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Understanding Personal Finances and Investments

Learning Objectives

What you will be able to do once you complete this chapter:

1. Explain why you should manage your personal finances and develop a personal investment program.
2. Describe how the factors of safety, risk, income, growth, and liquidity affect your investment program.
3. Understand how securities are bought and sold.
4. Recognize how you can reduce investment risk and increase investment returns.
5. Identify the advantages and disadvantages of savings accounts, bonds, stocks, mutual funds, and real estate investments.
6. Describe high-risk investment techniques.
7. Use financial information to evaluate investment alternatives.

FYI

inside business

Did You Know?

Raymond James, based in St. Petersburg, Florida, has 5,300 financial advisors working in 2,300 offices worldwide and rings up $2.6 billion in annual revenue.

Raymond James: Professional Investing with the Personal Touch

Expert financial advice, personalized service, and access to a wide range of investments—that's how Raymond James has built its reputation as a brokerage firm and investment bank. Since 1964, when Edward Raymond and Robert A. James merged their companies, Raymond James has been offering investment advice from its headquarters in St. Petersburg, Florida, as well as from its 2,300 offices worldwide.

Raymond James's 5,300 financial advisors help its two million customers choose just the right mix of investments to build a sizable nest egg for retirement, save for major outlays such as paying for a child's education, or put money aside for the next generation. Taking individual needs and concerns into consideration, an advisor examines each customer's assets, expenses, investments, and overall financial situation. Then he or she prepares a detailed financial plan for meeting the customer's short- and long-term investment goals, with the flexibility to make changes as requirements change and markets move up or down.

So that its advisors can make informed recommendations about buying and selling stocks, bonds, and other investments, Raymond James's economists monitor the global financial system and its securities analysts follow the fortunes of more than 1,000 public corporations. In addition, Raymond James works closely with companies to set up and manage retirement plans and provide a menu of investment choices for business owners, managers, and employees. On the investment banking side, it helps corporations obtain either debt or equity financing from sources such as an initial public offering, private placement, issuance of corporate bonds, and other sources.

Thanks to its reputation for providing professional, quality service with the personal touch, Raymond James is able to compete effectively against larger brokerage rivals such as Charles Schwab and Fidelity Investments. In fact, Raymond James now rings up $2.6 billion in annual revenue and has been attracting new customers and expanding its investment offerings for individual investors. The company is ready to help customers make the most of their investments and make sound financial decisions for today and tomorrow.[1]

As the saying goes, "I've been rich and I've been poor, but believe me, rich is better." Yet, just dreaming of being rich does not make it happen. Although being rich does not guarantee happiness, managing your personal finances and beginning an investment program are both worthy goals. Firms such as Raymond James—the company profiled in the Inside Business feature for this chapter—offer an array of services to help people manage their personal finances, research investments, and buy and sell stocks, bonds, mutual funds, and other securities. Nevertheless, you must be willing to invest the time and effort required to manage your personal finances and become a good investor. Furthermore, do not underestimate how important you are when it comes to managing your money. No one is going to make you manage your money. No one is going to make you save the money you need to fund an investment program. These are your decisions—important decisions that literally can change your life.

Many people ask the question: Why begin an investment program now? At the time of publication, this is a very important question given the recent economic crisis. Although it is true that many investors have lost a great deal of money as a result of the crisis, the experts agree that the best investment program is one that stresses long-term growth over a 20- to 40-year period. Although the dollar value of your investments may decrease over a short time period, historically the value of securities has always increased over a long time period. To illustrate this point, it may help to think of the financial markets as a roller coaster ride with ups (periods of increasing values) and downs (periods of declining values). The recent crisis is a very real example of how worldwide economic problems can cause the value of stocks, bonds, mutual funds, real estate, and other investments to decline. Faced with large dollar losses, many investors make a decision to sell their investments at the bottom of the roller coaster ride. The investors who decide to hold their investments will eventually see them recover and increase in value over time. In fact, many experts recommend buying quality stocks, mutual funds, and real estate during an economic downturn.

A second compelling reason to start an investment program is that the sooner you start an investment program, the more time your investments have to work for you. So why do people wait to begin investing? In most cases, there are two reasons. First, they do not have the money needed to fund an investment program. However, once you begin managing your personal finances and get your spending under control, you will be able to save the money needed to fund an investment program. The second reason people do not begin investing is because they do not know anything about investing. Again, this chapter provides the basics to get you started.

We begin this chapter by examining everyday money management activities and outlining the reasons for developing a personal investment plan. Next, we examine the process of buying and selling securities. Then we discuss both traditional and high-risk (or speculative) investments. Finally, we explain how to use information to evaluate potential investments. It is time! Take the first step, and begin managing your personal finances.

Managing Your Personal Finances

1

Explain why you should manage your personal finances and develop a personal investment program.

Although it would be nice if you could accumulate wealth magically, it is not magic. Most people begin by making sure that their "financial house" is in order. In this section, we examine several steps for effective money management that will help you to prepare for an investment program.

Step 1: Tracking Your Income, Expenses, Assets, and Liabilities

net worth the difference between the value of your total assets and your total liabilities

Many personal finance experts recommend that you begin the process of managing your money by determining your current financial condition. Often the first step is to construct a personal income statement and balance sheet. (*Note*: Both personal income statements and balance sheets were examined in more detail in Chapter 17.) A *personal income statement* lists your income and your expenses for a specific period of time—usually a month. By subtracting expenses from income, you can determine if you have a surplus or a deficit at the end of the time period. Surplus funds can be used for savings, investing, or for any purpose that you feel is important. Simply put: It is your choice how you spend the surplus. On the other hand, if you have a deficit, you must take actions to reduce spending and pay down any debts you may have that will keep you from starting an investment program.

To get another picture of your current financial condition, you should construct a personal balance sheet. A *personal balance sheet* lists your assets and liabilities on a specific date. By subtracting your total liabilities from your total assets, you can determine your net worth. For an individual, **net worth** is the difference between the value of your total assets and your total liabilities. Over time, the goal is to increase the value of your assets (items of value that you own) and decrease liabilities (your debts).

Based on the information contained in these two statements, you can determine your current financial

A good investment program can make a difference. The driving force behind your investment program should be the financial goals that are important to you. For some investors, having enough money to retire and sail around the world is a very important goal. For others, financial security and not having to worry about money is a more important goal.

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condition and where you spend your money. You can also take the next step: Construct a personal budget.

Step 2: Developing a Budget that Works

A **personal budget** is a specific plan for spending your income. You begin by estimating your income for a specific period—for example, next month. For most people, their major source of income is their salary. The second step is to list expenses for the same time period. Typical expenses include savings and investments, housing, food, transportation, entertainment, and so on. For most people, this is the area where you can make choices and increase or decrease the amount spent on different items listed in your budget. For example, you may decide to reduce the dollar amount spent on entertainment to increase the amount for savings. Above all, it is important to balance your budget so that your income is equal to the money you spend, save, or invest each month.

After you have constructed your personal budget, you will need to compare the amounts included in your budget with your actual income and expenses. The goal is that estimated income and expenses are correct and that you have a surplus at the end of the budgeting period. If income is less than anticipated or expenses are more than budgeted, then you will need to take corrective actions to get your budget back on track. For example, you may need to review areas where spending has been more than expected.

Like most personal financial planning, it will be necessary to review your budget on a regular basis. Certain changes in income or expenses may trigger a budget revision. A salary increase, for example, will affect your personal budget. Often one change will affect other areas of your budget as well. An increase in your monthly rent payment, for instance, may mean that you have to reduce the amount spent on entertainment to balance your budget. *Caution*: Avoid the temptation to spend more than you make by using credit cards or borrowing money.

Step 3: Managing Credit Card Debt

Unfortunately, many individuals spend more than they make. They purchase items on credit and then make monthly payments and pay finance charges ranging from 10 to 21 percent or more. It makes no sense to start an investment program until payments for credit card and installment purchases, along with the accompanying finance charges, are reduced or eliminated.

Although all cardholders have reasons for using their credit cards, the important point to remember is that it is *very easy* to get in trouble by using your credit cards. Watch for the following five warning signs.

1. Don't fall behind on payments. One of the first warning signs is the inability to pay your entire balance each month. Experts suggest that you pay your balance in full each month if you use credit cards.
2. Do not use your credit cards to pay for many small purchases during the month. This can often lead to a "real surprise" when you open your credit card statement at the end of the month.
3. Do not use the cash advance provision that accompanies most credit cards. The reason is simple: The interest rate is usually higher for cash advances when compared to credit card purchases.
4. Think about the number of cards you really need. Most experts recommend that an individual have one or two cards and use these cards for emergencies.
5. Get help if you think you are in trouble. An organization like Consumer Credit Counseling Service (http://www.cccs.net) can often help you work out a plan to pay off credit card debt.

By reducing or eliminating credit purchases, eventually the amount of cash remaining after the bills are paid will increase and can be used to start a savings and investment program that will help you obtain your investment goals.

personal budget a specific plan for spending your income

Career SUCCESS

It Is Never Too Early to Think About Retirement

Whether you are interviewing for your first full-time job or have already started climbing the career ladder, it is never too early to think about retirement. Here are some questions to help you think through the possibilities:

Does your employer offer a defined benefit retirement plan? These pension plans provide a specific monthly amount after you retire. Your employer sets up the plan, makes contributions, and handles investment decisions. Check the fine print: Even if you change jobs, you may still be able to receive pension income after retiring.

Does your employer offer a 401(k) plan (or, in the case of non-profits and government agencies, a 403(b) plan)? These plans allow you, the employee, to contribute toward your retirement, subject to a yearly cap, with many employers matching some or all of an employee's contributions. You will make investment decisions from a menu of options provided by your employer, usually mutual funds.

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Are you eligible for a traditional IRA or Roth IRA account? If your employer has no retirement plan, and your income meets IRS guidelines, consider a traditional IRA or Roth IRA to start investing on your own. Contributions to traditional IRAs are tax-deductible and provide immediate tax benefits. With a traditional IRA, you pay tax on the money you withdraw when you retire. Contributions to Roth IRAs are not tax-deductible. However, you do not pay tax on money you withdraw after you retire.

Remember: The sooner you begin an investment program, through your employer or on your own, the better off you will be at retirement. It's never too early to start!

Sources: Veronica Dagher, "The Game Plan: He's Young—and a Saver," *The Wall Street Journal,* April 12, 2010, http://www.wsj.com; Walter Updegrave, "First Job? Start Your First 401(k)," *Money,* September 3, 2009, http://money.cnn.com/2009/09/03/pf/expert/starter_401k.moneymag/index.htm.

Investment Goals

Personal investment is the use of your personal funds to earn a financial return. Thus, in the most general sense, the goal of investing is to earn money with money. However, such a goal is completely useless for the individual because it is so vague and so easily attained.

In reality, an investment goal must be specific and measurable. It must be tailored to you so that it takes into account your particular financial needs. It must also be oriented toward the future because investing is usually a long-term undertaking. A long-term investment program has a number of advantages. By investing small amounts of money each year over a 20- to 40-year period, you can accumulate money for emergencies and retirement. In addition, if you choose quality investments, the value of your investments will grow over a long period of time. Despite the recent economic crisis, financial experts believe that long-term investors will not only see the value of their investment portfolio recover, but also increase over the next few years. Finally, an investment goal must be realistic in terms of current economic conditions and available investment opportunities.

Some financial planners suggest that investment goals should be stated in terms of money: "By January 1, 2020, I will have total assets of $80,000." Others believe that people are more motivated to work toward goals that are stated in terms of the particular things they desire: "By May 1, 2022, I will have accumulated enough money so that I can take a year off from work to travel around the world." Like the goals themselves, the way they are stated depends on you. The following questions can be helpful in establishing valid investment goals:

1. What financial goals do you want to achieve?
2. How much money will you need, and when?

personal investment the use of your personal funds to earn a financial return

3. What will you use the money for?
4. Is it reasonable to assume that you can obtain the amount of money you will need to meet your investment goals?
5. Do you expect your personal situation to change in a way that will affect your investment goals?
6. What economic conditions could alter your investment goals?
7. Are you willing to make the necessary sacrifices to ensure that your investment goals are met?

A Personal Investment Program

Once you have formulated specific goals and have some money to invest, investment planning is similar to planning for a business. It begins with the evaluation of different investment opportunities—including the potential return and risk involved in each. At the very least, this process requires some careful study and maybe some expert advice. Investors should beware of people who call themselves "financial planners" but who are in reality nothing more than salespersons for various financial investments, tax shelters, or insurance plans.

A true **financial planner** has had at least two years of training in investments, insurance, taxation, retirement planning, and estate planning and has passed a rigorous examination. As evidence of training and successful completion of the qualifying examination, the Certified Financial Planner (CFP) Board of Standards (http://www.cfp.net) in Washington, DC, allows individuals to use the designation CFP. Similarly, the American College (http://www.theamericancollege.edu) in Bryn Mawr, Pennsylvania, allows individuals who have completed the necessary requirements to use the designation Chartered Financial Consultant (ChFC). Most CFPs and ChFCs do not sell a particular investment product or receive commissions for their investment recommendations. Instead, they charge consulting fees that range from $100 to $250 an hour.

Many financial planners suggest that you accumulate an "emergency fund"—a certain amount of money that can be obtained quickly in case of immediate need—before beginning an investment program. The amount of money that should be salted away in a savings account varies from person to person. Most financial planners agree that an amount equal to at least three months' living expenses is reasonable. However, you may want to increase your emergency fund in anticipation of a crisis.

After the emergency account is established, you may invest additional funds according to your investment program. Some additional funds may already be available, or money for further investing may be saved out of earnings. For suggestions to help you obtain the money needed to fund your investment program, see Table 20.1.

financial planner an individual who has had at least two years of training in investments, insurance, taxation, retirement planning, and estate planning and has passed a rigorous examination

Table 20.1	Suggestions to Help You Accumulate the Money Needed to Fund an Investment Program
1.	*Pay yourself first.* Many financial experts recommend that you (1) pay your monthly bills, (2) save a reasonable amount of money, and (3) use whatever money is left over for personal expenses.
2.	*Take advantage of employer-sponsored retirement programs.* Many employers will match part or all of the contributions you make to a 401(k) or 403(b) retirement account.
3.	*Participate in an elective savings program.* Elect to have money withheld from your paycheck each payday and automatically deposited in a savings account.
4.	*Make a special savings effort one or two months each year.* By cutting back to the basics, you can obtain money for investment purposes.
5.	*Take advantage of gifts, inheritances, and windfalls.* During your lifetime, you likely will receive gifts, inheritances, salary increases, year-end bonuses, or federal income tax returns. Instead of spending these windfalls, invest these funds.

Source: Jack R. Kapoor, Les R. Dlabay, and Robert J. Hughes, *Focus on Personal Finance,* 3rd ed. Copyright © 2010 by The McGraw Hill Companies Inc. Reprinted with permission of The McGraw Hill Companies Inc., 353.

Once your program has been put into operation, you must monitor it and, if necessary, modify it. Your circumstances and economic conditions are both subject to change. Therefore, all investment programs should be re-evaluated regularly.

Important Factors in Personal Investment

2

Describe how the factors of safety, risk, income, growth, and liquidity affect your investment program.

How can you (or a financial planner) tell which investments are "right" for your investment program and which are not? One way to start is to match potential investments with your investment goals in terms of safety, risk, income, growth, and liquidity.

Safety and Risk

Safety and risk are two sides of the same coin. *Safety* in an investment means minimal risk of loss; *risk* in an investment means a measure of uncertainty about the outcome. If you want a steady increase in value over an extended period of time, choose safe investments, such as certificates of deposit (CDs), highly rated corporate and municipal bonds, and the stocks of highly regarded corporations—sometimes called *blue-chip stocks*. A **blue-chip stock** is a safe investment that generally attracts conservative investors. Blue-chip stocks are generally issued by corporations that are industry leaders and have provided their stockholders with stable earnings and dividends over a number of years. Selected mutual funds and real estate may also be very safe investments.

If you want higher dollar returns on investments, you must generally give up some safety. In general, *the potential return should be directly related to the assumed risk*. That is, the greater the risk assumed by the investor, the better the potential monetary reward. As you will see shortly, there are a number of risky—and potentially profitable—investments.

Often beginning investors are afraid of the risk associated with many investments. However, it helps to remember that without risk, it is impossible to obtain larger returns that really make an investment program grow. In fact, some investors often base their investment decision on projections for rate of return. You can also use the same calculation to determine how much you actually earn on an investment over a specific period of time. To calculate **rate of return**, the total dollar amount of return you receive on an investment over a specific period of time is divided by the amount invested. For example, assume that you invest $5,000 in Home Depot stock, you receive $95 in dividends, and the stock is worth $5,300 at the end of one year. Your rate of return is 7.9 percent, as illustrated here.

blue-chip stock a safe investment that generally attracts conservative investors

rate of return the total dollar amount of return you receive on an investment over a specific period of time divided by the amount invested

Step 1: Subtract the investment's initial value from the investment's value at the end of the year.

$$\$5{,}300 - \$5{,}000 = \$300$$

Step 2: Add the dividend amount to the amount calculated in step 1.

$$\$95 + \$300 = \$395$$

Step 3: Divide the total dollar amount of return calculated in step 2 by the original investment.

$$\$395 \div \$5{,}000 = 0.079 = 7.9 \text{ percent}$$

Note: If an investment decreases in value, the steps used to calculate the rate of return are the same, but the answer is a negative number. With this information, it is possible to compare the rate of return for different investment alternatives that offer more or less risk.

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What better way to learn about a company and its products and services. Many corporations, like Berkshire Hathaway, use their annual stockholders' meeting to showcase their products and services. In this photo, stockholders are encouraged to visit the exhibit hall to see what the companies owned by Berkshire Hathaway actually sell to their customers. As an added bonus, stockholders can purchase the products and services they like—often at a discount.

Investment Income

Investors sometimes purchase certain investments because they want a predictable source of income. For example, CDs, corporate and government bonds, and certain stocks pay interest or dividends each year. Some mutual funds and real estate may also offer steady income potential. Such investments are generally used by conservative investors or retired individuals who need a predictable source of income.

When purchasing investments for income, most investors are concerned about the issuer's ability to continue making periodic interest or dividend payments. Investors in CDs and bonds know exactly how much income they will receive each year. The dividends paid to stockholders can and do vary, even for the largest and most stable corporations. As with dividends from stock, the income from mutual funds and real estate may also vary from one year to the next.

Investment Growth

To investors, *growth* means that their investments will increase in value. For example, growing corporations such as eBay, Adobe Systems, and the Apollo Group usually pay a small cash dividend or no dividend at all. Instead, profits are reinvested in the business (as retained earnings) to finance additional expansion. In this case, the value of their stock increases as the corporation expands.

Other investments that may offer growth potential include selected mutual funds and real estate. For example, many mutual funds are referred to as growth funds or aggressive growth funds because of the growth potential of the individual securities included in the fund.

Investment Liquidity

Liquidity is the ease with which an investment can be converted into cash. Investments range from cash or cash equivalents (such as investments in government securities or money-market accounts) to the other extreme of frozen investments, which you cannot convert easily into cash.

Although you may be able to sell stock, mutual-fund, and corporate-bond investments quickly, you may not regain the amount of money you originally invested because of market conditions, economic conditions, or many other reasons. It may also be difficult to find buyers for real estate. Furthermore, finding a buyer for investments in certain types of collectibles may also be difficult.

Managing Your Investments in an Economic Crisis

In fall 2007, the stock market, as measured by the Dow Jones Industrial Average, reached an all-time high at 14,000. By March 2009, the same average had declined to 6,600. What happened? The simple answer is that the United States (and most of the world) experienced an economic meltdown. This economic crisis had many causes including a banking and financial crisis, a downturn in home sales, lower consumer spending, and high unemployment rates. Although the economy shows signs of improving at the time of publication, it could happen again.

Although monitoring your investment program and re-evaluating your investment choices are always important, the recent economic crisis underscores the importance of managing your personal finances *and* your investment program. Because of the nation's economic problems, many people were caught off guard and had to scramble to find the money to pay their monthly bills. Many of these same individuals had to borrow money or use their credit cards to survive from one payday to the next. Moreover, some individuals were forced to sell some or all of their investments at depressed prices just to buy food for the family and pay for everyday necessities.

liquidity the ease with which an investment can be converted into cash

If you think the economy is about to take a nosedive, many experts recommend that you take action to make sure your financial affairs are in order. Eight steps you can take are:

1. *Establish a larger-than-usual emergency fund*. Although under normal circumstances, an emergency fund of three months' living expenses is considered adequate, you may want to increase your fund in anticipation of a crisis.
2. *Know what you owe*. It helps to make a list of all your debts and the amount of the required monthly payments. Then identify the debts that *must* be paid. Typically these include the mortgage or rent, medicine, utilities, food, and transportation costs.
3. *Reduce spending*. Cut back to the basics and reduce the amount of money spent on entertainment, dining at restaurants, and vacations. Although not pleasant, the money saved from reduced spending can be used to increase your emergency fund or pay for everyday necessities.
4. *Pay off credit cards*. Get in the habit of paying your credit-card bill in full each month. If you have credit-card balances, begin by paying off the balance on the credit card with the highest interest rate.
5. *Apply for a line of credit at your bank, credit union, or financial institution*. As defined in Chapter 18, a line of credit is a preapproved loan and will provide access to cash if needed for future emergencies.
6. *Notify credit-card companies and lenders if you are unable to make payments*. Although not all lenders are willing to help, many will work with you and lower your interest rate, reduce your monthly payment, or extend the time for repayment.
7. *Monitor the value of your investment accounts*. Tracking the value of your stock, mutual fund, and retirement accounts, for example, will help you decide which investments to sell if you need cash for emergencies. Continued evaluation of your investments can also help you reallocate your investments to reduce investment risk.
8. *Consider converting investments to cash to preserve value*. According to most personal finance experts, investors accumulate more money when they use a long-term approach when investing their money. Nevertheless, there may be times when you could sell some of your investments and place the cash in a savings account to weather an economic crisis. For this strategy to work, you must be able to sell when the economy is beginning a downturn and then repurchase quality investments before the economy begins to rebound.

Above all, do not panic. While financial problems are stressful, it helps to stay calm and consider all the options. Keep in mind that bankruptcy should be a last resort. The reason is simple: A bankruptcy will remain on your credit report for up to ten years.

How Securities Are Bought and Sold

3

Understand how securities are bought and sold.

To purchase a Geoffrey Beene sweater, you simply walk into a store that sells these sweaters, choose one, and pay for it. To purchase stocks, bonds, mutual funds, and many other investments, you often work through a brokerage firm. In turn, an employee of the brokerage firm buys or sells securities for you in either the primary or secondary market. The *primary market,* as discussed in Chapter 19, is a market in which an investor purchases financial securities (via an investment bank) directly from the issuer of these securities. The *secondary market* is a market for existing financial securities that are traded between investors. In the secondary market, securities are traded on a securities exchange or in the over-the-counter (OTC) market with the help of an account executive.

Brokerage Firms and Account Executives

An **account executive**—sometimes called a *stockbroker* or *registered representative*—is an individual who buys and sells securities for clients. Before choosing an account executive, you should have already determined your investment goals. Then you must be careful to communicate these goals to the account executive so that she or he can do a better job of advising you.

account executive an individual, sometimes called a *stockbroker* or *registered representative,* who buys and sells securities for clients

A system that works! Located in New York City's financial district, the New York Stock Exchange (NYSE) allows investors to buy and sell stocks and securities every business day. Organized under a buttonwood tree in 1792, today the NYSE is one of the largest and best-known security exchanges in the world.

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Choosing an account executive can be difficult for at least three reasons. First, you must trust your account executive to make investment recommendations to enhance your wealth. At the same time, your account executive is interested in your investment trading as a means to swell commission. Unfortunately, some account executives are guilty of *churning*—a practice that generates commissions by excessive buying and selling of securities.

Second, account executives are generally not liable for client losses that result from their recommendations. In fact, most brokerage firms require new clients to sign a statement in which they promise to submit any complaints to an arbitration board. This arbitration clause generally prevents a client from suing an account executive or a brokerage firm.

Third, you must decide whether you need a *full-service* broker or a *discount* broker. A full-service broker usually charges higher commissions but gives you personal investment advice and provides detailed research information. A discount broker simply executes buy and sell orders, usually over the phone or online. Most discount brokers offer no or very little investment advice; you must make your own investment decisions.

Before deciding if you should use a full-service or a discount brokerage firm, you should consider how much help you need when making an investment decision. Many full-service brokerage firms argue that you need a professional to help you make important investment decisions. Although this may be true for some investors, most account executives employed by full-service brokerage firms are too busy to spend unlimited time with you on a one-on-one basis, especially if you are investing a small amount. On the other side, many discount brokerage firms argue that you alone are responsible for making your investment decisions. Furthermore, they argue that discount brokerage firms have both the personnel and research materials to help you to become a better investor.

The Mechanics of a Transaction Once investors have decided on a particular security, most simply telephone their account executive or use the Internet to place a market or limit order. A **market order** is a request that a security be purchased or sold at the current market price. Figure 20.1 illustrates one method of executing a market order to sell a stock listed on the New York Stock Exchange (NYSE) at its current market value. It is also possible for a brokerage firm to match a buy order for a security for one of its customers with a sell order for the same security from another of its customers. Matched orders are not completed through a security exchange or OTC. Regardless of how the security is bought or sold, payment for stocks and many other financial securities generally is required within three business days of the transaction.

A **limit order** is a request that a security be bought or sold at a price equal to or better than (lower for buying, higher for selling) some specified price. Suppose that you place a limit order to *sell* Coca-Cola common stock at $52 per share. Your broker's representative sells the stock only if the price is $52 per share or *more*. If you place a limit order to *buy* Coca Cola at $52, the representative buys it only if the price is $52 per share or *less*. Usually, a limit order is good for one day, one week, one month, or good until canceled.

market order a request that a security be purchased or sold at the current market price

limit order a request that a security be bought or sold at a price that is equal to or better than some specified price

Commissions Most brokerage firms have a minimum commission ranging from $7 to $35 for buying and selling stock. Additional commission charges are based on the number of shares and the value of stock bought and sold.

Figure 20.1 Steps in a Typical Stock Transaction on the New York Stock Exchange

Although not quite a horse race, a typical stock transaction takes only about 20 minutes.

1. Account executive receives your order to sell stock and relays order electronically to brokerage firm's representative on floor of NYSE.
2. Firm's clerk signals transaction from booth to broker on stock-exchange floor.
3. Broker goes to trading post where stock is traded with a stock-exchange member who has an order to buy.
4. After the trade is executed, a notice is sent to the brokerage firm and the consolidated ticker tape.
5. Sale appears on the ticker tape, and confirmation is relayed to account executive, who notifies you of completed transaction.

Table 20.2 shows typical commission fees charged by online brokerage firms. Generally, online transactions are less expensive when compared with the costs of trading securities through a full-service brokerage firm. As a rule of thumb, full-service brokerage firms charge as much as 1 to 2 percent of the transaction amount. Commissions for trading bonds, commodities, and options are usually lower than those for trading stocks.

For example, the charge for buying or selling a $1,000 corporate bond typically is $5 to $25. With the exception of most mutual funds, the investor generally pays a commission when buying *and* selling securities. When purchasing mutual funds, you usually pay a commission to buy or sell shares. *Reminder*: For fund investments, you will also pay other fees that are usually assessed each year.

It should be apparent that vast sums of money are involved in securities trading. In an effort to protect investors from unfair treatment, both federal and state governments have acted to regulate securities trading.

Regulation of Securities Trading

Government regulation of securities was begun as a response to abusive and fraudulent practices in the sale of stocks, bonds, and other financial securities. Today, with

Table 20.2 Typical Commission Costs Charged by Online Brokerage Firms

	Internet ($)	Interactive Voice-Response Telephone System ($)	Broker-Assisted ($)
TD Ameritrade	9.99	34.99	44.99
E*Trade	12.99	12.99	57.99
Schwab	12.95	17.95	37.95
Scottrade	7.00	17.00	27.00

Source: The BestCashCow.com Web site at http://www.bestcashcow.com (accessed July 13, 2010).

A man in big trouble. While you may not recognize Daniel Bonventre, you can be sure that many investors know this man. Mr. Bonventre was director of operations for Bernard Madoff Investment Securities LLC. He was arrested in 2010 for helping to run an investment scheme that bilked millions of dollars from investors. To prevent this type of investment fraud, securities regulations are enforced by the Securities and Exchange Commission (SEC).

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so many news reports of banks with a portfolio of bad loans and of corporations that are in "hot water" over financial reporting problems that range from simple mistakes to out-and-out fraud, the concerns of both government officials and investors have grown.

Today, a regulatory pyramid consisting of four different levels exists to make sure that investors are protected. The U.S. Congress is at the top of the pyramid. Early on, Congress passed the Securities Act of 1933 (sometimes referred to as the Truth in Securities Act). This act provides for full disclosure. **Full disclosure** means that investors should have access to all important facts about stocks, bonds, and other securities so that they can make informed decisions. This act also requires that corporations issuing new securities file a registration statement and publish a prospectus. A **prospectus** is a detailed, written description of a new security, the issuing corporation, and the corporation's top management. Since 1933, Congress has passed additional legislation that includes creating the Securities Investor Protection Corporation to protect investors. Congress also has passed legislation to curb insider-trading abuses. **Insider trading** occurs when insiders—board members, corporate managers, and employees—buy and sell a corporation's stock. Although insiders can buy and sell a corporation's stock, they must disclose their trading activities to the public. More recently, Congress passed the Sarbanes-Oxley Act to improve corporate accountability and financial reporting (see Chapter 17).

On the next level of the regulatory pyramid is the Securities and Exchange Commission (SEC), created in 1934 by the Securities Exchange Act of 1934. The SEC is the agency that enforces federal securities regulations. The SEC also supervises all national exchanges, investment companies, the OTC market, brokerage firms, and just about every other organization involved in trading securities.

On the next level of the regulatory pyramid is individual states. Today, most states require that new security issues be registered with a state agency and that brokers and securities dealers operating within the state be licensed. Most state regulations also provide for the prosecution of individuals accused of the fraudulent sale of stocks, bonds, and other securities.

The foundation and most important level of the regulatory pyramid is self-regulation by securities exchanges and brokerage firms. According to the NYSE, self-regulation—the way the securities industry monitors itself to create a fair and orderly trading environment—begins here.[2] To provide guidelines of ethical behavior, the NYSE has published rules, policies, and standards of conduct. These standards are applied to every member in the NYSE's investment community. The NYSE also conducts a thorough examination of each member firm that does business with the public at least once a year.[3] In addition, there are more than 300 brokerage firms that buy and sell securities for their customers. These firms are responsible for ensuring that their employees are highly trained and meet rigorous ethical standards.

full disclosure requirement that investors should have access to all important facts about stocks, bonds, and other securities so that they can make informed decisions

prospectus a detailed, written description of a new security, the issuing corporation, and the corporation's top management

insider trading the practice of board members, corporate managers, and employees buying and selling a corporation's stock

4

Recognize how you can reduce investment risk and increase investment returns.

Factors that Can Improve Your Investment Decisions

We begin this section with an overview of how portfolio management can reduce investment risk. Then we describe how specific investments can help you to reach your investment goals. A number of the investments listed in Table 20.3 have been discussed. Others have only been mentioned and will be examined in more detail.

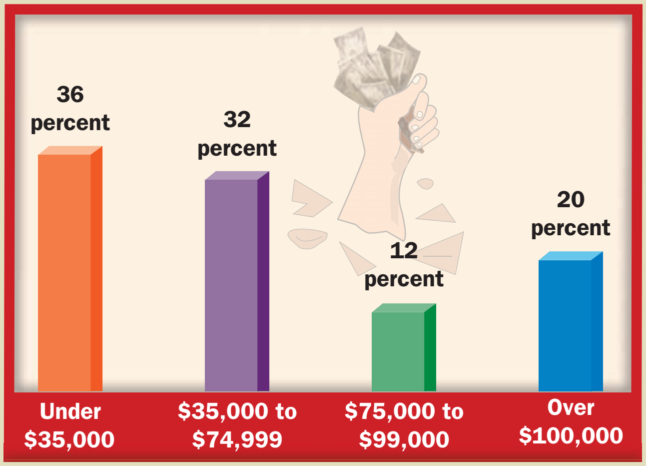
Portfolio Management

"How can I choose the right investment?" Good question! Unfortunately, there are no easy answers because your investment goals, age, tolerance for risk, and financial resources are different from those of the next person. To help you to decide what investment is right for you, consider the following: Since 1926, as measured by the Standard and Poor's 500 stock index, stocks have returned on average about 10 percent a year. During the same period, U.S. government bonds have returned about 6 percent.[4] Therefore, why not just invest all your money in stocks or mutual funds that invest in stocks? After all, they offer the largest potential return. In reality, stocks may have a place in every investment portfolio, but there is more to investing than just picking a bunch of stocks or stock mutual funds.

SPOTLIGHT

The More You Make, the More You Can Invest!

Even if you make more money, you still must control spending and manage debt in order to develop a successful investment program. Below are household income levels for U.S. families.



Source: The U.S. Bureau of the Census, *Statistical Abstract of the United States 2010* (Washington, DC: U.S. Government Printing Office), Table 676, http://www.census.gov.

Asset Allocation, the Time Factor, and Your Age

Asset allocation is the process of spreading your money among several different types of investments to lessen risk. Although the term *asset allocation* is a fancy way of saying it, simply put, it really means that you need to diversify and avoid the pitfall of putting all of your eggs in one basket—a common mistake made by investors. Asset allocation is often expressed in percentages. For example, what percentage of my assets do I want to put in stocks and mutual funds? What percentage do I want to put in more conservative investments such as CDs and government bonds? In reality, the answers to these questions are determined by:

- The time your investments have to work for you
- Your age
- Your investment objectives
- Your ability to tolerate risk
- How much you can save and invest each year
- The dollar value of your current investments
- The economic outlook for the economy
- Several other factors

Table 20.3 Investment Alternatives

Traditional investments involve less risk than high-risk investments.

Traditional	High Risk
Bank accounts	Short transactions
Corporate and government bonds	Margin transactions
Common stock	Stock options
Preferred stock	Commodities
Mutual funds	Precious metals
Real estate	Gemstones
	Coins/antiques/collectibles

asset allocation the process of spreading your money among several different types of investments to lessen risk

Two factors—the time your investments have to work for you and your age—are so important they deserve special attention.

The Time Factor The amount of time you have before you need your investment money is crucial. If you can leave your investments alone and let them work for five to ten years or more, then you can invest in stocks, mutual funds, and real estate. On the other hand, if you need your investment money in two years, you probably should invest in short-term government bonds, highly rated corporate bonds, or CDs. By taking a more conservative approach for short-term investments, you reduce the possibility of having to sell your investments at a loss because of depressed market value or a staggering economy. For example, during the recent economic crisis, many retirees who were forced to sell stocks and mutual funds to pay for everyday living expenses lost money. On the other hand, many young investors with long-term investment goals could afford to hold their investments until the price of their securities recovered.

Your Age You also should consider your age when developing an investment program. Younger investors tend to invest a large percentage of their nest egg in growth-oriented investments. On the other hand, older investors tend to choose more conservative investments. As a result, a smaller percentage of their nest egg is placed in growth-oriented investments. How much of your portfolio should be in growth-oriented investments? Well-known personal financial expert Suze Orman suggests that you subtract your age from 110, and the difference is the percentage of your assets that should be invested in growth investments. For example, if you are 30 years old, subtract 30 from 110, which gives you 80. Therefore, 80 percent of your assets should be invested in growth-oriented investments, whereas the remaining 20 percent should be kept in safer conservative investments.[5]

Your Role in the Investment Process

Investors want large returns, yet they are often unwilling to invest the time required to become a good investor. They would not buy a car without a test drive or purchase a home without comparing different homes, but for some unknown reason they invest without doing their homework. The suggestions given here will help you choose investments that will increase in value.

- *Evaluate potential investments.* Keep in mind that successful investors evaluate their investments before making investment decisions. Often, it is useful to keep copies of the material you used to evaluate each investment. Then, when it is time to re-evaluate an existing investment, you will know where to begin your search for current information. Much of the information in the last section of this chapter will help you learn how to evaluate different investment opportunities.
- *Monitor the value of your investments.* Would you believe that some people invest large sums of money and do not know what their investments are worth? They do not know if their investments have increased or decreased in value and if they should sell their investments or continue to hold them. A much better approach is to monitor the value of your investments.
- *Keep accurate and current records.* Accurate record keeping can help you spot opportunities to maximize profits, reduce dollar losses when you sell your investments, and help you decide whether you want to invest additional funds in a specific investment. For tax purposes, you should keep purchase records for each of your investments that include the actual dollar cost of the investment, plus any commissions or fees you paid, along with records of dividends, interest income, or rental income you received.

Traditional Investment Alternatives

5

Identify the advantages and disadvantages of savings accounts, bonds, stocks, mutual funds, and real estate investments.

Bank Accounts

Bank accounts that pay interest—and therefore are investments—include passbook savings accounts, CDs, and interest-bearing accounts. These were discussed in Chapter 18. The interest paid on bank accounts can be withdrawn to serve as income, or it can be left on deposit and increase the value of the bank account and provide for growth. At the time of this publication, one-year CDs were paying between 1 and 2 percent. Although CDs and other bank accounts are risk-free for all practical purposes, many investors often choose other investments because of the potential for larger returns.

Corporate and Government Bonds

In Chapter 19, we discussed the issuing of bonds by corporations to obtain financing. The U.S. government and state and local governments also issue bonds for the same reason. Investors generally choose bonds because they provide a predictable source of income.

Corporate Bonds Because they are a form of long-term debt financing that must be repaid, investment-grade bonds are generally considered a more conservative investment than either stocks or mutual funds. One of the principal advantages of corporate bonds is that they are primarily long-term, income-producing investments. Between the time of purchase and the maturity date, the bondholder will receive interest payments—usually semiannually, or every six months. For example, assume that you purchase a $1,000 bond issued by the rail-based transportation giant CSX Corporation and that the interest rate for this bond is 6 percent. In this situation, you receive interest of $60 ($1,000 × 0.06 = $60) a year from the corporation. CSX pays the interest every six months in $30 installments.

Most beginning investors think that a $1,000 bond is always worth $1,000. In reality, the price of a bond may fluctuate until its maturity date. Changes in the overall interest rates in the economy are the primary cause of most bond price fluctuations. For example, when overall interest rates in the economy are rising, the market value of existing bonds with a fixed interest rate typically declines. Then they may be purchased for less than their face value. By holding such bonds until maturity or until overall interest rates decline (causing the bond's market value to increase), bond owners can sell their bonds for more than they paid for them. In this case, the difference between the purchase price and the selling price is profit and is in addition to annual interest income. However, remember that the price of a corporate bond can decrease and that interest payments and eventual repayment may be a problem for a corporation that encounters financial difficulty. To compare potential risk and return on corporate bond issues, many investors rely on the bond ratings provided by Moody's Investors Service, Inc., Fitch Ratings, and Standard & Poor's Corporation.

Convertible Bonds Some corporations prefer to issue convertible bonds because they carry a lower interest rate than nonconvertible bonds—by about 1 to 2 percent. In return for accepting a lower interest rate, owners of convertible bonds have the opportunity for increased investment growth. For example, assume that you purchase a Medtronic $1,000 corporate bond that is convertible to 18.0474 shares of the company's common stock. This means that you could convert the bond to common stock whenever the price of the company's stock is $55.41 ($1,000 ÷ 18.0474 = $55.41) or higher.[6] However, owners may opt not to convert their bonds to common stock even if the market value of the common stock does increase to $55.41 or more. The reason for not exercising the conversion feature is quite simple. As the market value of the common stock increases, the price of the convertible bond also increases. By not converting to common stock, bondholders enjoy interest income from the bond in addition to the increased bond value caused by the price movement of the common stock.

Government Bonds The federal government sells bonds and securities to finance both the national debt and the government's ongoing activities. Generally, investors choose from five different types of U.S. government bonds:

1. *Treasury bills*. Treasury bills, sometimes called *T-bills,* are sold in minimum units of $100, with additional increments of $100 above the minimum. Although the maturities may be as long as one year, the Treasury Department currently only sells T-bills with 4-, 13-, 26-, and 52-week maturities. T-bills are sold at a discount, and the actual purchase price is less than $100. When the T-bill matures, you receive the $100 maturity value.
2. *Treasury notes*. Treasury notes are issued in $100 units with a maturity of more than one year but not more than ten years. Typical maturities are two, three, five, seven, and ten years. Treasury notes pay interest every six months until maturity.
3. *Treasury inflation-protected securities (TIPS)*. TIPS are sold in $100 units and are sold with 5-, 10-, or 30-year maturities. The principal of TIPS increases with inflation and decreases with deflation, as measured by the consumer price index. When TIPS mature, you are paid the adjusted principal or original principal, whichever is greater. TIPS also pay interest twice a year, at a fixed rate.
4. *Treasury bonds*. Treasury bonds are issued in minimum units of $100 and have a 30-year maturity. Like Treasury notes, Treasury bonds pay interest every six months until maturity.
5. *Savings bonds*. Series EE bonds are often called *U.S. savings bonds*. Paper bonds are purchased for one-half their maturity value. Thus, a $100 bond costs $50 when purchased. Electronically issued bonds purchased on the TreasuryDirect Web site (http://www.treasurydirect.gov) are sold at face value. (*Note:* If the interest derived from savings bonds is used to pay qualified college expenses, it may be exempt from federal taxation.)

municipal bond sometimes called a *muni,* a debt security issued by a state or local government

A conservative investment backed by the U.S. government. The securities issued by the U.S. Treasury Department are often referred to as the "safest" investments because they are backed by the full faith and credit of the U.S. government. In order to secure these safe investments, investors must accept smaller returns. In fact, the search for larger returns is why some investors choose stocks, mutual funds, real estate, and other investment alternatives.

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The main reason investors choose U.S. government bonds is that they consider them risk-free. The other side of the coin is that these bonds pay lower interest than most other investments. Interest paid on U.S. government securities is taxable for federal income tax purposes, but is exempt from state and local taxation.

Like the federal government, state and local governments sell bonds to obtain financing. A **municipal bond**, sometimes called a *muni,* is a debt security issued by a state or local government. One of the most important features of municipal bonds is that the interest on them may be exempt from federal taxes. Whether or not the interest on municipal bonds is tax-exempt often depends on how the funds obtained from their sale are used. *Caution: It is your responsibility, as an investor, to determine whether or not the interest paid by municipal* *bonds is taxable. It is also your responsibility to evaluate municipal bonds.* Although most municipal bonds are relatively safe, defaults have occurred in recent years.

Common Stock

As mentioned in Chapter 19, corporations issue common stock to finance their business start-up costs and help pay for expansion and their ongoing business activities. Before investing in stock, keep in mind that corporations do not have to repay the money a stockholder pays for stock. Usually, a stockholder may sell her or his stock to another individual.

How do you make money by buying common stock? Basically, there are three ways: through dividend payments, through an increase in the value of the stock, or through stock splits.

Dividend Payments One of the reasons why many stockholders invest in common stock is *dividend income.* Generally, dividends are paid on a quarterly basis. Although corporations are under no legal obligation to pay dividends, most corporate board members like to keep stockholders happy (and prosperous). A corporation may pay stock dividends in place of—or in addition to—cash dividends. A **stock dividend** is a dividend in the form of additional stock. It is paid to shareholders just as cash dividends are paid—in proportion to the number of shares owned.

Increase in Dollar Value Another way to make money on stock investments is through capital gains. A **capital gain** is the difference between a security's purchase price and its selling price. To earn a capital gain, you must sell when the market value of the stock is higher than the original purchase price. The **market value** is the price of one share of a stock at a particular time. Let's assume that on June 8, 2007, you purchased 100 shares of General Mills at a cost of $59 a share and that you paid $35 in commission charges, for a total investment of $5,935. Let's also assume that you held your 100 shares until June 8, 2010, and then sold the General Mills stock for $75. Your total return on investment is shown in Table 20.4. You realized a profit of $1,781 because you received dividends totaling $2.61 a share during the three-year period and because the stock's market value increased by $16 a share. Of course, if the stock's market value had decreased, or if the firm's board of directors had voted to reduce or omit dividends, your return would have been less than the total dollar return illustrated in Table 20.4.

stock dividend a dividend in the form of additional stock

capital gain the difference between a security's purchase price and its selling price

market value the price of one share of a stock at a particular time

stock split the division of each outstanding share of a corporation's stock into a greater number of shares

Is General Mills a good investment? To be a good investment, a corporation must increase sales revenues *and* profits. For most companies, the way to accomplish both financial goals is to produce products or services that customers need and want. During the 2007–2010 time period, General Mills, the corporation that manufactures Wheaties—the Breakfast of Champions—was a good (and profitable) investment. To see how much money you could have made by investing in General Mills, see Table 20.4.

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Stock Splits Directors of many corporations feel that there is an optimal price range within which their firm's stock is most attractive to investors. When the market value increases beyond that range, they may declare a *stock split* to bring the price down. A **stock split** is the division of each outstanding share of a corporation's stock into a greater number of shares.

The most common stock splits result in one, two, or three new shares for each original share. For example, in 2010, the board of directors of NetLogic, the semiconductor and technology company, approved a two-for-one stock split. After this split, a stockholder who originally owned 100 shares owned 200 shares. The value of an original share was proportionally reduced. In the case of NetLogic, the market value per share was reduced to half the stock's value before the two-for-one stock split. There is no evidence to support that a corporation's long-term performance is improved by a stock split; however, some

Table 20.4	Sample Common-Stock Transaction for General Mills		
Assumptions: 100 shares of common stock purchased on June 8, 2007, for $59 a share; 100 shares sold on June 8, 2010, for $75 a share; dividends for three years total $2.61 a share.			
Cost when Purchased		**Return when Sold**	
100 shares @ $59	$5,900	100 shares @ $75	$7,500
Plus commission	+ 35	Minus commission	− 45
Total investment	$5,935	Total return	$7,455
Transaction Summary			
Total return	$7,455		
Minus total investment	−5,935		
Profit from stock sale	$1,520		
Plus total dividends (three years)	+ 261		
Total return for this transaction	$1,781		

Source: Price data and dividend amounts were taken from the Yahoo Finance Web site, http://finance.yahoo.com (accessed July 14, 2010).

investors do profit from stock splits on a short-term basis. *Be warned: There are no guarantees that the stock will increase in value after a split.* However, the stock may be more attractive to the investing public because of the potential for a rapid increase in dollar value. This attraction is based on the belief that most corporations split their stock only when their financial future is improving and on the upswing.

Merrill Lynch makes it easy to develop an investment program. Beginning investors often feel that the investment world is a jungle because of the different investment alternatives. At Merrill Lynch, professionals can help you choose the right stocks, mutual funds, bonds, and other securities to build an investment program that will achieve not only your investment goals, but also your dreams for the future.

Image courtesy of The Advertising Archives

Preferred Stock

As we noted in Chapter 19, a firm's preferred stockholders must receive their dividends before common stockholders are paid any dividend. Moreover, the preferred-stock dividend amount is specified on the stock certificate. In addition, the owners of preferred stock have first claim, after bond owners and general creditors, on corporate assets if the firm is dissolved or enters bankruptcy. These features make preferred stock a more conservative investment with an added degree of safety and a more predictable source of income when compared with common stock.

In addition, owners of preferred stock may gain through special features offered with certain preferred-stock issues. Owners of *cumulative* preferred stocks are assured that omitted dividends will be paid to them before common stockholders receive any dividends. Owners of *convertible* preferred stock may profit through growth as well as dividends. When the value of a firm's common stock increases, the market value of its *convertible* preferred stock also increases. Convertible preferred stock thus combines the lower risk of preferred stock with the possibility of greater speculative gain through conversion to common stock.

Mutual Funds and Exchange-Traded Funds

For many investors, mutual funds are the investment of choice. There are plenty of funds from which to choose. In 1970, there were only about 400 mutual funds. In January 2010, there were just over 12,000 funds.[7]

According to the Mutual Fund Education Alliance (http://www.mfea.com), a **mutual fund** pools the money of many investors—its shareholders—to invest in a variety of different securities.[8] The major advantages of a mutual fund are its professional management and its diversification, or investment in a wide variety of securities. Most investment companies do everything possible to convince you that they can do a better job of picking securities than you can. In reality, mutual funds are managed by professional fund managers who devote large amounts of time to picking just the "right" securities for their funds' portfolios. *Be warned:* Even the best portfolio managers make mistakes. So you, the investor, must be careful and evaluate different funds before investing. Diversification spells safety because an occasional loss incurred with one security is usually offset by gains from other investments.

Mutual-Fund Basics There are basically three types of mutual funds: (1) closed-end funds, (2) open-end funds, and (3) exchange-traded funds (ETFs). A *closed-end fund* sells shares in the fund to investors only when the fund is originally organized. Once all the shares are sold, an investor must purchase shares from some other investor who is willing to sell them. The mutual fund itself is under no obligation to buy back shares from investors. The investment company sponsoring an *open-end fund* issues and sells new shares to any investor who requests them. It also buys back shares from investors who wish to sell all or part of their holdings.

An **exchange-traded fund (ETF)** is a fund that generally invests in the stocks or other securities contained in a specific stock or securities index. Although most investors think of an ETF as investing in the stocks contained in the Standard & Poor's 500 Stock Index, there are many different types of ETFs available that attempt to track all kinds of indexes including stocks, bonds, and even commodities. Exchange-traded funds tend to mirror the performance of a specific index, moving up or down as the individual stocks or securities contained in the index move up or down.

Like a closed-end fund, shares of an exchange-traded fund are traded on a securities exchange or in the OTC market at any time during the business day. Although exchange-traded funds are similar to closed-end funds, there is an important difference. Most closed-end funds are actively managed, with portfolio managers making the selection of stocks and other securities contained in a closed-end fund. Almost all exchange-traded funds, on the other hand, normally invest in the stocks, bonds, or securities included in a specific index. Therefore, there is less need for a portfolio manager to make investment decisions. Because of passive management, fees associated with owning shares are generally less when compared to both closed-end and open-end funds. Although increasing in popularity, there are only about 775 exchange-traded funds.[9]

The share value for any mutual fund is determined by calculating its net asset value. **Net asset value (NAV)** per share is equal to the current market value of the mutual fund's portfolio minus the mutual fund's liabilities divided by the number of outstanding shares. For most mutual funds, NAV is calculated once a day and is reported in newspapers and financial publications and on the Internet.

Mutual-Fund Sales Charges and Fees With regard to costs, there are two types of mutual funds: load and no-load funds. An individual who invests in a *load fund* pays a sales charge every time he or she purchases shares. This charge may be as high as 8.5 percent. Although many exceptions exist, the average load charge for mutual funds is between 3 and 5 percent. Instead of charging investors a fee when they purchase shares in a mutual fund, some mutual funds charge a *contingent deferred sales fee*. Generally, this fee ranges from 1 to 5 percent of the amount withdrawn during the first five to seven years. Typically, the amount of the contingent deferred sales fee declines each year that you own the fund until there is no withdrawal fee. The purchaser of shares in a *no-load fund* pays no sales charges at all. Although some fund salespeople claim that load funds outperform no-load

mutual fund pools the money of many investors—its shareholders—to invest in a variety of different securities

exchange-traded fund (ETF) a fund that generally invests in the stocks or other securities contained in a specific stock or securities index

net asset value (NAV) current market value of a mutual fund's portfolio minus the mutual fund's liabilities divided by the number of outstanding shares funds, there is no significant performance difference between funds that charge load charges (commissions) and those that do not.[10] Because no-load funds offer the same type of investment opportunities as load funds, you should investigate them further before deciding which type of mutual fund is best for you.

Mutual funds also collect a yearly management fee of about 0.25 to 1.5 percent of the total dollar amount of assets in the fund. Although fees vary considerably, the average management fee is between 0.50 and 1 percent of the fund's assets. Finally, some mutual funds charge a 12b-1 fee (sometimes referred to as a *distribution fee*) to defray the costs of advertising and marketing the mutual fund. Annual 12b-1 fees are calculated on the value of a fund's assets and cannot exceed 1 percent of the fund's assets. Unlike the onetime sales fees that some mutual funds charge to purchase *or* sell mutual-fund shares, the management fee and the 12b-1 fee are ongoing fees charged each year. Together, all the different management fees; 12b-1 fees, if any; and additional operating costs for a specific fund are referred to as an **expense ratio**. As a guideline, many financial planners recommend that you choose a mutual fund with an expense ratio of 1 percent or less.

Today, mutual funds can also be classified as A, B, or C shares. With A shares, investors pay commissions when they purchase shares in the mutual fund. With B shares, investors pay commissions when money is withdrawn or shares are sold during the first five to seven years. With C shares, investors pay no commissions to buy or sell shares but usually must pay higher ongoing management and 12b-1 fees.

Managed Funds Versus Indexed Funds Most mutual funds are managed funds. In other words, there is a professional fund manager (or team of managers) who chooses the securities that are contained in the fund. The fund manager also decides when to buy and sell securities in the fund.

Instead of investing in a managed fund, some investors choose to invest in an index fund. Why? The answer to this question is simple: Over many years, index funds have outperformed managed funds. The exact statistics vary depending on the year and the specific fund, but a common statistic is that the Standard & Poor's 500 stock index outperforms 80 percent of all mutual funds.[11] Simply put: It is hard to beat an index such as the Standard & Poor's 500. If the individual securities included in an index increase in value, the index goes up. Because an index mutual fund is a mirror image of a specific index, the dollar value of a share in an index fund also increases when the index increases. Unfortunately, the reverse is also true. A second reason why investors choose index funds is the lower fees charged by these passively managed funds. (*Note:* Various indexes are discussed later in this chapter.)

Types of Mutual-Fund Investments Based on the type of securities they invest in, mutual funds generally fall into three broad categories: stocks, bonds, and other. The majority of mutual funds are *stock funds* that invest in stocks issued by small, medium-size, and large corporations that provide investors with income, growth, or a combination of income and growth. *Bond funds* invest in corporate, government, or municipal bonds that provide investors with interest income. The third category includes funds that stress asset allocation and money-market investments or strive for a balance between stocks and bonds. In most cases, the name of the category gives a pretty good clue to the type of investments included in the fund. Typical fund names include:

- Aggressive growth stock funds
- Global stock funds
- Growth stock funds
- High-yield (junk) bond funds
- Income stock funds
- Index funds
- Lifecycle funds
- Long-term U.S. bond funds

expense ratio all the different management fees; 12b-1 fees, if any; and additional operating costs for a specific fund

Ethical Challenges &
SUCCESSFUL SOLUTIONS

Balancing Returns with Social Responsibility

How far can "ethical" investing go in achieving social responsibility objectives as well as generating a solid return? Some investors with a social-responsibility agenda steer clear of stocks, bonds, and mutual funds that invest in controversial products such as tobacco, gambling, and guns. Others go even further, avoiding investments in corporations that do business with suppliers or countries that violate human rights. Finding the right balance of social responsibility and financial return is, well, a balancing act as the list of restrictions gets longer, which narrows the number of investment choices.

Even large investors that use investments to advance social responsibility may have difficulty with this balance. For example, the California Public Employees' Retirement System (CalPERS) handles retirement benefits for more than a million people and has billions of dollars to invest. Despite its long record of social responsibility, CalPERS had invested in some real estate deals where financial returns depended on raising rents above regulated levels or ending rent controls for tenants. After being criticized, CalPERS changed its policy to avoid such real-estate investments.

The good news is that more mutual fund companies are offering investments linked to specific social-responsibility goals. Choices include funds such as those holding securities issued by companies recognized for treating employees well, companies involved in alternative energy, and companies that have a low carbon footprint. The experts recommend that before you invest, you should understand your personal goals, study each investment carefully, and make an educated decision that is right for your situation.

Sources: Paul Sullivan, "With Impact Investing, a Focus on More Than Returns," *The New York Times*, April 23, 2010, http://www.nytimes.com; "CalPERS Changes Policy on Real Estate Investing," *Associated Press*, April 19, 2010, http://www.nytimes.com; Jamie Heller, "Calpers Rule Would Limit Evictions at Investments," *The Wall Street Journal*, April 15, 2010, http://www.wsj.com; Richard Marwood, "Industry Voice: Ethical Is Not a Dirty Word," *Investment Adviser*, November 23, 2009, n.p.; Sophia Grene, "The Long Road to Sustainable Investing," *Financial Times*, October 19, 2009, 14.

- Regional funds
- Sector stock funds
- Small-cap stock funds

To help investors obtain their investment objectives, most investment companies now allow shareholders to switch from one fund to another fund within the same family of funds. A **family of funds** exists when one investment company manages a group of mutual funds. For example, shareholders, at their option, can change from the Fidelity International Growth Fund to the Fidelity Growth and Income Fund. Generally, investors may give instructions to switch from one fund to another fund within the same family either in writing, over the telephone, or via the Internet. Charges for exchanges, if any, are small for each transaction.

family of funds a group of mutual funds managed by one investment company

Real Estate

Real estate ownership represents one of the best hedges against inflation, but like all investments it has its risks. A piece of property in a poor location, for example, can actually decrease in value. Table 20.5 lists some of the many factors you should consider before investing in real estate.

There are, of course, disadvantages to any investment, and real estate is no exception. If you want to sell your property, you must find an interested buyer with the ability to obtain enough money to complete the transaction. Finding such a buyer can be difficult if loan money is scarce, the real estate market is in a decline, or you overpaid for a piece of property. For example, many real estate investors were forced to hold some properties longer than they wanted because buyers could not obtain financing during the recent economic crisis. If you are forced to hold your investment longer than you originally planned, taxes, interest, and installment payments can be a heavy burden. As a rule, real estate increases in value and eventually sells at a profit, but there are no guarantees. The degree of your success depends on how well you evaluate different alternatives.

Table 20.5	Real Estate Checklist	
Although real estate offers one of the best hedges against inflation, not all property increases in value. Many factors should be considered before investing in real estate.		
Evaluation of Property	**Inspection of the Surrounding Neighborhood**	**Other Factors**
Is the property priced competitively with similar property?	What are the present zoning requirements?	Why are the present owners selling the property?
What type of financing, if any, is available?	Is the neighborhood's population increasing or decreasing?	How long will you have to hold the property before selling it to someone else?
How much are the taxes?	What is the average income of people in the area?	How much profit can you reasonably expect to obtain?
How much will it cost to repair or remodel a property?	What is the state of repair of surrounding property? Do most of the buildings and homes need repair?	Is there a chance that the property value will decrease?

high-risk investment an investment made in the uncertain hope of earning a relatively large profit in a short time

buying long buying stock with the expectation that it will increase in value and then can be sold at a profit

selling short the process of selling stock that an investor does not actually own but has borrowed from a brokerage firm and will repay at a later date

6

Describe high-risk investment techniques.

High-Risk Investment Techniques

A **high-risk investment** is one made in the uncertain hope of earning a relatively large profit in a short time. (See the high-risk investment category in Table 20.3.) Although all investments have some risk, some investments become high-risk because of the methods used by investors to earn a quick profit. These methods can lead to large losses as well as to impressive gains. They should not be used by anyone who does not fully understand the risks involved. We begin this section with a discussion of selling short. Then we examine margin transactions and other high-risk investments.

A high-risk investment that paid off. Vincent Zurzolo, chief operating officer of Metropolis Collectibles, holds a 1938 Action comic book that sold for $1 million in 2010. This comic book, which introduced Superman to the world, was a "super" investment. Because many high-risk investments like this collectible are too speculative for most people, most long-term investors choose the more traditional investments described in this chapter.

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Selling Short

Normally, you buy stocks expecting that they will increase in value and then can be sold at a profit. This procedure is referred to as **buying long**. However, many securities decrease in value for various reasons. Consider what happened to the values of many stocks during the economic crisis. Because of the nation's depressed economy, many corporations also experienced a financial downturn. Many of these same corporations experienced lower-than-expected sales revenues and profits. In some cases, corporations actually posted losses during this same time period. For the firms that were able to weather the economic storm, their stock values were quite a bit lower than they were before the economic downturn. When this type of situation occurs, you can use a procedure called *selling short* to make a profit when the price of an individual stock is falling. **Selling short** is the process of selling stock that an investor does not actually own but has borrowed from a brokerage firm and will repay at a later date. The idea is to sell at today's higher price and then buy later at a lower price. To make a profit from a short transaction, you must proceed as follows:

1. Arrange to borrow a certain number of shares of a particular stock from a brokerage firm.
2. Sell the borrowed stock immediately, assuming that the price of the stock will drop in a reasonably short time.
3. After the price drops, buy the same number of shares that were sold in step 2.
4. Give the newly purchased stock to the brokerage firm in return for the stock borrowed in step 1.

Your profit is the difference between the amount received when the stock is sold in step 2 and the amount paid for the stock in step 3. For example, assume that you think Barnes & Noble stock is overvalued at $20 a share. You also believe that the stock will decrease in value over the next three to four months. You call your broker and arrange to borrow 100 shares of Barnes & Noble stock (step 1). The broker then sells your borrowed stock for you at the current market price of $20 a share (step 2). In addition, suppose that three months later the Barnes & Noble stock has dropped to $13 a share. You instruct your broker to purchase 100 shares of Barnes & Noble stock at the current lower price (step 3). The newly purchased Barnes & Noble stock is given to the brokerage firm to repay the borrowed stock (step 4). In this example, you made $700 by selling short ($2,000 selling price − $1,300 purchase price = $700 profit).[12] Naturally, the $700 profit must be reduced by the commissions you paid to the broker for buying and selling the Barnes & Noble stock.

People often ask where the broker obtains the stock for a short transaction. The broker probably borrows the stock from other investors who have purchased Barnes & Noble stock and left stock certificates on deposit with the brokerage firm. As a result, the person who is selling short must pay any dividends declared on the borrowed stock. The most obvious danger when selling short, of course, is that a loss can result if the stock's value increases instead of decreases.

Buying Stock on Margin

An investor buys stock *on margin* by borrowing part of the purchase price, usually from a stock brokerage firm. The **margin requirement** is the portion of the price of a stock that cannot be borrowed. This requirement is set by the Federal Reserve Board.

Today, the current margin requirement is 50 percent, which means you can borrow up to 50 percent of the cost of a stock purchase. Some brokerage firms require that you deposit more cash, which reduces the percentage that can be borrowed. However, why would investors want to buy stock on margin? Simply because they can buy up to twice as much stock that way. Suppose that an investor expects the market price of a share of common stock of Duke Energy Corporation—a U.S. energy company—to increase in the next three to four months. Let us say that this investor has enough money to purchase 200 shares of the stock. However, if the investor buys on margin, he or she can purchase an additional 200 shares for a total of 400 shares. If the price of Duke Energy's stock increases by $8 per share, the investor's profit will be $1,600 ($8 × 200 = $1,600) if he or she pays cash. But it will be $3,200 ($8 × 400 = $3,200) if he or she buys the stock using margin. By buying more shares on margin, the investor will earn more profit (less the interest he or she pays on the borrowed money and customary commission charges).

Financial leverage—a topic covered in Chapter 19—is the use of borrowed funds to increase the return on an investment. When margin is used as leverage, the investor's profit is earned by both the borrowed money and the investor's own money. The investor retains all the profit and pays interest only for the temporary use of the borrowed funds. Note that the stock purchased on margin serves as collateral for the borrowed funds. Before you become a margin investor, you should consider two factors. First, if the market price of the purchased stock does not increase as quickly

margin requirement the portion of the price of a stock that cannot be borrowed as expected, interest costs mount and eventually drain your profit. Second, if the price of the margined stock falls, the leverage works against you. That is, because you have purchased twice as much stock, you lose twice as much money.

If the value of a stock you bought on margin decreases to approximately 60 percent of its original price, you may receive a *margin call* from the brokerage firm. You then must provide additional cash or securities to serve as collateral for the borrowed money. If you cannot provide additional collateral, the stock is sold, and the proceeds are used to pay off the loan and commissions. Any funds remaining after the loan and commissions are paid off are returned to you.

Other High-Risk Investments

We have already discussed two high-risk investments—selling short and margin transactions. Other high-risk investments include the following:

- Stock options
- Derivatives
- Commodities
- Precious metals
- Gemstones
- Coins
- Antiques and collectibles

Without exception, investments of this kind are normally referred to as high-risk investments for one reason or another. For example, the gold market has many unscrupulous dealers who sell worthless gold-plated lead coins to unsuspecting, uninformed investors. It pays to be careful. *Although investments in this category can lead to large dollar gains, they should not be used by anyone who does not fully understand all the potential risks involved.*

7

Use financial information to evaluate investment alternatives.

Sources of Financial Information

A wealth of information is available to investors. Sources include the Internet, newspapers, professional advisory services, brokerage firm reports, business periodicals, corporate reports, and securities averages.

The Internet

By using the Internet, investors can access a wealth of information on most investment and personal finance topics. For example, you can obtain interest rates for CDs; current price information for stocks, bonds, and mutual funds; and experts' recommendations to buy, hold, or sell an investment. You can even trade securities online.

Because the Internet makes so much information available, you need to use it selectively. One of the Web search engines such as Yahoo! (http://www.yahoo.com) or Google (http://www.google.com) can help you locate the information you really need. These search engines allow you to do a word search for the personal finance or investment alternative you want to explore. Why not take a look? To access a search engine, enter the Web site address and then type in a key term such as *personal finance* or *financial planning* and see the results.

Corporations; brokerage firms; investment companies that sponsor mutual funds; real estate brokers and agents; and federal, state, and local governments also have Web sites where you can obtain valuable investment information. You may want to explore these Web sites for two reasons. First, they are easily accessible. All you have to do is type in the Web address or use a search engine to locate the site. Second, the information on these sites may be more up-to-date than printed material obtained from published sources.

In addition, you can access professional advisory services—a topic discussed later in this section—for information on stocks, bonds, mutual funds, and other investment alternatives. Although some of the information provided by these services is free, there is a charge for the more detailed information you may need to evaluate an investment.

Financial Coverage of Securities Transactions

Many local newspapers carry several pages of business news, including reports of securities transactions. *The Wall Street Journal* (published on weekdays) and *Barron's* (published once a week) are devoted almost entirely to financial and economic news. Both include coverage of transactions on major securities exchanges.

Because transactions involving stocks, bonds, and mutual funds are reported differently, we shall examine each type of report separately.

Common and Preferred Stocks Stock transactions are reported in tables that usually look like the top section of Figure 20.2. Stocks are listed alphabetically. Your first task is to move down the table to find the stock you are interested in. To read the *stock quotation,* you read across the table. The highlighted line in Figure 20.2 gives detailed information about common stock issued by Aflac—the insurance company with the talking duck.

Bonds Although some newspapers and financial publications provide limited information on certain corporate and government bond issues, it is usually easier to obtain more detailed information on a greater number of bond issues by accessing the Internet. Regardless of the source, bond prices are quoted as a percentage of the face value, which is usually $1,000. Thus, to find the current price, you must multiply the face value ($1,000) by the quotation. For example, a price quoted as 84 translates to a selling price of $840 ($1,000 × 0.84 = $840). Detailed information obtained from the Yahoo! Finance Web site for a $1,000 AT&T corporate bond, which pays 5.50 percent interest and matures in 2018, is provided in Figure 20.3.

Sustaining the Planet

GreenMoney Journal

The *GreenMoney Journal* has been reporting on the business side of sustainability since 1992, including coverage of eco-friendly stocks and mutual funds as well as industry analysis and commentary. Take a look: http://www.greenmoneyjournal.com.

Mutual Funds Purchases and sales of shares of mutual funds are reported in tables like the one shown in Figure 20.4. As in reading stock quotations, your first task is to move down the table to find the mutual fund you are interested in. Then, to find the mutual-fund price quotation, read across the table. Figure 20.4 gives information for the Vanguard 500 Index mutual fund.

Other Sources of Financial Information

In addition to the Internet and newspaper coverage, other sources, which include professional advisory services, brokerage firm reports, business periodicals, and corporate reports, offer detailed and varied information about investment alternatives.

Professional Advisory Services For a fee, various professional advisory services provide information about investments. Information from these services may also be available at university and public libraries.

As discussed earlier in this chapter, Moody's, Standard & Poor's, and Fitch Ratings provide information that can be used to determine the quality and risk

Figure 20.2 Reading Stock Quotations

Reproduced at the top of the figure is a portion of the stock quotations listed in *The Wall Street Journal*. At the bottom is an enlargement of the same information. The numbers above each of the enlarged columns correspond to the numbered entries in the list of explanations that appears in the middle of the figure.

STOCK	(SYM)	CLOSE	NET CHG
ACE Ltd	ACE	55.88	0.86
AES Cp	AES	10.23	−0.02
Aflac	AFL	48.88	0.97

1. Name (often abbreviated) of the corporation: Aflac
2. Ticker symbol or letters that identify a stock for trading: AFL
3. Close is the price paid in the last transaction of the day: $48.88
4. Difference between the price paid for the last share sold today and the price paid for the last share sold on the previous day: 0.97 (in Wall Street terms, Aflac "closed up $0.97" on this day).

1	2	3	4
STOCK	(SYM)	CLOSE	NET CHG
ACE Ltd	ACE	55.88	0.86
AES Cp	AES	10.23	−0.02
Aflac	AFL	48.88	0.97

Source: *The Wall Street Journal*, July 14, 2010, C4.

Figure 20.3 Reading Bond Quotations

Reproduced at the top of the figure is bond information obtained from the Yahoo! Finance Web site. The numbers beside each line correspond to numbered entries in the list of explanations that appears at the bottom of the figure.

AT&T INC	
OVERVIEW	
1. Price	113.21
2. Coupon (%)	5.500
3. Maturity Date	1-Feb-2018
4. Yield to Maturity (%)	3.489
5. Current Yield (%)	4.858
6. Fitch Ratings	A
7. Coupon Payment Frequency	Semi-annual
8. First Coupon Date	1-Aug-2008
9. Type	Corporate
10. Callable	No

1. Price quoted as a percentage of the face value: $1,000 × 113.21% = $1,132.10
2. Coupon (%) is the rate of interest: 5.500 percent
3. Maturity Date is the date when bondholders will receive repayment: February 1, 2018
4. Yield to Maturity (%) takes into account the relationship among a bond's maturity value, the time to maturity, the current price, and the amount of interest: 3.489 percent
5. Current Yield (%) is determined by dividing the dollar amount of annual interest by the current price of the bond: ($55 ÷ $1,132.10 = 0.04858 = 4.858 percent)
6. Fitch Ratings is used to assess risk associated with this bond: A
7. Coupon Payment Frequency tells bondholders how often they will receive interest payments: Semi-annual
8. First Coupon Date: August 1, 2008
9. Type: Corporate
10. Callable: No

Source: The Yahoo! Finance bond Web site at http://bonds.yahoo.com (accessed July 18, 2010).

Figure 20.4 Reading Mutual-Fund Quotations

Reproduced at the top of the figure is a portion of the mutual-fund quotations as reported by *The Wall Street Journal*. At the bottom is an enlargement of the same information. The numbers above each of the enlarged columns correspond to numbered entries in the list of explanations that appears in the middle of the figure.

FUND	NAV	NET CHG	YTD %RET
Vanguard 500 Index	100.93	+1.54	–0.8
DevMktInst	8.86	+0.16	NS
EmerMktr	25.54	+0.20	–1.4
Europe	23.72	+0.58	–8.6

1. The name of the mutual fund: Vanguard 500 Index
2. The net asset value (NAV) is the value of one share of the Vanguard 500 Index Fund: $100.93
3. The difference between the net asset value today and the net asset value on the previous trading day: 1.54 (in Wall Street terms, the "Vanguard 500 Index fund closed up $1.54" on this day)
4. The YTD% RET gives the total return for the Vanguard 500 Index fund for the year to date: –0.8%

1	2	3	4
FUND	NAV	NET CHG	YTD %RET
Vanguard 500 Index	100.93	+1.54	–0.8
DevMktInst	8.86	+0.16	NS
EmerMktr	25.54	+0.20	–1.4
Europe	23.72	+0.58	–8.6

Source: ***The Wall Street Journal*, July 14, 2010, C13.**

associated with bond issues. Standard & Poor's, Mergent, Inc., and Value Line also rate the companies that issue common and preferred stock. Each investor service provides detailed financial reports. Take a look at the Mergent's research report for The Coca-Cola Company illustrated in Figure 20.5. Notice that there are six main sections that provide financial data, summary information about the company's business operations, recent developments, prospects, and other valuable information. Research reports published by Standard & Poor's and Value Line are like Mergent's report and provide similar information.

A number of professional advisory services provide detailed information on mutual funds. Morningstar, Inc., Standard & Poor's, Lipper Analytical Services, and Value Line are four widely tapped sources for such information. Although some information may be free, a fee is generally charged for more detailed research reports. In addition, various mutual-fund newsletters supply financial information to subscribers for a fee.

Brokerage Firm Analysts' Reports Brokerage firms employ financial analysts to prepare detailed reports on individual corporations and their securities. Such reports are based on the corporation's sales, profits or losses, management, and planning, plus other information on the company, its industry, demand for its products, its efforts to develop new products, and the current economic environment. The reports, which may include buy or sell recommendations, are usually provided free

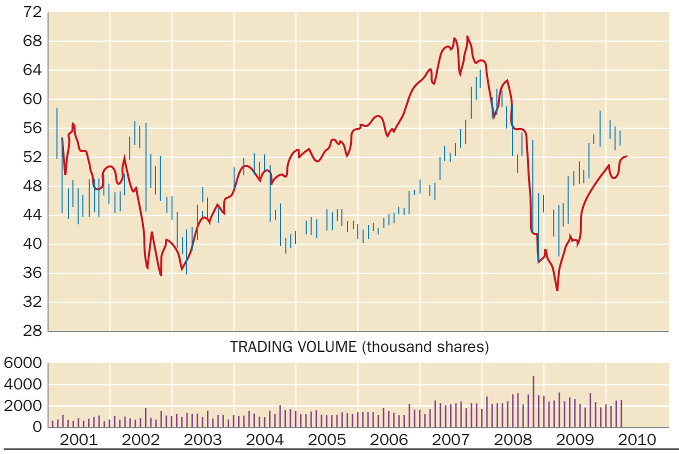
Figure 20.5 Mergent's Research Report for The Coca-Cola Company

A research report from Mergent's is divided into six main parts that describe not only the financial condition of a company but also its history and outlook for the future.

COCA-COLA CO. (THE)

Exchange	Symbol	Price	52Wk Range	Yield	P/E	Div Acheiver
NYS	KO	$55.00 (3/31/2010)	59.11-42.24	3.20	18.77	47 Years

*7 Year Price Score 122.49 *NYSE Composite Index = 100 *12 Month Price Score 97.24



Interim Earnings (Per Share)

Qtr.	Mar	Jun	Sep	Dec
2005	0.42	0.72	0.54	0.37
2006	0.47	0.78	0.62	0.29
2007	0.54	0.80	0.71	0.52
2008	0.64	0.61	0.81	0.41
2009	0.58	0.88	0.81	0.66

Interim Dividends (Per Share)

Amt	Deci	Ex	Rec	Pay
0.41Q	04/23/2009	06/11/2009	06/15/2009	07/01/2009
0.41Q	07/23/2009	09/11/2009	09/15/2009	10/01/2009
0.41Q	10/22/2009	11/27/2009	12/01/2009	12/15/2009
0.41Q	02/18/2010	03/11/2010	03/15/2010	04/01/2010

Indicated Div: $1.76 (Div. Reinv. Plan)

Valuation Analysis		**Institutional Holding**
Forecast EPS	$3.42	No of Institutions
	(04/21/2010)	1518
Market Cap	$126.7 Billion	Shares
Book Value	$24.8 Billion	1,720,219,648
Price/Book	5.11	% Held
Price/Sales	4.09	60.39

Business Summary: Beverages (MIC: 1.2.2 SIC: 2086 NAIC: 312111)
Coca-Cola is an owner and marketer of nonalcoholic beverage brands as well as a manufacturer, distributor and marketer of concentrates and syrups used to produce nonalcoholic beverages. Co. owns or licenses and markets over 500 nonalcoholic beverage brands, primarily sparkling beverages including Diet Coke. Fanta and Sprite as well as still beverages such as waters, enhanced waters, juices and juice drinks, ready-to-drink teas and coffees, and energy and sports drinks. Co. also manufactures, or authorizes bottling partners to manufacture, fountain syrups, which Co. sells to fountain retailers such as restaurants and convenience stores or to fountain wholesalers or bottlers.

Recent Developments: For the year ended Dec 31 2009, net income increased 17.6% to US$6.91 billion from US$5.87 billion in the prior year. Revenues were US$30.99 billion, down 3.0% from US$31.94 billion the year before. Operating income was US$8.23 billion versus US$8.45 billion in the prior year, a decrease of 2.5%. Direct operating expenses declined 2.5% to US$11.09 billion from US$11.37 billion in the comparable period the year before. Indirect operating expenses decreased 3.7% to US$11.67 billion from US$12.12 billion in the equivalent prior-year period.

Prospects: On Feb 25 2010, Co. signed an agreement with Coca-Cola Enterprises Inc. (CCE) to acquire CCE's North American operations for $3.40 billion and assumption of $8.90 billion of CCE debt. Simultaneously, Co. reached an agreement to sell its ownership interests in its Norway bottling operation Coca-Cola Drikker AS, and its Sweden bottling operation, Coca-Cola Drycker Sverige AB, to the new CCE entity for $822.0 million. Co. expects the transactions will close in the fourth quarter of 2010. Accordingly, Co. will generate immediate operational cost savings of $350.0 million over four years, and the transactions are expected to be accretive to earnings per share on a fully diluted basis by 2012.

Financial Data								
(US$ in Thousands)	12/31/2009	12/31/2008	12/312007	12/31/2006	12/31/2005	12/31/2004	12/31/2003	12/31/2002
Earnings Per Share	2.93	2.49	2.57	2.16	2.04	2.00	1.77	1.23
Cash Flow Per Share	3.54	3.26	3.09	2.54	2.69	2.45	2.22	1.91
Tang Book Value Per Share	5.20	3.45	4.11	5.08	5.29	5.02	4.14	3.34
Dividends Per Share	1.640	1.520	1.360	1.240	1.120	1.000	0.880	0.800
Dividend Payout %	55.97	61.04	52.92	57.41	54.90	50.00	49.72	65.04
Income Statement								
Total Revenue	30,990,000	31,944,000	28,857,000	24,088,000	23.104,000	21,962,000	21,044,00	19,564,000
EBITDA	9,294,000	9,430,000	8,404,000	7,266,000	6,767,000	6,355,000	5,758,000	5,719,000
Depn & Amortn	1,023,000	1,012,000	979,000	763,000	752,000	715,000	667,000	614,000
Income Before Taxes	8,165,000	8,313,000	7,205,000	6,476,000	6,010,000	5,601,000	5,089,000	5,115,000
Income Taxes	2,040,000	1,632,000	1,892,000	1,498,000	1,818,000	1,375,000	1,148,000	1,523,000
Net Income	6,824,000	5,807,000	5,981,000	5,080,000	4,872,000	4,847,000	4,347,000	3,050,000
Average Shares	2,329,000	2,336,000	2,331,000	2,350,000	2,393,000	2,429,000	2,462,000	2,483,000
Balance sheet								
Current Assets	17,551,000	12,176,000	12,105,000	8,441,000	10,250,000	12,094,000	8,396,000	7,352,000
Total Assets	48,671,000	40,519,000	43,269,000	29,963,000	29,427,000	31,327,000	27,342,000	24,501,000
Current Liabilities	13,721,000	12,988,000	13,225,000	8,890,000	9,836,000	10,971,000	7,886,000	7,341,000
Long-Term Obligations	5,059,000	2,781,000	3,277,000	1,314,000	1,154,000	1,157,000	2,517,000	2,701,000
Total Liabilities	23,872,000	20,047,000	21,525,000	13,043,000	13,072,00	15,392,000	13,252,000	12,701,000
Stockholders' Equity	24,799,000	20,472,000	21,744,000	16,920,000	16,355,000	15,935,000	14,090,000	11,800,000
Shares Outstanding	2,303,000	2,312,000	2,318,000	2,318,000	2,369,000	2,409,339	2,441,531	2,470,979
Statistical Record								
Return on Assets %	15.30	13.82	16.33	17.11	16.04	16.48	16.77	13.00
Return on Equity %	30.15	27.44	30.94	30.53	30.18	32.20	33.58	26.33
EBITDA Margin %	29.99	29.52	29.12	30.16	29.29	28.94	27.36	29.23
Net Margin %	22.02	18.18	20.73	21.09	21.09	22.07	20.66	15.59
Asset Turnover	0.69	0.76	0.79	0.81	0.76	0.75	0.81	0.83
Current Ratio	1.28	0.94	0.92	0.95	1.04	1.10	1.06	1.00
Debt to Equity	0.20	0.14	0.15	0.08	0.07	0.07	0.18	0.23
Price Range	59.11-37.85	65.56-41.01	64.09-45.89	49.00-40.09	45.25-40.31	53.00-38.65	50.75-37.07	57.64-43.47
P/E Ratio	20.17-12.92	26.33-16.47	24.94-17.86	22.69-18.56	22.18-19.76	26.50-19.32	28.67-20.94	46.86-35.34
Average Yield %	3.36	2.82	2.53	2.83	2.62	2.15	2.00	1.61

Address: One Coca-Cola Plaza, Atlanta, GA 30313
Telephone: 404-676-2121
Fax: 404-676-6792

Web Site: www.coca-cola.com
Officers: Ahmet Muhtar Kent - Chairman, President Chief Executive Officer Gary P. Fayard - Executive Vice President, Chief Financial Officer

Auditors: Ernst & Young LL.P
Investor Contact: 404-676-5766
Transfer Agents: ComputerShare Investor Services. Providence, RI

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to the clients of full-service brokerage firms. Brokerage firm reports may also be available from discount brokerage firms, although they may charge a fee.

Business Periodicals Business magazines such as *Bloomberg BusinessWeek, Fortune,* and *Forbes* provide not only general economic news but also detailed financial information about individual corporations. Trade or industry publications such as *Advertising Age* include information about firms in a specific industry. News magazines such as *U.S. News & World Report, Time,* and *Newsweek* feature financial news regularly. *Money, Kiplinger's Personal Finance Magazine, Smart Money,* and similar magazines provide information and advice designed to improve your investment skills. These periodicals are available at libraries and are sold at newsstands and by subscription. Many of these same periodicals sponsor an online Web site that may contain all or selected articles that are contained in the print version. Why not check out the investing information available from *BusinessWeek Online* at http://www.businessweek.com or *Kiplinger's Personal Finance Magazine* at http://www.kiplinger.com.

Corporate Reports Publicly held corporations must publish annual reports which include a description of the company's performance, information about the firm's products or services, and detailed financial statements that readers can use to evaluate the firm's actual performance. There should also be a letter from the accounting firm that audited the corporation. As mentioned in Chapter 17, an audit does not guarantee that a company has not "cooked" the books, but it does imply that the company has followed generally accepted accounting principles to report revenues, profits, assets, liabilities, and other financial information.

In addition, a corporation issuing a new security must—by law—prepare a prospectus and ensure that copies are distributed to potential investors. A corporation's prospectus and its annual and quarterly reports are available to the general public.

Security Averages

Investors often gauge the stock market through the security averages reported in newspapers and on television news programs. A **security average** (or **security index**) is an average of the current market prices of selected securities. Over a period of time, these averages indicate price trends, but they do not predict the performance of individual investments. At best, they can give the investor a "feel" for what is happening to investment prices generally. Today, there are averages for stocks, mutual funds, bonds, mortgage rates, real estate, and most other investments.

Before they can start investing, most people have to decide on a career and obtain a job that will provide the money needed to finance an investment program. To help you find the right job (and the money needed to fund an investment program), read Appendix A where we provide information that can help you to explore different career options (see text Web site).

security average (or security index) an average of the current market prices of selected securities

return to inside business

Raymond James

Raymond James has nearly five decades of experience helping individual investors and small business owners achieve their financial goals as well as providing corporations with investment banking services of all kinds. The company itself went public in 1983 and today its stock is traded on the NYSE under the symbol RJF.

As a full-service brokerage firm, Raymond James specializes in personalized attention. Customers can choose to sit down with their advisors, call with questions, or go online to check their accounts. "Our business is people and their financial well-being" is the company's mission statement, and advisors live that mission every day by delivering service with integrity, educating customers about their investment options, striving for excellence in every detail, and giving back to their communities through philanthropy and volunteerism.

Questions

1. Would you choose a full-service brokerage firm such as Raymond James or a discount or deep-discount brokerage firm when investing for a long-term goal such as retirement? Explain your answer.
2. As an investor, what questions would you like to ask a Raymond James financial advisor? How do these questions relate to your financial goals?

CHAPTER REVIEW

SUMMARY

Summary

1 Explain why you should manage your personal finances and develop a personal investment program.

Many personal finance experts recommend that you begin the process of managing your money by determining your current financial condition. The first step often is to construct a personal balance sheet and a personal income statement. You can also construct a personal budget. Before you begin investing, you must manage your credit card debts. For most people, the next step is to formulate realistic investment goals. A personal investment program then is designed to implement these goals. Many financial planners also suggest that the investor should establish an emergency fund equivalent to at least three months' living expenses. Then additional funds may be invested according to the investment program. Finally, all investments should be monitored carefully, and if necessary, the investment program should be modified.

2 Describe how the factors of safety, risk, income, growth, and liquidity affect your investment program.

Depending on their particular investment goals, investors seek varying degrees of safety, risk, income, growth, and liquidity from their investments. Safety is, in essence, freedom from the risk of loss. Generally, the greater the risk, the greater should be the potential return on an investment. To determine how much risk you are willing to assume, many investors calculate the rate of return. It is also possible to compare the rate of return for different investments that offer more or less risk. Income is the periodic return from an investment. Growth is an increase in the value of the investment. Liquidity is the ease with which an asset can be converted to cash.

3 Understand how securities are bought and sold.

Securities may be purchased in either the primary or the secondary market. The secondary market involves transactions for existing securities that are currently traded between investors and are usually bought and sold through a securities exchange or the OTC market. If you invest in securities, chances are that you will use the services of an account executive who works for a brokerage firm. It is also possible to use a discount broker or trade securities online with a computer. Both a market order and a limit order can be used to purchase stocks on a securities exchange or in the OTC market. Full-service brokerage firms usually charge higher commissions than discount brokerage firms. With the exception of mutual funds, you generally pay a commission to buy *and* sell stocks, bonds, commodities, and options. Today, a regulatory pyramid consisting of four different levels exists to make sure that investors are protected. The U.S. Congress, the Securities and Exchange Commission (SEC), individual states, and securities exchanges and brokerage firms are all involved in regulating the securities industry.

4 Recognize how you can reduce investment risk and increase investment returns.

Asset allocation is the process of spreading your money among several different types of investments to lessen risk. Two other factors—the time your investments have to work for you and your age—should also be considered before deciding where to invest your money. To reduce investment risk and increase the returns on your investments, you should evaluate potential investments before investing your money, monitor the value of your investments on a regular basis, and keep accurate and current records.

5 Identify the advantages and disadvantages of savings accounts, bonds, stocks, mutual funds, and real estate investments.

In this section, we examined traditional investments that include bank accounts, corporate bonds, government bonds, common stock, preferred stock, mutual funds, and real estate. Although bank accounts and bonds can provide investment growth, they are generally purchased by investors who seek a predictable source of income. Both corporate and government bonds are a form of debt financing. As a result, bonds are generally considered a more conservative investment than stocks or most mutual funds. With stock investments, investors can make money through dividend payments, an increase in the value of the stock, or stock splits. The major advantages of mutual-fund investments are professional management and diversification. Today, there are mutual funds to meet just about any conceivable investment objective. The success of real estate investments is often tied to how well each investment alternative is evaluated.

6 Describe high-risk investment techniques.

High-risk investment techniques can provide greater returns, but they also entail greater risk of loss. You can make money by selling short when the market value of a financial security is decreasing. Selling short is the process of selling stock that an investor does not actually own but has borrowed from a brokerage firm and will repay at a later date. An investor can also buy stock on margin by borrowing part of the purchase price, usually from a stock brokerage firm. Because you can purchase up to twice as much stock by using margin, you can increase your return on investment as long as the stock's market value increases. Other high-risk investments include stock options, derivatives, commodities, precious metals, gemstones, coins, and antiques and collectibles.

7 Use financial information to evaluate investment alternatives.

Today, there is a wealth of information on stocks, bonds, and other securities and the firms that issue them. There is also a wealth of investment information on other types of investments, including mutual funds, real estate, and high-risk investment alternatives. Two popular sources—the Internet and newspapers—report daily securities transactions. The Internet can also be used to obtain detailed research information about different investment alternatives. Often, the most detailed research information about securities—and the most expensive—is obtained from professional advisory services. In addition, brokerage firm reports, business periodicals, and corporate reports can also be used to evaluate different investment alternatives. Finally, there are a number of security indexes or averages that indicate price trends but reveal nothing about the performance of individual securities.

Key Terms

You should now be able to define and give an example relevant to each of the following terms:

net worth (599)
personal budget (600)
personal investment (601)
financial planner (602)
blue-chip stock (603)
rate of return (603)
liquidity (604)
account executive (605)
market order (606)
limit order (606)
full disclosure (608)
prospectus (608)
insider trading (608)
asset allocation (609)
municipal bond (612)
stock dividend (613)
capital gain (613)
market value (613)
stock split (613)
mutual fund (615)
exchange-traded fund (ETF) (615)
net asset value (NAV) (615)
expense ratio (616)
family of funds (617)
high-risk investment (618)
buying long (618)
selling short (618)
margin requirement (619)
security average (or security index) (625)

Review Questions

1. How could developing a personal budget help you obtain the money needed to fund your investment program?
2. What is an "emergency fund," and why is it recommended?
3. What is the trade-off between safety and risk? How do you calculate rate of return?
4. In general, what kinds of investments provide income? What kinds provide growth?
5. Would you use a full-service or a discount brokerage firm? Explain your answer.
6. What is the difference between a market order and a limit order?
7. Describe how the securities industry is regulated.
8. How do you think that asset allocation, the time your investments have to work for you, and your age affect the choice of investments for someone who is 25 years old? For someone who is 59 years old?
9. Characterize the purchase of corporate and government bonds as an investment in terms of safety, risk, income, growth, and liquidity.
10. Describe the three methods by which investors can make money with stock investments.
11. An individual may invest in stocks either directly or through a mutual fund. How are the two investment methods different?
12. When would a speculator sell short?
13. What are the risks and rewards of purchasing stocks on margin?
14. How could the Internet help you to research an investment?
15. In addition to the Internet, what other sources of financial information could help you to obtain your investment goals?

Discussion Questions

1. At the time of publication, many investors had lost money on stocks and mutual funds because of an economic crisis. At the same time, many experts argued that this was a "real investing opportunity" because of the depressed prices for many stocks and mutual funds. Based on current economic and investment information available at the time you answer this question, do you think that it is a good time to begin an investment program? Justify your answer.
2. What personal circumstances might lead investors to emphasize income rather than growth in their investment planning? What might lead them to emphasize growth rather than income?
3. In this chapter, it was apparent that stocks have outperformed other investment alternatives over a long period of time. With this fact in mind, why would investors choose to use asset allocation to diversify their investments?
4. What type of individual would invest in government bonds? In global mutual funds? In real estate?
5. Suppose that you have just inherited 500 shares of IBM common stock. What would you do with it, if anything?
6. What kinds of information would you like to have before you invest in a particular common stock or mutual fund? From what sources can you get that information?
7. Take another look at Figure 20.5 (Mergent's research report for The Coca-Cola Company). Based on the research provided by Mergent's, would you buy stock in Coca-Cola? Justify your decision by providing specific examples from Figure 20.5.

Video Case 20.1

For E*Trade Investors, Help Is Just a Click Away

E*Trade, the big online brokerage firm, offers products and services for investors at every level of experience and for almost every financial goal. Its free research and educational materials cater to the novice, the very experienced, and the investor in between by means of webinars, short videos, written articles, and other resources that users can access online at their own convenience. Users can make long-term investment plans, conduct quick trades for short-term gains, or track the performance of stocks and other securities they are thinking of buying or selling in the future.

"As I think about financial services," says one of the company's senior vice presidents, "you really separate it into two areas: there's long-term planning and then there's…single stock trading. You need to decide first which avenue you want to actually go down. The active traders have a completely different need than long-term investors. They're much more heavily reliant upon tools that can provide them with up-to-the-minute information about a company's financial performance." For long-term investors, E*Trade's Web site helps individuals determine why they are investing. What immediate goals do they want to achieve, for example, or what kind of lifestyle do they want to maintain in retirement. "Once we answer some of those questions…we can then give them a better idea of how to actually meet those particular goals. The first thing to understand is their risk tolerance."

E*Trade's automated Online Advisor tool asks a short series of questions to help investors gauge their own risk level for each investment while considering its purpose and its time horizon. One key question, for instance, is how soon the investor expects to start drawing money out of the investment program and for how many years. Another is the investor's age, and yet another is the investor's likely response to a sudden drop in the value of his or her investment. "Once you establish the type of risk [level] they have, then we can start developing a type of plan that's really comfortable for their risk level." Whether the investor wants to start college savings for a newborn, is ready to put money away for retirement, or has just come into an inheritance or other windfall and is looking for guidance about how to manage it, E*Trade can help.

Another way E*Trade helps customers invest at a comfortable risk level is through its Managed Investment Portfolios. For those investors with larger investment portfolios, the brokerage company offers a range of preselected portfolios, each with a different mix of securities offering different levels of risk and return, based on whether the investor's goals are aggressive (high risk and high return), moderate, or conservative (low risk and low return). So that one of the company's relationship managers can personally help customers choose the right portfolio, based on the investor's risk level and time horizon, this customized product is available at E*Trade's brick-and-mortar branches or by telephone. Ongoing monitoring of the portfolio, monthly statements, and quarterly performance reports are also provided, and portfolios can be periodically rebalanced to ensure that they continue to meet investors' goals.[13]

Questions

1. How would you determine whether investing in securities should be part of your personal financial plan at this time in your life? Would you prefer to manage your own investments or to invest in a managed portfolio like the one that E*Trade offers?
2. E*Trade focuses on two different types of investors, active and long term. What differentiates these investors in terms of their investing methods and goals and why?
3. Why does E*Trade offer its Managed Investment Portfolio only in person or on the phone?

Case 20.2

Investing in Your Financial Future

Nearly four in ten people in your age group (18 to 35) have already started investing for their future. What about you?

Although you may not think you have enough money to invest just now, you can start saving small amounts on a regular basis—weekly or monthly, or each time you get paid. Although it may feel like a stretch in the early months, once you get in the habit of "paying yourself first," soon you will have enough set aside to consider making some long-term investments.

Before you decide to put this step off, consider the cost of waiting. If you invest just $150 a month beginning at age 25, you can put away $1,800 a year. If the investments you choose earn a hefty 11 percent per year, for example, you'll have $1,047,294 by the time you're 65. If you wait a mere ten years, however, and begin at age 35, you will have only $358,236. That's almost $700,000 less you will have to live on when you tap your retirement account. To get a return of 11 percent, you will need to learn how to invest in stocks and mutual funds—investments that have the potential for larger returns and also carry more risk. Even if your investments earn just 5 percent per year, you will be thousands of dollars ahead if you start investing early.

Sure, the value of stocks and bonds can go down as well as up, especially during periods of financial crisis or economic uncertainty. That's why you have to take the long view when you commit your funds. You've probably heard the advice, "Buy low, sell high." During an economic slowdown, when stock prices hover near historic lows, think about starting or adding to your investment nest egg. Even when the market is soaring, there are good investments to be had.

Where should you put your investment? John C. Bogle, founder of the Vanguard Investment Company, is generally bullish about the stock market and mutual funds invested in it. Bogle advises choosing a conservative portfolio that's both balanced and diversified. Increase your investment regularly, he says, and ignore day-to-day market fluctuations. Remember, you are in this for the long term. Consider how much risk you can handle, and choose investments accordingly. Do not put all your dollars in one investment basket, and do your homework before you make your first move.

The late Sir John Templeton, whom *Money* magazine called "arguably the greatest stock picker of the century," founded a fund called Templeton Growth that grew an average of more than 15 percent each year for almost half a century. His maxims for successful investing agree with Bogle's focus on the long term. "Invest," Templeton advised. "Don't trade or speculate." Keep in mind that when you buy shares in companies that continue to grow, you are investing in their ability to keep earning money in good times and bad. Frantically buying and selling shares at the first sign of a decline is more like gambling than investing.

Of course, before you invest money you plan to park for the next 20 years or so, make sure you've eliminated as much of your current debts as possible, such as credit cards or student loans. Allow yourself enough financial flexibility to start (or continue) contributing to a separate retirement fund, especially if your employer matches your contributions. Set aside cash for emergencies, as well as for near-term purchases like a home, a car down payment, or graduate school tuition if these are in your five-year plan.

Finally, remember Bogle's observation: "If you were to put your money away and not look at it for many years, until you were ready for retirement, when you finally looked at it, you would probably faint with amazement at how much money is in there." Start investing now, and you will thank yourself in 30 years.[14]

For online quizzes and calculators to get you started, see http://www.finra.org/Investors/ToolsCalculators/index.htm.

Questions

1. Assume you can invest only half the amount suggested here, or about $75 a month. Use an online investment calculator to determine how much you can earn at 4 percent interest by age 65, if you start at age 25. Recalculate to see how much you would earn if you start at 35. What does the difference between the two results suggest about the value of long-term investing?
2. Why do you think experts advise buying low and selling high? Read the financial pages of a major newspaper for a few days or check the newspaper's Web site, paying particular attention to the behavior of buyers and sellers of securities. Do you think they consistently follow this advice? Why or why not? What other ways can investors profit from buying stock shares?
3. Make a list of your financial liabilities. How much debt do you need to pay down before you can begin setting aside money for long-term investing? Do not forget to allow for other kinds of saving, such as for retirement and emergencies.

Building Skills for Career Success

1 JOURNALING FOR SUCCESS

According to many financial experts, the logical place to begin the search for a quality investment is to examine the products and services you use on a regular basis—products and services that provide a high level of consumer satisfaction.

The preceding statement is based on the assumption that if you like the product or service and you feel that you got excellent value for your money, other consumers will too. And while it may be obvious, a satisfied, growing customer base can mean increased sales revenues, profits, and ultimately higher stock values for the company that manufactured the product or provided the service.

Assignment

1. To begin this journal exercise, think about purchases you made over the last month. Describe one product or service that you feel "was worth the money."
2. For the product or service you chose, describe the attributes or features that impressed you.
3. Determine if the company that made the product or provided the service is a public company that has issued stock.* Then use the Internet or go to the library to research the investment potential for this company. Finally, describe why you feel this would be a good or bad investment at this time.

*If the company that manufactured the product or service you chose is not a public company, choose another product or service.

2 EXPLORING THE INTERNET

For investors seeking information about individual companies and the industry to which they belong, the Internet is an excellent source. If you find the right Web site, it provides information about sales and revenue, graphs of recent trading activity, and discussions of anticipated changes within a firm or an industry. You can also look at Internet business reports of stock and bond market activity. Among the many companies that issue these reports are Mergent, Morningstar, Standard & Poor's, Moody's, and Value Line—all firms that provide research services. Visit the text Web site for updates to this exercise.

Assignment

1. Suppose that you are interested in investing within a particular industry, such as the semiconductor or computer industry. Explore some of the Web sites listed below, gathering information about the industry and a few related stocks that are of interest to the "experts."

   Bloomberg BusinessWeek: http://www.businessweek.com
   Fortune: http://www.fortune.com

Mergent: http://www.mergent.com
Standard & Poor's: http://www.standardandpoors.com
Morningstar: http://www.morningstar.com
The Wall Street Journal: http://www.wsj.com

2. List the stocks the experts recommend and their current trading value. In addition, list several stocks the experts do not like and their current selling prices. You can use one of the Web search engines such as Yahoo! Finance (http://finance.yahoo.com) to check the price. Then list your own choices of "good" and "bad" stocks.
3. Explain why you and the experts believe that these stocks are good or poor buys today. (You might want to monitor the value of all stocks over the next six months to see how well your stocks are performing.)

3 DEVELOPING CRITICAL-THINKING SKILLS

One way to achieve financial security is to invest a stated amount of money on a systematic basis. This investment strategy is called *dollar-cost averaging.* When the cost is lower, your investment buys more shares. When the cost is higher, your investment buys fewer shares. A good way to begin investing is to select a mutual fund that meets your financial objectives and to invest the same amount each month or each year.

Assignment

1. Select several mutual funds from the financial pages of *The Wall Street Journal* or a personal finance periodical such as *Money, Kiplinger's Personal Finance,* or *SmartMoney* that provides information about mutual funds. Call the toll-free number for each fund and ask about its objectives. Furthermore, request that the company send you a prospectus and an annual report.
2. Select one fund that meets your financial objectives.
3. Prepare a table that includes the following data:
   a. An initial investment of $2,000 in the mutual fund you have selected
   b. The net asset value (NAV)
   c. The number of shares purchased
4. Record the investment information on a weekly basis. Look in *The Wall Street Journal* or on the Internet to find the NAV for each week.
5. Determine the value of your investment until the end of the semester.
6. Write a report describing the results. Include a summary of what you learned about investments. Be sure to indicate if you think that dollar-cost averaging (investing another $2,000 next year) would be a good idea.

4 BUILDING TEAM SKILLS

Investing in stocks can be a way to beat inflation and accumulate money. Traditionally, stocks have returned about 10 percent per year since 1926. Bonds and certificates of deposit, on the other hand, often earn little more than the inflation rate, making it very difficult to accumulate enough money for retirement.

Assignment

1. Form teams of three people. The teams will compete against each other, striving for the largest gain in investments.
2. Assume that you are buying stock in three companies; some should be listed on the NYSE, and some should be traded in the NASDAQ OTC market.
   a. Research different investments, and narrow your choices to three different stocks.
   b. Divide your total investment of $25,000 into three amounts.
   c. Determine the number of shares of stock you can purchase in each company by dividing the budgeted amount by the price of the stock. Allow enough money to pay for the commission. To find the cost of the stock, multiply the number of shares you are going to purchase by the closing price of the stock.
   d. Assume that the commission is 1 percent. Calculate it by multiplying the cost of the stock by 0.01. Add the dollar amount of commission to the cost of the stock to determine the total purchase price.
3. Set up a table to reflect the following information:
   a. Name of the company
   b. Closing price per share
   c. Number of shares purchased
   d. Amount of the commission
   e. Cost of the stock
4. Record the closing price of the stock on a weekly basis. Prepare a chart to use for this step.
5. Before the end of the semester, assume that you sell the stock.
   a. Take the closing price on the day you sell your stocks and multiply it by the number of shares; then calculate the commission at 1 percent.
   b. Deduct the amount of commission from the selling price of the stock. This is the total return on your investment.
6. Calculate your profit or loss. Subtract the total purchase price of the stock from the total return. If the total return is less than the total purchase price, you have a loss.
7. Prepare a report summarizing the results of the project. Include the table and individual stock charts, as well as a statement describing what you learned about investing in stocks.

5 RESEARCHING DIFFERENT CAREERS

Today many people choose a personal financial planner or financial advisor to help develop an investment program that will help them achieve their financial goals. Not only is this career choice an opportunity to help others, it is also one of the fastest growing career fields in the United States. According to the 2010-2011 *Occupational Outlook Handbook*, the job opportunities for personal financial planners and financial advisors are expected to increase by 30 percent between now and the year 2018. For help completing this exercise, use the *Occupational Outlook Handbook* in your college's library or career center or go to http://www.bls.gov.

Assignment

1. Answer the following questions based on information obtained in the *Occupational Outlook Handbook*.
   a. What is the nature of the work performed by personal financial planners and financial advisors?
   b. What type of training or qualifications is required for a career in financial planning?
   c. Where are the job opportunities for personal financial planners and advisors?
   d. What are typical annual wages for a personal financial planner or financial advisor?
2. Summarize your findings in a report. Be sure to include if you would choose this career and why.

Running a Business PART 7

Graeter's

Graeter's Plans for Financing Growth

So few family-owned companies are still in business after one generation that you might think a successful *fourth*-generation firm would be content to maintain the status quo, serving its current customers with a tried-and-true product and staying close to home.

That's not the strategic plan being followed by the premium ice-cream maker Graeter's, however. This 140-year-old family business, headquartered in Cincinnati where it was founded, has big ideas. Its current management team includes three great-grandsons of the original founders; one of them, Richard Graeter II, serves as CEO. In five years, "I'd like to see us basically from coast to coast in the United States," he says of the company's mid-range outlook. Thanks to Graeter's ambitious expansion plans, that vision could well come true.

FROM ONE FACTORY TO TWO

Graeter's, worth about $20 million in annual sales, currently operates a few dozen company-owned retail stores in Ohio, Missouri, Kentucky, and neighboring states. It makes and sells a particularly rich and creamy product derived from a simple old family recipe. Graeter's uses only the freshest natural ingredients and a unique manufacturing process yielding only about two gallons of ice cream every 20 minutes for each machine on one of its assembly lines. Flavor selections vary depending on which fresh fruits are in season. Graeter's stores also offer a selection of chocolate candies, bakery items, and frozen desserts. Its ice cream, available in quart containers that are still hand-packed in its factories, is also available in hundreds of supermarkets, most notably those in the Kroger chain, in states as far away as Colorado and Texas. It can also be purchased online for overnight UPS delivery anywhere in the continental United States.

For many years one factory met all of Graeter's production needs. However, a few years ago, in anticipation of its first major expansion, the company undertook the construction of a second plant, an $11 million, 28,000-square-foot facility in the Bond Hill neighborhood of Cincinnati. The city of Cincinnati contributed $3.3 million in financial incentives, some in the form of loans, to help pay for the land and the new building (Graeter's sought outside financing for the rest). In addition to adding at least 50 new jobs to the local economy, with the promise of more in the future as growth continues, Graeter's also committed to "stay and grow" in Cincinnati for at least 20 years.

"As a Cincinnati-based, family-run company, we are proud of our association with this wonderful city and look forward to new generations of success," said Richard Graeter. "We are incredibly grateful [for the City's assistance], because not only will their support help us expand nationally but it is also helping us create jobs locally."

FROM TWO FACTORIES TO THREE

A few months before the new plant was due to open. However, Graeter's found itself facing an unexpected opportunity. Its remaining franchisee, who operated several stores and a factory, decided to put the business up for sale and offered to sell it back to the company. Suddenly, Graeter's had the option to operate not one, not two, but three production facilities. The timing was almost perfect for its growth plans, but how would the company pay for this unanticipated acquisition?

"My role as CEO would be to evaluate those opportunities as they come along and really see how they can fit into our long-term strategic vision," says Richard Graeter. "In the case of buying the franchisee, we had to come up with several millions of dollars in additional financing over and above what we had borrowed to build our new plant. So that means working with the bankers and lawyers and accountants to model how the business would look after the acquisition to determine if it makes financial sense, and then going out and raising the investment that you need to make the acquisition."

Graeter's would like to make its premium-quality products available in supermarkets across the country, and to continue opening retail stores in new states—perhaps even California (already the most popular shipping destination on the company Web site) and New York. Based on those goals, it was clear why the firm would want to buy back the franchise and its factory. Quality control was an issue as well. While the firm has had no complaints about any of the three franchisees with which it has worked in the past, all its stores are now company-owned, and the management team is happy to keep it that way. "There is something about the personal touch on a product that you just can't replace," says a management consultant who works with the firm. "Franchising really is a financial game," Richard Graeter agrees, "and it's all about growth. You can quickly lose control of the product and the brand, and after dipping our toe in the waters of franchising we decided not to get any deeper. . . . We've never really been in it just to make the most money or to be everywhere. We've really been all about the quality of the product and our connection to the product, which tends to be pretty hands-on."[15]

Questions

1. At one point, Graeter's considered expanding solely through franchising. Why do you think the company decided to retain control of its production and sales operations instead, even though this strategy, unlike franchising, requires it to take on debt?
2. Graeter's needed to raise several millions of dollars to buy out its franchisee after borrowing to build its new plant. One of the strategies it did not use to raise the needed funds was going public, that is, issuing shares through an initial public offering to sell ownership shares in the firm. What are the advantages and disadvantages of issuing stock to obtain the money needed to expand a business?
3. As an investor, would you be willing to buy shares in Graeter's if it were to raise money through an IPO? Explain why the company's stock would or would not be a good investment for you.

Building a Business Plan PART 7

To access the online *Interactive Business Plan*, go to www.cengagebrain.com.

In this last section, provide some information about your exit strategy, and discuss any potential trends, problems, or risks that you may encounter. These risks and assumptions could relate to your industry, markets, company, or personnel. Make sure to incorporate important information not included in other parts of the business plan in an appendix. Now is also the time to go back and prepare the executive summary, which should be placed at the beginning of the business plan.

THE EXIT STRATEGY COMPONENT

Your exit strategy component should at least include answers to the following questions:

7.1. How do you intend to get yourself (and your money) out of the business?
7.2. Will your children take over the business, or do you intend to sell it later?
7.3. Do you intend to grow the business to the point of an IPO?
7.4. How will investors get their money back?

THE CRITICAL RISKS AND ASSUMPTIONS COMPONENT

Your critical risks and assumptions component should answer at least the following questions:

7.5. What will you do if your market does not develop as quickly as you predicted? What if your market develops too quickly?
7.6. What will you do if your competitors underprice or make your product obsolete?
7.7. What will you do if there is an unfavorable industry-wide trend?
7.8. What will happen if trained workers are not available as predicted?
7.9. What will you do if there is an erratic supply of products or raw materials?

THE APPENDIX COMPONENT

Supplemental information and documents are often included in an appendix. Here are a few examples of some documents that can be included:

- Résumés of owners and principal managers
- Advertising samples and brochures
- An organization chart
- Floor plans of a retail facility or factory

REVIEW OF BUSINESS PLAN ACTIVITIES

As you have discovered, writing a business plan involves a long series of interrelated steps. As with any project involving a number of complex steps and calculations, your business plan should be reviewed carefully and revised before you present it to potential investors or lenders.

Remember, there is one more component you need to prepare after your business plan is completed: The executive summary should be written last, but because of its importance, it appears after the introduction.

THE EXECUTIVE SUMMARY COMPONENT

In the executive summary, give a one- to two-page overview of your entire business plan. This is the most important part of the business plan and is of special interest to busy bankers, investors, and other interested parties. Remember, this section is a summary; more detailed information is provided in the remainder of your business plan.

Make sure that the executive summary captures the reader's attention instantly in the first sentence by using a key selling point or benefit of the business.

Your executive summary should include answers to at least the following:

7.10. *Company information*. What product or service do you provide? What is your competitive advantage? When will the company be formed? What are your company objectives? What is the background of you and your management team?

7.11. *Market opportunity*. What is the expected size and growth rate of your market, your expected market share, and any relevant market trends?

Once again, review your answers to all the questions in the preceding parts to make sure that they are all consistent throughout the entire business plan.

Although many would-be entrepreneurs are excited about the prospects of opening their own business, remember that it takes a lot of hard work, time, and in most cases a substantial amount of money. Though the business plan provides an enormous amount of information about your business, it is only the first step. Once it is completed, it is now your responsibility to implement the plan. Good luck in your business venture.

The information contained in "Building a Business Plan" will also assist you in completing the online *Interactive Business Plan*.