Investing, Saving, Bonds, Stock

Time is the friend of the wonderful business, the enemy of the mediocre.

Warren Buffett

Private Enterprise and Investing

- Investment is the act of redirecting resources from being consumed today so that they may create benefits in the future.
- In short, investment is the use of assets to earn income or profit.
- When people save or invest their money, their funds become available for businesses to use to expand and grow. In this way, investment promotes economic growth.

The Financial System

- When savers invest, they receive documents confirming their deposit or bond purchase, such as passbooks or bond certificates.
- These documents are known as financial assets. They represent claims on property or income of the borrower.
- A financial system is a system that allows the transfer of money between savers and borrowers.

Financial Intermediaries

- Financial intermediaries are institutions that help channel funds from savers to borrowers.
  - Banks, Saving and Loan Associations and Credit Unions -- Take in deposits from savers and then lend some of these funds to various businesses.
  - Finance Companies -- Make loans to consumers and small businesses, but charge borrowers higher fees and interest rates to cover possible losses.
  - Mutual Funds -- Pool the savings of many individuals and invest this money in a variety of stocks and bonds.
  - Life Insurance Companies -- Provide financial protection to the family or other beneficiaries of the insured.
  - Pension Funds -- Are set up by employers to collect deposits and distribute payments to retirees.

Diagram: The Flow of Savings and Investments

Financial intermediaries accept funds from savers and make loans to investors.

Savers make deposits to....

Financial Institutions that make loans to....

- Commercial Banks
- Saving and Loan institutions
- Savings Banks
- Mutual Savings Banks
- Credit Unions
- Life Insurance companies
- Pensions Funds
- Finance Companies

Investors

Services Provided by Financial Intermediaries

- Sharing Risk
  - Diversification is the spreading out of investments to reduce risk. Financial intermediaries help individual savers diversify their investments.
- Providing Information
  - Financial intermediaries reduce the costs in time and money that lenders and borrowers would pay if they had to search out investment information on their own.
- Providing Liquidity
  - Financial intermediaries allow savers to easily convert their assets into cash.

Risk and Return

- Return is the money an investor receives above and beyond the sum of money initially invested.
- Return and Liquidity
  - Savings accounts have greater liquidity, but in general have a lower rate of return.
  - Certificates of deposit usually have a greater return but liquidity is reduced.
- Return and Risk
  - Investing in a friend's Internet company could double your money, but there is the risk of the company failing.
  - In general, the higher potential return of the investment, the greater the risk involved.

Bonds as Financial Assets

Bonds are basically loans or IOUs that represent debt that the government or a corporation must repay to an investor. Bonds have three basic components.

1. The coupon rate -- the interest rate that the issuer will pay the bondholder
2. The maturity -- the time when payment to the bondholder is due
3. The par value -- the amount that an investor pays to purchase the bond and that will be repaid to the investor at maturity

Not all bonds are held to maturity. Sometimes bonds are traded or sold and their price may change. Economists therefore refer to a bond's yield, which is the annual rate of return on the bond if the bond were held to maturity.

Example: Buying Bonds at a Discount

Investors earn interest on the bonds they buy. They can also earn money by buying bonds at a discount from par.

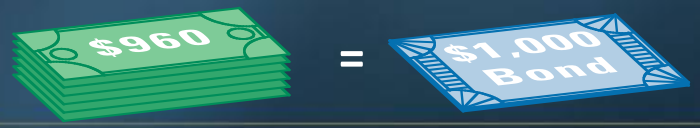
Bond Purchase Without Discount From Par

1. Sharon buys a bond with a par value of $1,000 at 5% interest.

2. Interest rates go up to 6%.

Bond Purchase With Discount From Par

3. Sharon needs to sell her bond. Nate wants to buy it, but is unwilling to buy a bond at 5% interest when the current rate is 6%.
4. Sharon offers to discount the bond, taking $40 off the price and selling it for $960.
5. Nate accepts the offer. He now owns a $1,000 bond paying 5% interest, which he purchased at a discount from par.



Example: Bond Ratings

Standard & Poor's and Moody's rate bonds on a number of factors, including the issuer's ability to make future payments and to repay the principal when the bond matures.

A high bond rating usually means that the bond will sell at a higher price and that the firm will be able to issue the bond at a lower interest rate.

Standard & Poor's		Moody's	
Highest investment grade	AAA	Best quality	Aaa
High grade	AA	High quality	Aa
Upper medium grade	A	Upper medium grade	A
Medium grade	BBB	Medium grade	Baa
Lower medium grade	BB	Possesses speculative elements	Ba
Speculative	B	Generally not desirable	B
Vulnerable to default	CCC	Poor, possibly in default	Caa
Subordinated to other debt rated CCC	CC	Highly speculative, often in default	Ca
Subordinated to CC debt	C	Income bonds not paying income	C
Bond in default	D	Interest and principal payments in default	D

Advantages and Disadvantages to Bond Issuers

- Bonds are desirable from the issuer's point of view for two reasons.
  1. Once the bond is sold, the coupon rate for that bond will not go up or down.
  2. Unlike stock, bonds are not shares of ownership in a company.
- Bonds also pose two disadvantages to the issuer.
  1. The company must make fixed interest payments, even in bad years when it does not make money.
  2. If the issuer does not maintain financial health, its bonds may be downgraded to a lower bond rating. This makes it harder to sell future bonds unless a discount or higher interest rate is offered.

Types of Bonds

- Saving Bonds -- Saving bonds are low-denomination ($50 to $10,000) bonds issued by the United States government. Saving bonds are purchased below par value (a $100 saving bond costs $50 to buy) and interest is paid only when the bond matures.
- Treasury Bonds, Bills and Notes -- These investments are issued by the United States Treasury Department.
- Municipal Bonds -- Municipal bonds are issued by state or local governments to finance such improvements as highways, state buildings, libraries and schools.
- Corporate Bonds -- A corporate bond is a bond that a corporation issues to raise money to expand its business.
- Junk Bonds -- Junk bonds are lower-rated, *potentially* higher-paying bonds.

Other Types of Financial Assets

- Certificates of Deposit
  - Certificates of deposit (CDs) are available through banks, which use the funds deposited in CDs for a fixed amount of time.
  - CDs have various terms of maturity, allowing investors to plan for future financial needs.
- Money Market Mutual Funds
  - Money market mutual funds are special types of mutual funds.
  - Investors receive higher interest on a money market mutual fund than they would receive from a saving account or a CD. However, assets in money market mutual funds are not FDIC insured. Because of that higher risk, they pay a higher interest rate.

Financial Asset Markets

- One way to classify financial asset markets is according to the *length of time* for which the funds are lent.
  - Capital markets are markets in which money is lent for periods longer than a year. CDs and corporate bonds are traded in capital markets.
  - Money markets are markets in which money is lent for periods of less than a year. Short-term CDs and Treasury bills are traded in money markets.
- Markets can also be classified according to whether assets can be *resold* to other buyers.
  - Primary markets involve financial assets that cannot be transferred from the original holder, such as savings bonds.
  - Secondary markets involve financial assets that can be resold, such as stocks.

Buying Stock

Corporations can raise money by issuing stock, which represents ownership in the corporation. A portion of stock is called a share. Stocks are also called equities.

Stockowners can earn a profit in two ways.

1. Dividends, which are portions of a corporation's profits, are paid out to stockholders of many corporations. The higher the corporate profit, the higher the dividend.
2. A capital gain is earned when a stockholder sells stock for more than he or she paid for it. A stockholder that sells stock at a lower price than the purchase price suffers a capital loss.

Types of Stock

- Stocks may be classified either by whether or not they pay dividends or whether or not the stockholder has a say in the corporation's affairs.
- Dividend Differences
  - Income stock pays dividends at regular times during the year.
  - Growth stock pays few or no dividends. Instead, the issuing company reinvests earnings into its business.
- Decision-Making Differences
  - Investors who buy common stock are voting owners of the company.
  - Preferred stock owners are nonvoting owners of the company, but receive dividends before the owners of common stock.

Stock Splits and Stock Risks

- Stock Splits
  - A stock split is the division of a single share of stock into more than one share.
  - Stock splits occur when the price of a stock becomes so high that it discourages potential investors from buying it.
- Risks of Buying Stock
  - Purchasing stock is risky because the firm selling the stock may encounter economic downturns that force dividends down or reduce the stock's value. Stocks are considered a riskier investment than bonds.

How Stocks Are Traded

- A stockbroker is a person who links buyers and sellers of stock.
- Stockbrokers work for brokerage firms, businesses that specialize in trading stock.
- Some stock is bought and sold on stock exchanges, markets for buying and selling stock.

Stock Exchanges

- The New York Stock Exchange (NYSE)
  - The NYSE is the country's largest stock exchange. Only stocks for the largest and most established companies are traded on the NYSE.
- NASDAQ-AMEX
  - NASDAQ-AMEX is an exchange that specializes in high-tech and energy stock.
- The OTC Market
  - The OTC (over-the-counter) market is an electronic marketplace for stock that is not listed or traded on an organized exchange.
- Daytrading
  - Daytraders use computer programs to try and predict minute-by-minute price changes in hopes of earning a profit.

Futures and Options

Futures are contracts to buy or sell at a specific date in the future at a price specified today.

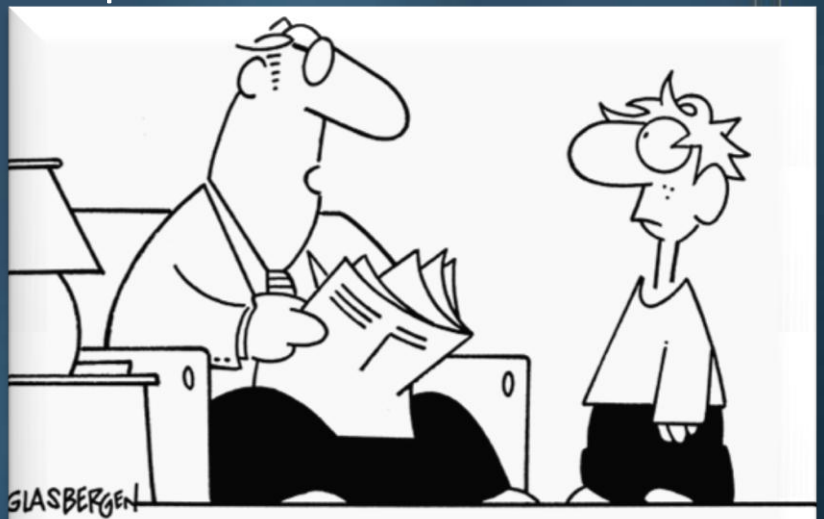
Options are contracts that give investors the option to buy or sell stock and other financial assets.

There are two types of options.

1. Call options give buyers the option to buy shares of stock at a specified time in the future.
2. Put options give buyers the option to sell shares of stock at a specified time in the future.

Measuring Stock Performance

- Bull and Bear Markets
  - When the stock market rises steadily over time, a bull market exists. Conversely, when the stock market falls over a period of time, it's called a bear market.
- Stock Performance Indexes
  - The Dow Jones Industrial Average is an index that shows how the stocks of 30 companies in various industries have changed in value.
  - The S & P 500 is an index that tracks the performance of 500 different stocks.



"They picked 2 animals to represent the Stock Market. Sometimes your money is trampled by a bull, sometimes it's ripped apart by a bear."

The Great Crash

- The collapse of the stock market in 1929 is called the Great Crash.
- Causes of the Crash
  - Many ordinary Americans were struggling financially. Many purchased new consumer goods by borrowing money.
  - Speculation, the practice of making high-risk investments with borrowed money in hopes of getting a big return, was common.
- Effects of the Great Crash
  - The Crash contributed to a much wider, long-term crisis -- the Great Depression during which many people lost their jobs, homes and farms.
  - Americans also became wary of buying stock. As recently as the early 1980s, only about 25% of US households owned stock.

The End