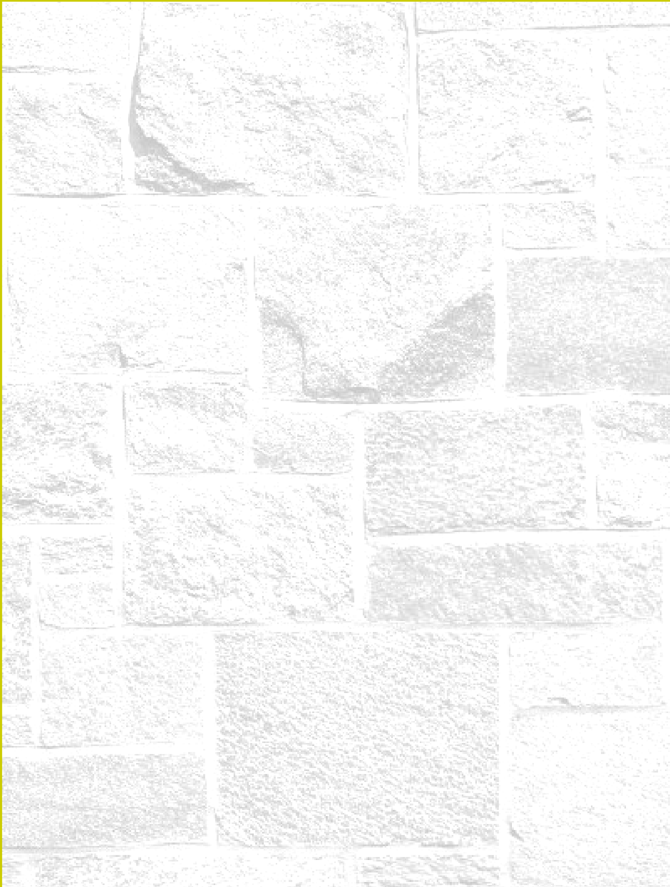

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THE BEGINNERS GUIDE TO INVESTING

Nowadays, more and more people are beginning to invest their hard earned money in various investment projects in hope of gaining profitable outcomes. Investors have the opportunity of investing in various financial options such as stocks, bonds, mutual funds and etc as well as other alternative investment opportunities like real estate and gold. However, consumers must keep in mind that all types of investments come with varying degrees of risks and hence should carefully compare future financial gains with its associated risks.

CreditGUARD of America, Inc. has produced this publication to educate its clients the basics of investing as well as to gain insight on how financial markets work. This publication will also cover various types of investment products, timeframes, risk factors, portfolio management and diversification.

Keep in mind, before investing any large sums of money, all investors should take time to develop a personal investment strategy. If the process becomes too difficult, we recommend that you consult a personal financial advisor to guide you through the process.

INVESTING

"The dollar in hand today is worth much more than a dollar promised at a future time".

WHAT IS INVESTING?

As we mentioned earlier, investments can come from various financial securities and other alternative investment opportunities. The idea behind investing is putting your money to work for you. The time value of money plays the principal role in investing as it determines how much your money is worth in the future. The concept of time value of money is quite simple; **'the dollar in hand today is worth much more than a dollar promised at a future time'**.

Money that you hold today is worth more because you can invest the money and earn interest. After all, you should receive some compensation for foregoing spending. For instance, you can invest your dollar for one year at a 5% annual interest rate and accumulate $1.05 at the end of the year. So the future value of the dollar is 5 cents more than the value of the dollar today. Based on this principle, people who invest money in various financial and other alternative investments should expect their investments to grow at a certain percentage and yield profits.

Before venturing further, lets look at the two main financial concepts that define investing principles,

Simple Interest: can be defined as interest earned only on the initial principle investment. The amount of interest depends on the interest rate, the amount of money invested (principal) and the length of time that the money is invested. For instance, if you invest $100 for two years on a savings account with a simple interest rate of 10%, you should earn $20 on your investment after two years ($\$100 \times [1.10^{2}]$).

Compound Interest: can be defined as interest earned on both the initial principal plus the interest reinvested from prior periods. For instance, if you invest $100 for two years on a savings account with a compound interest rate of 10%, at the end of the first year the interest gains would be $10 ($100 x 1.10 = $110). In the second year, the interest rate of 10% will not only applies for the original investment of $100 but also for the $10 interest gained from the first year. Thus, the second year interest gained will be $11 ($110 x 1.10 = $121). Together, the investor will earn $21 dollars from his investment.

FINANCIAL PRODUCTS

In the following section, we will closely analyze some of the existing financial products that are available for investors today.

Stocks: also known as 'Shares', can be classified as an ownership interest in a company. Each stock represents a proportional stake in the corporation's assets and earnings. If the company does well financially during a particular period the stockowners might get a share of those profits as dividends. Stocks are usually traded on a stock market such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation (NASDAQ), where investors and companies come together to buy and sell stocks from a wide range of companies.

Bonds: can be classified as debts issued by companies or governments who guarantee payment of the original investment plus interest on a specified future date. The bond issuer

usually discloses the interest rate before purchase. The interest earnings are paid at specific times and the final pay back of the principal amount occurs once the bond reaches its maturity. The prices of bonds change as interest rates fluctuate and hence are more attractive to investors when the interest rate falls and vice versa. Bonds are generally lower risk investments when compared to stocks.

Mutual Funds: a mutual fund is simply a collection of stocks, bonds and other financial securities, which are professionally managed by investment specialists. Investment companies collect funds from thousands of investors and pool their investments to buy a large number of financial securities from various companies and governments. In addition, mutual funds are categorized according to its risk and earning capacity and investors can customize their mutual funds according to their preferences.

Certificates of Deposits: widely known as CD's are debt instruments issued to investors by banks and other financial institutions. The banks pay the holder of the CD's a set interest rate as the CD matures. The maturity timeframe on CD's can range from only a few weeks to several years. Usually, the longer the maturity date the higher the interest rate will be. Investors who withdraw money from a CD before its maturity date can expect heavy

penalties from the financial institution. CD's are one of the safest investments available for investors as it guarantees payment.

U.S. Treasury Bills: can be classified as debt obligations of the U.S. Treasury that have maturity dates of one year or less. Treasury bills are sold at a discount from their face value. For instance, you might pay $970 for a $1,000 bill. When the bill matures, you would be paid $1,000. The difference between the purchase price and face value can be considered as interest. Treasury bills are backed by the full faith and credit of the U.S. Treasury and hence considered the safest securities available to the U.S. investors.

INVESTMENT TIMEFRAME

Your personal investment strategy should clearly identify a specified timeframe for your investment. An investment timeframe can be classified as the length of time your investment needs to mature and earn the expected return. Generally, the longer you maintain your investment, the greater your returns will be. Investors should prepare short and long term investment goals and should stick to those plans without too many modifications.

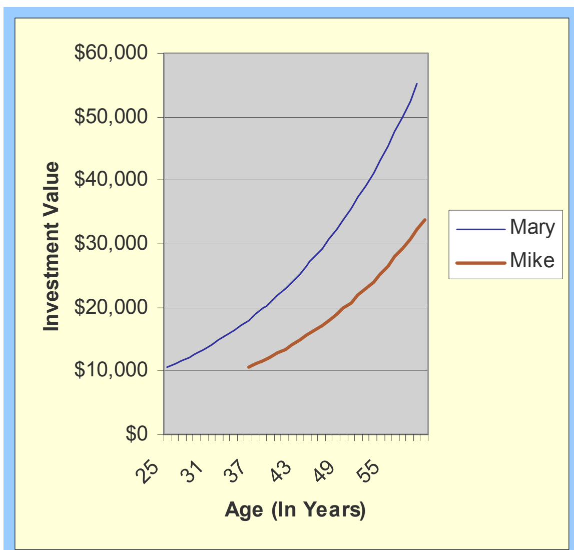
Short-term: investments usually mature in 1-3 years. Short-term Bonds, CD's, Money Market Funds, Commercial Paper and Treasury Bills are ideal for such investments.

Long-term: investments usually require 3-5 years of continuous investment to yield satisfactory gains. Long-term Bonds, Stocks, Mutual Funds and Real Estate can all be classified as long-term investments.

As we mentioned earlier, keeping your investment longer will yield higher profit margins for the future and hence consumers should start investing early. By starting early, you can capitalize on the powerful growth potential of compound earnings.

For example, lets assume two individuals; named Mary and Mike are the same age. When Mary turned 25, she invested $10,000 on a savings account with an interest rate of 5%, compounded annually. By the time Mary reaches her retirement age of 60, she will have $55,160 ($10,000 x [1.05^{35}]).

Mike, who is in a similar situation as Mary, invested the same amount at the same compounded interest rate but only invested the money at the age of 35. When Mike reaches his retirement age of 60, he will only have $33,863 ($10,000 x [1.05^{25}]).



Looking at the above line graph, we can clearly see that even though both Mary and Mike started out slowly, Mary's investment curve becomes steeper towards her retirement age when compared to Mike's. The reason behind this acceleration is quite simple, by investing early Mary has accumulated more interest on her investment and the compounding of that interest has resulted in a higher investment margin.

RISK FACTORS

Investing in any financial or other alternative investment products involves some degree of risks that investors need to be aware of. In the financial world, the higher the degree of risk, the higher your earnings will be. Investors should decide what degree of risks they can take and how much they are willing to risk.

Investor's age, lifestyle and income all play a prominent role in deciding the risk factors. For instance, an unmarried 25 year old investor who makes $60,000 per year can take on much greater risks when it comes to investing when compared to a 55 year old with a family of four who makes the same amount of money.

There are three major risk factors that all investors should keep an eye on; namely, economic, business and market value risks.

Economic Risks: play a major role in deciding market rates for all the securities as it takes into effect the current and future economic outlook of a country. The likelihood of adverse events such as terrorist attacks, hyperinflation, economic mismanagement and etc will cause drastic changes in a country's business environment and hence reduce the future growth and profits of businesses.

Business Risks: unlike economic risks, investors have a certain degree of control over the business risks since they are able to assess the risk levels of most public companies. Companies lose their business value due to fierce competition, financial insolvency, mismanagement, failed partnerships/ventures and etc. Losing business value may force the management to file for bankruptcy, leaving most investors in dire financial conditions.

Market Value Risks: most often, securities and stock markets ignore stable and profitable

investments and go off chasing the "next hot trend" in investing. For instance, during the late nineties many investors ignored regular financial securities and invested heavily on the dotcom securities. This prompted regular securities prices to go down due to the lack of interest and demand. Investors who bought most of regular securities were forced to hang on to those securities with low profit margins or sell it at a discounted price.

PORTFOLIOS AND DIVERSIFICATION

An investment portfolio can be classified as the sum of all different investments a person holds. Checking and savings accounts, mutual funds,

401(K)'s, stocks, treasury bills, bonds, commercial paper, IRAs, real estate and almost all other investments can be included in an investment portfolio. Building a successful portfolio is dependent on a number of factors, but it is important to remember that a portfolio should be designed around an investor's financial needs and goals.

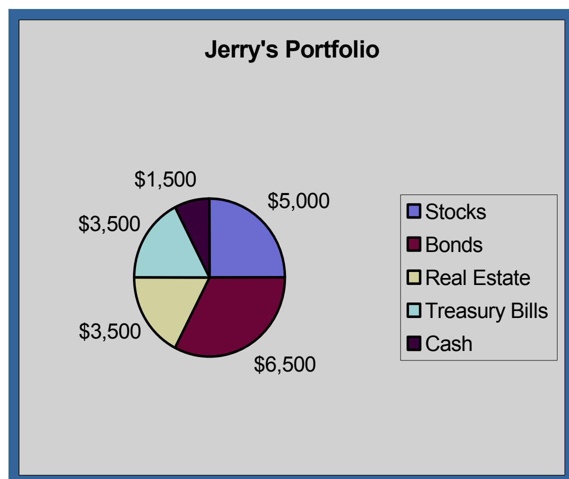
A winning investment portfolio should also be cleverly diversified to guard against any economic, business and market value risks and should retain overall value during difficult economic times. The diversification principle encourages investors to diversify their portfolios with various financial instruments and products to reduce risks. The idea behind this strategy is quite simple; don't put all your eggs in one basket.

Building an investment portfolio designed around an investor's specific financial needs and goals can be achieved by figuring out the investor's risk preference and lifestyle. For instance, an investor who prefers stable and uninterrupted flow of returns can opt for a Conservative portfolio when compared to another investor who likes to take on higher risk levels while reeking in higher returns by investing in an Aggressive portfolio. Investors who prefer to invest in the middle ground can choose a Moderate, Balanced or a Growth portfolio.

To illustrate this concept in detail, lets assume Jerry has $ 20,000 to invest and he is planning to allocate all the money on a diversified portfolio. The following table shows the actual allocation of the money.

Financial Options	Money Allocated ($)	Percentage (%)
Stocks	$5,000	25%
Bonds	$6,500	32.5%
Real Estate	$3,500	17.5%
Treasury Bills	$3,500	17.5%
Cash	$1,500	7.5%
Total	**$20,000**	**100%**

The following Pie Chart shows us how the money is allocated among the five financial options.



CHOOSING AN INVESTMENT ADVISOR

In the beginning of this publication we emphasized the need for an investment advisor for consumers who are not too familiar with basic investing. For such consumers, investment advisors can design and implement investment portfolios around the investor's financial needs and goals. Before hiring an investment advisor all consumers should do the following:

- Know your investment goals.
- Examine your current financial situation.
- Acquire some basic knowledge about investing and different financial products.
- Get recommendations from your friends, business colleagues and personal bankers who are already successful investors.
- Research various investment advisors and find out about their services and fees.
- Document the questions you want to ask your potential investment advisor before the initial meeting.

All potential investment advisors should be registered and in good standing with the appropriate regulatory bodies of their state. Investment advisors should also be able to provide a list of references upon request. Be wary of advisors who make extraordinary claims, especially regarding extremely high returns. When you finally select your investment advisor, request a written advisory contract or engagement letter to document the nature and scope of services the planner will provide. The contract or the letter should also clarify how the investment advisor will be compensated for his/her services.

If you have any questions or comments regarding this publication, please contact Nemal Perera at [nemal@creditguard.org.](mailto:nemal@creditguard.org)

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