Financial Literacy: How to Become an Investor
(it's easier than you think)

What is Investing?

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When we consider investing, many of us automatically think we don't have enough money to invest. The truth is that investing has been around since the 1600s in an assortment of vehicles for all sizes of investors.

In very basic terms, investing is spending money and anticipating a profit. A simple savings account is a type of investment, a safe investment to be sure, but not a very profitable one. You put your money into a savings account and your bank pays you a very small amount of interest each year. And, while investing is for everyone, the nature and amount of your investment, and a strong knowledge base will help you determine the best investment for your needs.

Your portfolio is your "book" of investments.

Portfolio diversification is usually recommended as it provides some protection should one particular industry that you invest in suffers a fall.

For example, if you invest all your funds in the utility industry and the industry does not perform well, your entire portfolio will sustain a loss. Divesting into multiple industries is usually the better option.

Typical methods of investing include:

- Stocks and Bonds (Growth Stocks, Small Cap Funds, Blue Chip Stocks, Municipal Bonds)
- Mutual Funds
- Properties/Real Estate
- Life Insurance
- Self-Directed Individual Retirement Accounts (IRAs)
- 401(k) Retirement Savings Accounts
- Health Savings Accounts
- Savings Accounts, Certificates of Deposit (CDs), Fixed Annuities, Treasury Bills (T-Bills)

There are also a number of alternative, generally higher risk, investment types, including Exchange Traded Funds (ETFs), cryptocurrency, options, derivatives, futures, commodities, and online businesses.

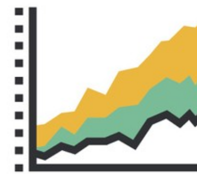
More information follows about the meaning and risks associated with each of these investments, so keep reading to find out more. We'll also learn more about the risks and returns, and the varied types of investors.

Remember, there is no right or wrong when it comes to investing, it's all a matter of your degree of risk tolerance versus the potential return on your investment.

Investing isn't only for a select few, it's for all of us. This series is designed to help you increase your investing knowledge-base, find out the questions you may not have known to ask, and get you started on the path towards investing.

Investment Vehicles

Let's take a closer look at the different types of investments available to investors.



Stocks and Bonds (Growth Stocks, Small Cap Funds, Blue Chips, Municipal Bonds)

Both stocks and bonds are ways a business can raise funds to fund projects or expand operations.

By selling stocks, the company sells a portion of its business to investors and receives cash in exchange.

A bond, on the other hand, becomes a liability or debt to the business to be paid back later with interest to the investor.

With stocks, a successful business can go public by splitting the company into shares, which are then sold on the market during an initial public offering (IPO). By selling their equity to you, you own a portion of the

business the size of which is based on the number of shares offered. These shares become part of the company Balance Sheet as Stockholders Equity. Assuming the company performs well, you can expect the stock price to rise, increasing the value of your ownership. The risk you accept upon purchase is that if the business does not perform well and the share price drops below your original investment, you lose money.

Example: If you purchased 100 shares of Amazon stock back in 1997 when it was first offered at $18 per share, you would have spent $1,800 plus any fees and commissions. Today, those 100 shares are worth an estimated $1,750 per share (June 2019) and your initial investment would be worth $175,000.

And that doesn't count the stock splits that have taken place over the years. A stock split happens at the discretion of the company's Board of Directors when added shares are granted to existing shareholders. For example, in a two for one split, an owner of 100 shares would receive an added 100 shares, at no added cost to the shareholder. Splits generally reduce the stock price temporarily.

Another means of raising funds for the business is to create debt for themselves or issue bonds. The business borrows money from investors and pays them what is known as the par value, which is the selling price plus interest via coupons. Par value is also known as your initial principal investment and the interest rate assigned to the coupon.

Example: You purchase a $2,000 bond with a 4% coupon rate. You can expect $80 interest per year (that's the coupon rate) until the maturity date when you also are repaid your initial $2,000 investment. While bonds can default if the business is not able to make the repayment, or declares bankruptcy, they are generally considered a low-risk investment.

When purchasing bonds, make sure you buy at a discount (paying less than the face value) and not a premium (paying more than the face value). Remember there are several types of bonds and issuers.

Growth Stocks are expected to grow at a significantly faster rate than the average market and usually do not pay a dividend because companies want to reinvest them to accelerate short term growth. As an investor in growth stocks, you benefit via capital gains when you sell your shares.

Growth stocks are usually found in the technology and biotech industries and present some added risks because the company could suffer losses before you sell your shares. Most growth stocks offer a specialized product and, by reinvesting their dividends, try to stay ahead of the pack regarding new technologies.

Small Cap Funds can also be growth stocks, but are considered "small cap" because they have a lower market value. The small-cap can be defined differently by brokerage firms; however, most tend to be companies with asset values between $300,000,000 and $2,000,000,000.

The advantage of small-cap funds is that they historically have outperformed large-cap and you can usually make your purchase ahead of institutional investors, which is a bit more risky, but has a lot more potential for growth.

Blue Chip Stocks are more well-known, and the term is probably familiar to you. Larger, older and more stable companies are considered blue chip. In order to qualify as blue chip, dividends must be paid, which are customarily larger than most, and more stable. These are also more expensive stocks, for example, IBM and Coca-Cola.

While the bankruptcies of large, reputable companies like General Motors and Lehman Brothers occurred in the 2008 recession, blue chips are generally perceived as safe investments.

The Dow Jones Industrial Average is made up of 30 blue chip stocks. See page 25 for a list of these stocks along with their Weiss Overall Rating, Closing Price, 1-Year Total Return, and 5-Year Total Return.

Municipal Bonds are also securities and, as we noted above in the stocks and bonds section, they are loans made to local governments, cities, states, or counties. The good news regarding municipal bonds is that most interest payments are tax-free to the investor.

There are general obligation bonds, which means the bonds are paid back using current tax revenues, and revenue bonds, which are paid back from the revenues of a specific project like the construction of a toll highway. It's important to note that if the revenue source (the toll highway for example) fails to generate revenue, the municipality is not required to repay the issued bonds.

Since they are typically tax-free, municipal bonds usually offer a lower interest rate, and interest is normally paid twice per year. The bond amount (principal investment) is repaid at the end of the bond term, which can vary from three years to more than ten years.

These are a good investment for an investor who needs tax free income, usually those investors in the highest income tax brackets.

Mutual Funds

Pools of money that come from public investors are called mutual funds. Managed by a professional, the funds are invested in many different securities, so when you invest in this type of fund, you are really buying a portion of an existing portfolio that offers you a net asset value (NAV). You can arrive at the NAV by dividing the total value of the securities by the total number of shares.

Unlike stock share prices, which can vary throughout the business day, mutual funds are valued at the end of each business day.

By virtue of the hundreds of stocks held in a mutual fund, the portfolio is automatically diverse with all types of industries. If one stock takes a loss, others may experience gains, so investors are not tied to one company or one industry. Most mutual funds offer low prices and annual fees.

There are four basic types of mutual funds:

- Equity funds are mostly invested in stocks and can be further broken down by cap-size and domestic versus international stocks.
- Fixed income funds are largely invested in municipal bonds and other debt instruments because they offer a fixed income stream.
- Index funds are created with a cost-sensitive investor focus and are built based on a major market index like the S&P 500 or Dow Jones. Because less effort is required on the part of the fund manager, these are a less expensive fund investment.
- Balanced funds are a mix of stocks and bonds with a general goal of asset appreciation; while a loss can occur, they are considered lower risk.

Again, there are numerous fund types that come with annual returns and operating expenses, so watch the fee schedules!

Example: If you invest $10,000 with a 10% annual return after 20 years, you would have earned about $50,000 if operating expenses were about 1.5%. Contrast that with operating expenses of 0.5%, in which case your earnings would be $60,000.

There are five main classes of mutual funds.

- Class A shares usually have a front-load, meaning you pay the fee at the time of purchase. If you already have shares or if you purchase many shares, ask about a fee discount. Funds in the A-class may also provide for

less of a 12-b-1 fee, which is a fee permitted by federal regulations to cover marketing and distribution.

- Class B shares have no front load fees, but you are likely to pay a fee upon sale. If you hold your shares for five or more years, the selling fee may be waived. Expect higher maintenance and management fees as well as a higher 12-b-1 fee.

- Class C shares vary by fund, so you may find no loads, front loads, fees at sale time as well as 12-b-1 fees. Class C fees are often lower but rarely waived no matter how many or how long you've held the shares. This class is the suggested buy for beginners or those who have a limited amount to invest.

- Class I shares are sold to institutional shareholders. Also called Y-Shares, these have different fees and do not charge traditional loads.

- Class R shares, also known as K shares, are for retirement accounts, and the R share class mutual funds are only available through employer-sponsored retirement plans. R share mutual funds do not have any loads, but they do have annual asset based fees typically 0.25% to 0.50%.

When evaluating which class of mutual fund is right for you:

- Assess the price variances between each class;
- Determine if any discounts apply and when they apply;
- When in doubt, always consult your advisor for counsel.

Properties/ Real Estate

Investing in real estate can be a bit overwhelming, but knowledge is key.

We all live through a variety of life stages with goals which change as we age. The stages are (1) just starting out as young adults working to provide ourselves with the basic needs of housing and food. Next, we hopefully become (2) stable, then (3) savers, then (4) growers, and finally (5) financially independent.

If you are in stages one or two, you can build your knowledge-base about the real estate options available to you now and in the future. You can rent a home or apartment, or master lease a residence and rent out bedrooms, reducing your monthly payments. Another option is to work

with another real estate investor to help find deals and learn the process.

By becoming a buying agent, you can help purchasers find their homes, learning the retail housing business. You can also be a leasing agent by matching properties managed by a landlord or property manager with potential tenants, learning that side of the housing market. Finally, by overseeing remodeling projects for fellow investors you will gain insights into how to remodel in the most cost-effective manner.

In stages three and four, based on the knowledge you have already acquired, it would be smart to purchase your first home and flip it. Make improvements that add value and resell for a profit or keep it as a rental property. Charge rent based on your mortgage payment plus a profit for you.

As you move into the growth phase of life, buy more homes with either cash or by borrowing and paying down more quickly than required with regular principal curtailments that are as large as you can afford.

As you become financially independent, keep your debt low and continue to pay it off quickly, or refinance with long term debt and low-interest rates. Sell off lower quality properties and keep investing in higher quality ones.

You can also make loans to beginning investors but be sure you feel confident about the borrower's ability to repay in a timely manner and acquire the appropriate documentation to support the debt. You generally want to keep your debt to income ratio below 33%.

Next, where do you want your investments to be located — close to your residence or in a different market? Start by researching Metropolitan Statistical Areas (MSA) and narrow your search down to a zip code(s). Some things to consider are school districts; crime experiences; proximity to shopping, parks, recreation; public transportation; rent to price ratio; job availability; homeowner associations; and population growth statistics.

The next step is to determine your target market and criteria. For example, single-family homes with "X" number of bedrooms/baths, in the price range of $X, with/without a garage, yards, decks or patios, etc. When considering price be sure to include all costs as well as any repairs or improvements you need to make before you rent or resell. For single-family homes, for example, you want at least $200 added monthly income over your costs.

Determine your financing resources, like the Federal Housing Authority (FHA), the Veterans Administration (VA), private lenders, and banks or credit unions. The best-case scenario is seller financing, which is when the seller of the home has the equity to finance the sale on their own, which

offers your more creative options for repayment. You can also use an IRA or 401(k) to pay for home purchases.

You can raise cash from your own savings, you can go into the deal with a partner, borrow on your own or sell off existing properties at a profit.

Start looking for deals! Be sure to carefully schedule your time tracking your next steps so you don't overwhelm yourself with work to be done before you are able to move to the income earning phase of your purchases.

Example: If you purchase a home for $250,000, resell that home for $500,000, you've made $250,000; however, you must also consider the return on investment (ROI) when you invest in real estate. ROI is a calculation of how much profit you make as a percentage of your investment.

Use the following formula:

Divide the Cost of the Investment by the difference between the Cost of Investment and the Gain on Investment.

Gain on Investment (assuming you sold after two years) = $4,600
Cost of Investment = $2,000

$2,000 divided by the difference of $4,600 and $2,000 ($2,600) and you get a 76.9% gain.

Life Insurance

If you are considering investing in life insurance, you will want to consider a whole life policy rather than a term life policy. A whole life policy never expires, and it also has a cash value portion. Part of a whole life policy premium is applied to the policy while another part goes toward an interest-bearing investment. The interest rate is fixed.

Whole life policies are more costly than term policies. If you are already into your retirement years, this may not be the best investment option for you because you have fewer investment years left.

A term life insurance policy only offers a benefit upon your death, so the beneficiary(s) named on the policy will receive the funds. Terms vary from one to 30 years.

There are other types of life insurance (universal, variable, simplified, guaranteed issue, final expense, and group); however, from an investment perspective, we suggest the whole life category.

The cost of life insurance varies greatly. Several factors weigh on this calculation, like smoking, overall health, age, obesity, etc.

Example: 30-year-old female gets a $1,000,000, 20-year policy that costs

her $480 annually. If she dies at the age of 49, her 19 years of payments total $9,120; however, her beneficiaries will receive the full $1,000,000 payout. The less healthy she is, the higher her payments would be.

Self-Directed Individual Retirement Accounts (IRAs)

The difference between a self-directed IRA and a traditional IRA is that the self-directed IRA offers you more investments options.

Traditionally IRAs invest in stocks, bonds, and other more common investments. When you self-direct, you can invest in anything from a private company to a horse breeding facility or a rental property, understanding that these are usually higher risk investments.

Not all brokerage firms offer self-directed IRAs, but if you find one, you can expect higher returns and more diversification. Brokerage firm names are included later, to get you started on this quest.

Note that traditional IRA contributions are state and federal tax deductible for the year you make the contribution, and withdrawals are taxable at the normal income tax rate. Roth IRAs do not permit contribution tax breaks, but both earnings and withdrawals are usually tax-free. The IRS defines what investments are allowable in this investment vehicle.

If you are under the age of 50, the maximum investment for 2019 is $6,000. If you exceed the age of 50, you are permitted to invest an added $1,000. The rest is up to the performance of the chosen investment and as discussed in Part 1, a diverse portfolio is recommended. IRS rules govern IRAs, so be aware of prohibited transactions as well as tax implications for your unique circumstances.

401(k) Retirement Savings Accounts

Most employers offer 401(k)s and offer a matching program. If you aren't currently participating in your company provided 401(k), start today, especially if they offer to match funds. You will want to contribute at least as much as the company matches otherwise you are leaving money on the table.

A 401(k) is a very good retirement tool as you remain employed. These plans are tax-qualified and offer you defined contributions, as determined by the IRS. Although only in existence since the 1970s, they are a very popular investment vehicle. Contributions are automatically

deducted from your pay BEFORE taxes are assessed (pre-tax), so you pay fewer taxes during your working years.

Generally, if you wait until the age of 59 or older to withdraw from your 401(k), your withdrawals are without penalties. In many cases, you can obtain a loan from your 401(k). You are not required to make withdrawals from the account until you reach the age of 70. Prior to age 70, withdrawals are subject to ordinary income taxes.

With an employee 401(k) plan, there are factors that should be considered when you decide what percentage of your salary you want to invest.

Example: Let's look at an employee who makes $75,000 annually and opts to contribute 10% of their salary per paycheck. Assume the employee is 30 years of age and expects to work to age 65 with 2% annual salary increases. Assuming a 7% annual rate of return, the employee can expect to contribute about $382,500 of their own money over the course of 35 years. If the employer matches half of the employee's contribution, up to 6%, their contribution will be nearly $115,000 when the employee turns 65, the employee will have a total amount of $1,755,400. If there is zero matching (which is rare), the total is still considerable, at $1,350,300.
If you aren't participating in a 401(k) now and one is offered at your place of employment, sign up today!
Earnings will vary based on the nature of the investment vehicles chosen for your 401(k) plan.

Search online for a 401(k) calculator to learn more.

Health Savings Accounts

Health Savings Accounts (HSA) can be opened by individuals who are enrolled in high deductible health plans (HDHP) and offer a tax advantage because contributions are not subject to federal income tax. George W. Bush signed HSAs into law in December 2003.

Withdrawals from an HSA can be made at any time for medical expenses as defined by the IRS. Employers can make HSA contributions, and many do so as a way of encouraging employees to participate in an HDHP which offers the participant lower monthly premiums but higher deductible amounts.

Like the 401(k), HSA contributions are made on a pre-tax basis. The IRS defines annual contribution limits, as well as catch-up limits for individuals over the age of 55. Medicare participants are not eligible for an HSA.
Much like an IRA, funds in an HSA can be invested and those investment earnings are not taxable until withdrawal.

Health Savings Accounts (HSA) are akin to IRAs in that they are governed by the IRS and there are maximum annual contributions set each year. In 2019, the maximum contribution for an individual is $3,500 and $7,000 for a family.

Remember that your annual contribution reduces your income tax and since you're in a High Deductible Health Plan (HDHP), your monthly premium is lower than average as well. So, opening an HSA at your first employment opportunity allows you to invest for several years when your medical expenses are usually at the lowest level of your lifetime.

Those funds accumulate over the years. At the age of 50, if you require major surgery, the balance in your HSA will more than cover your deductible.

Look for HSA calculators online to dig deeper into your specific financial needs and goals.

If you're looking for a way to save for upcoming medical expenses or some added flexibility regarding your health care, a high deductible health plan (HDHP) may be the right product for you. It easily combines a Health Savings Account (HSA) or a Health Reimbursement Account (HRA) with your medical insurance for some tax benefit.

The drawback, particularly if you are an older investor or are in poor health, is that the deductible is usually quite high, and it must be met before the health plan kicks in to pay for covered services. The good news is once your deductible is met, you are covered 100 percent for the remainder of that calendar year. If, for example, you face a diagnosis that requires long term treatments, surgeries, etc., you have protection for in-network care, co-payments and prescriptions. Be sure you read the fine print before you sign up for a HDHP!

Savings Accounts, Certificates of Deposit (CDs), Fixed Annuities, Treasury Bills (T-Bills)

Savings accounts are the most common means of saving and have been around the longest. Unfortunately, the current interest rates are so low, your earnings will be low and slow.

On a more positive note, savings accounts are federally insured and if you don't make any withdrawals, your funds will add up in a safe, secure location. And if necessary, your funds are available to you easily. Review bank rules to determine what, if any, fees apply and if minimum balances are required.