest return	2.1	-7.3	-9.0	-14.0	-21.2	-22.1	1.0	1.2	3.0	1.2	-5.2	-43.1	-14.9	0.1	-11.7	0.1	-12.8	-4.5	-3.6	0.2

• Small stocks
• Large stocks
• International stocks
• Long-term government bonds
• Treasury bills
• Diversified portfolio

PRIYL09

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How Much Stocks Should I Have In My Portfolio

1. What are you saving for?

- House down payment
- Child's college education
- Retirement

2. What is your *ability* to tolerate risk?






- Will your lifestyle change significantly if the portfolio goes down 10%? How about 20%?

3. What is your *willingness* to tolerate risk?

- Will you sell all your investments if your portfolio goes down 10%? How about 20%?

Probability of Meeting Income Needs

Various withdrawal rates and portfolio allocations over a 25-year retirement

	84%	97%	95%	92%	87%	4% Withdrawal rate
	28%	69%	79%	79%	77%	5%
	3%	26%	54%	63%	65%	6%
	0%	4%	29%	46%	52%	7%
	0%	0%	12%	29%	40%	8%
	100% Bonds	75% B 25% S	50% B 50% S	25% B 75% S	100% Stocks	
						

PRIYL13

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