INVESTMENT CONSIDERATION

FOR

SMALL INVESTORS

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CONTENTS

CHAPTER	TITLE	PAGE
	INTRODUCTION	1
	DEFINITIONS	5
1	FINANCIAL PLANNING	8
2	INVESTMENT OPTIONS	12
3	TYPES OF RISK	33
4	SOURCES OF INFORMATION	41
	SELECTED BIBLIOGRAPHY	52

INVESTMENT CONSIDERATION FOR SMALL INVESTORS

Introduction

The economic environment in the United States has been volatile for many years. Recently inflation reached an all time high. The value of the dollar fluctuates constantly. Unemployment is high in many social circles. These are serious problems to major corporations and small businesses alike. Corporations are headed by well educated and innovative people. Entire law firms are hired to provide advice to corporate decision makers. The small investor must learn to survive in this fast paced environment on his own.

An investor must research the markets he intends to enter. He should know about the risks associated with the different types of investments, and the returns to be received. He should know about the participants in the investment process, including organizations issuing the securities, investment bankers, and informational services. He should research the tax laws and regulations covering his area of interest. The investor should evaluate his current and prospective financial resources and uses for them. After establishing his objectives, an investment program can be prepared which is designed to meet these goals based on his personal characteristics, capacities, and limitations.

Many small investors do not have the time or inclination to research and investigate the investment markets. Financial counseling provides an alternative for these investors.

Counseling services provide knowledge and suggestions to the investor for a fee. Most counseling services are reputable businesses that are a valuable source of information to investors, others are not. Some research will be required by the investor to determine which counseling service is best for him.

Throughout this paper all material is designed to help the small investor with his or her personal investment decisions. The securities criteria mentioned are suggestions, not recommendations. They are the type of variables to consider when they can help you meet your investment goals. Take nothing for granted and always check the latest laws and data before committing any money. Your investment strategy should be compatible with your state of mind. Loss of peace of mind is a high price to pay for attempting to make a profit.

PURPOSE AND OBJECTIVE

Investment instruments provide a means of gaining future income with today's dollars. Your retirement and educational expenses for your children are only two of many reasons to invest. In order to have the desired funds when required, an investment plan will be necessary. Investment strategy bears the

most fruit when there is a careful match between financial objectives and the types of investments most likely to meet those objectives. Reasonable goals, not great expectations, are the foundation of a rewarding investment strategy. Expectations can be reasonable only when investors understand the true nature of the financial marketplace.

Knowledge about important aspects of the investment arena may be obtained two ways. First, an investor may hire the services of a broker or other financial advisor. If this method of investing is used the investor should conduct a thorough research of the company. Investigating a company should include a record check with the Security Exchange Commission and check on quality of service provided with previous customers. The second approach is to personally research several prospective investment companies before investing. Researching investment markets does not require great sophistication, but does require planning and patience. The information in this paper is designed to help the small investor:

1. Obtain the information necessary to consistently make investment decision which gain maximum returns for their investment dollars.

2. Understand tax laws to minimize their tax liability on their investment profits.

3. Establish an evaluation criteria to serve as a basis for comparing information or advisory services.

ASSUMPTIONS

1. This paper assumes that funds to invest are obtained from regular wage income and the reinvestment of profits.

2. It is assumed that peace of mind is more important to the investor than quick profits.

DEFINITIONS

The following definitions are provided to clarify terminology used in this paper. All definitions were taken from the glossary of "Personal Investing" by Wilbur Widicus and Thomas Stitzel 1971.

1. Broker: An agent who handles buy and sell orders for securities or commodities for a commission charge.

2. Call Option: A contract which gives its owner the right to buy a certain number of shares of stock, at a specific price, within a specified time period.

3. Capital Gain: The profit from the sale of a capital asset, such as a security or real estate.

4. Commodities: Items having useful value. Active trading occurs mainly in food stuffs and metals.

5. Common Stock: Securities which represent the primary ownership interest of a corporation. The owners of these securities vote for the directors of the company.

6. Discount: The amount by which a preferred stock or bond may sell below its par value.

7. Equity: The ownership interest of common and preferred stockholders in a company.

8. Liquidity: The ability to convert assets into cash with little money loss in relation to the original purchase price.

9. Moody's Investors Service: A company which provides information for investors. It assembles financial data, assigns ratings to securities, and offers buy and sell recommendations.

10. National Association of Securities Dealers: A self-regulatory body of broker dealer firms organized to develop, promote, and enforce standard procedures and ethical practices in the securities industry.

11. Net Asset Value: A term commonly used to define the value of shares in investment companies.

12. Par Value: The dollar amount assigned to each share of stock by the corporate charter.

13. Preferred Stock: An equity security whose dividends must be paid before any dividend may be paid on the company's common stock.

14. Price/Earning Ratio: The price of a share of common stock divided by earnings per share for a twelve month period.

15. Put Option: A contract which gives its owner the right to sell a certain number of shares of stock, at a specific price, within a specific time period.

16. Secondary Markets: The trading of securities after they

have been originally sold in the primary market.

17. Sinking Fund: Required payments made by a company to retire a bond or preferred stock issue gradually before maturity, or to provide money to retire the issue at maturity.

18. Speculation: The act of investing so as to assume relatively high short-term financial and other risk in the hope of better than average gains.

19. Standard and Poor's Corporation: An organization which publishes finanacial data on organizations which have issued securities. It also rates securities and offers advisory services.

20. Tax Shelter: An investment in which certain expenses can be offset against regular income or in which the taxes on income are deferred.

21. Yield: Dividends or interest paid on a security expressed as a percentage of either the current price, the purchase price, or the par value of the security.

CHAPTER ONE

Financial Planning

A plan of action and a strong supply of patience are key ingredients of any investment plan. Financial planning should be the first step in any investment strategy (Lang/Gillespie). Planning is the process of setting goals and identifying actions to achieve your goals (Robinson/Wrightsman). Your short-term and long-term goals must be compatible and well coordinated. A balance between income and expenditures is essential if you are to reach your goals. Before thinking about investments, you should accumulate a cash reserve (Martin). Martin advises clients to pull together the equivalent of three or four months salary. Another priority is to fund your individual retirement account (IRA) in order to start taking advantage of tax-deferred compounding.

Financial planning consist of five stages which will ensure a sound plan (Lang/Gillespie)

1. Identify all available income.

2. Establish your financial goals. This involves specifying exactly what you want to do, estimating the cost of completing your goal, and setting a completion date.

3. Use a budget to plan expenditures. The principal purpose

of a budget is to serve as a plan of how you want to spend your resouces. Be sure that your budget is well thought-out and that you can stick to it.

4. You must carefully decide how to spend your money. Careful spending decisions can greatly increase what your resources can accomplish and allow you to stick to your budget.

5. You must review and analyze your progress. The major purpose of this stage is to check whether your actual spending is proceeding along the lines you established in your budget.

Use these steps to establish a sound plan of action. This is critically important because it allows funds that are invested to be left alone. Your cash reserves will protect your investment portfollio if an emergency should arise.

A properly designed insurance package will greatly enchance the survivability of your cash reserves, as well as your investments (Gitman). Your insurance coverage should include home, automobile (especially liability coverage), health, and life insurance. With these coverages in place your risk of loss due to catastrophe will be minimized.

A comprehensive finanacial plan will provide a sound foundation upon which to start your investment planning (Dougall). The financial plan provides a low risk cash reserve, a well thoughtout budget, a balance between income and expenditures, coordination between long and short-term goals and

an insurance program to meet your current and future needs. Financial planning does not provide the information necessary to start investing your money.

An investment plan will provide information on where to invest, a relationship between risk and return, when to invest, and other essential data. Investment planning is a personal activity which seeks to find a balance between peace of mind and potential profit (Haft).

Personal investment planning involves three major activities:

1. Assessing capital available for investing (current and projected).

2. Selecting the investment instruments which match your goals.

3. Determing tax advantages of a given instrument.

Personal investment planning is distinctly different from personal financial planning, but still related (Raphaelson). Different, because financial planning is concerned with expending funds and providing security for living expenses, and investment planning is concerned with income acquisition and handling risk. Related because the capital for investing is acquired as the result of financial planning.

The investor can only match investment instrument and investment goals if he or she has an understanding of investment options. The next chapter provides information on the advantages

and disadvantages of several popular investment options, and includes tax considerations for each option.

CHAPTER TWO

Investment options

What have you invested in -- and why? Answering the first part of that question may be just a matter of pulling out your brokerage statements. But if you are a typical investor, the second part may leave you with a loss for words. Each investment decision an investor makes should be based on sound information and complete understanding of the advantages and disadvantages of each investment. Many investment options are discussed in this chapter with an emphasis on tax considerations, typical interest rates, and pertinent information on entering a given investment market. Many other facts and specific trends are discussed when the information seems beneficial to the investor.

Savings Account

Savings accounts are by far the most common form of personal investment (Widicus/Stitzel). This type of investment is virtually risk free and readily available. The depositor's money is theoretically available upon demand. The interest rate which will be paid to the depositor is variable. Variable interest rates allow depositor's interest income to change as the economic

environment changes. Savings accounts have no commissions and no fees to be paid by the depositor. Most savings accounts require as little as five dollars balance to remain open. Saving accounts accounted for 20% of the individual financial assets in the United States in 1979 (Widicus/Stitzel). Saving Accounts have the backing of the federal government through the Federal Deposit Insurance Corporation. Any depositor with an account balance of less than $100,000 is completely protected from loss.

A disadvantage of a saving account is the low interest rates that are offered. Most saving accounts pay between five and seven percent annual interest. Some people use whole life insurance policies as a means of saving money. Generally it is poor strategy to combine your saving and insurance programs (Williams). The common saving account provides safety, but produces small amounts of income, and has no tax shelter features. The popularity of the saving account has decreased since deregulation went into effect (Swift).

Government Investment Options

United States Savings Bonds (Series EE)

United States Savings Bonds have many of the advantages and disadvantages of the regular savings account, yet are distinctly different. Bonds can not be sold or traded between individuals

and must be redeemed at a financial institution.(Bretton). Series EE are currently the most popular bonds sold by the government, but are not the only bonds in force. Series EE bonds are available in a wide variety of denominations that are tailored for investors who have limited investment funds. Savings bonds are very safe, because they are backed by the full taxing power of the United States. Since bonds are not subject to open-market interest rates there is no danger of a decrease in value.

Series EE bonds are sold at discount from its face value; currently, that discount is 50%. This bond has a maturity of 10 years, and a promised return of 7.5% if you hold it for at least five years. If you redeem your bond at any time between six months and five years, your rate of return will range from 5.5% to 7.5% (Dougall).

The interest on Series EE bonds is fully taxable for federal purposes. Tax on interest earned may be paid annually or upon redeemption of the bond. Interest on government savings bonds is exempt from state and local income taxes. There is no fee for redeeming government bonds (Dougall). Savings bonds offer little protection from inflation, because the maturity value is fixed. Also bonds generally pay a lower rate of return than open-market investments (Harper).

Series EE bonds have many factors to consider in determing their compatibility to your goals. They are a poor choice for short-term goals, due to stiff penalties if redeemed early. They

are much better for long-term goals, but offer limited income compared to other investments (Harper).

United States Treasury Securities

United States Treasury Bonds and Notes differ from savings bonds in three major ways (Landreth). First, Treasury securities are marketable. This means they can be bought, sold, or transferred any time. There is a well-established secondary market where investors stand ready to buy and sell. Secondly, since Treasury securities are sold in the open market, their interest rates can fluctuate in relation to the supply and demand for them. Thirdly, the returns on Treasury securities is not regulated or controlled.

There are three major types of Treasury securities:

1. Treasury Bonds: The maturity on treasury bonds are longer than 10 years, usually 20 to 30 years (Lang/Gillespie). Most bonds are available in $1000 denominations. They pay a fixed interest rate and pay interest twice annually.

2. Treasury Bills: The maturity on Treasury bills is 1 year or less, and the minimum denomination is $10,000. The 90-and-180 day bills are sold at weekly auctions. The 279-and-360 day bills are available, but offered less frequently. All Treasury bills are sold at discount, with the difference between the amount paid and the face amount being the interest at maturity (Lang/Gillespie)

3. Treasury Notes: The maturity on Treasury notes ranges from 1 year to 10 years. For notes with maturities of less than 4 years, the minimum purchase is usually set at $1000 (Lang/Gillespie). Treasury notes specify a fixed interest rate and pay that interest twice annually.

The interest rate on a Treasury security is controlled by supply and demand, but once the security is initially sold the rate is fixed at that current rate. The United States Treasury will not redeem a security before maturity, but the investor is free to sell the security to another investor. The Treasury will transfer ownership, so the new owner receives the interest payments and the face value at maturity (Dreman).

The return for Treasury notes and bonds should reflect both the interest and income and any difference between purchase price and sale price. The rate of return on Treasury bills reflects only their price change, since they do not pay a separate amount of interest (Tole). Treasury notes react much more quickly to changes in monetary policy than do other fix-income securities. So when interest rates are moving up, you may be able to enhance your yield by investing in them (Dreman).

Treasury securities provide a wide range of options. Both short-term and long-term goals may be pursued with these securities. Interest is exempt from state and local income tax. This is a risk free investment, but requires sizable minimum purchase. The investor should carefully compare goals with

applicable characteristics of the security.

Municipal Bonds

The principal characteristic of this market is that it is composed of securities whose interest income is exempt from federal income tax. This income may be taxed by states other than the one in which the securities are issued. Capital gains on these securities can be taxed by the federal government (Lohman). However, the basic exemption of income from taxation sharply sets these securities aside from the securities issued by the federal government itself, and those issued by corporations.

There are some 80,000 units of state and local governments in existence (Robinson). Sophisticated investors generally make their own evaluation of the credit quality of the securities they buy. However, the vast majority of individuals and many smaller institutional investors rely heavily on agency bond ratings (Dreman). The two major professional bond-rating services, Moody's and Standard Poor's (SP), evaluate corporate as well as municipal bonds to determine whether a particular bond will perform -- pay the stated interest on time and redeem the issue at maturity -- as originally promised (Casey). A summary of bond ratings by the two major bond services is shown in figure 1. In rating a bond the services analyze the strengths and weaknesses of the corporation or government body issuing the bond. Bonds rated Baa or better by Moody's, and those rated BB or better by

Figure 1.

Popular Bond Rating Services

Moody's Bond Rating List

Rating	Description
AAA	Best Quality
Aa	High Quality
A	High Medium Grade
Baa	Lower Medium Grade
Ba	Possessing Speculative Elements
B	Generally Lacking Characteristics desireable for Investment

Standards Poor's Rating List

Rating	Description
AAA	Highest Grade
AA	High Grade
A	Upper Medium Grade
BBB	Medium Grade
BB	Lower Medium Grade
B	Speculative

SP, are appropriate for most investors (Lang/Gillespie).

There are two types of municipal bonds (Gitman):

1. General obligation bonds, which promise to pay interest and redeem bonds based on the taxing authority of the issuing organizations.

2. Revenue bonds receive the money to pay the interest on the bonds and to redeem them at maturity from the project or special facility that was constructed with the bonds. The return from municipal bonds is subject to variability and therefore there is risk associated with them. One possibility is that the bond issurer or seller will encounter financial difficulty and not be able to pay interest when it is due.

Corporate Bonds

The major nongovernmental issurers of bonds are corporations. The market for "corporates" is customarily subdivided into several segments, which include industrial, public utilities, rail and transportation bonds, and financial issues (Lohman). The bonds specify a fixed interest rate and a maturity date at which the corporation will redeem the bond at face value. The corporation must pay the interest and redeem the bonds at maturity regardless of whether or not it makes a profit. Should the firm fail to redeem the bonds at maturity, the bond holders can force payment even if their action means closing the firm and selling off its buildings, machines, and other property to raise

money (Lohman). Bondholders must be fully repaid before the owners of the business -- the common shareholders -- can receive any payment. Investors can minimize the possiblity of these problems by concentrating on bonds from corporations which are both profitable and highly rated.

Corporate bonds are sold in the open market where they compete with other investments. Interest rates vary because of differences in the perceived quality of the borrowing corporations (Gitman). Moody's and Standard Poor's provide extensive professional analysis of corporate bonds.

All interest payments received from corporate bonds are fully taxable for federal,state, and local income tax purposes. Corporate bonds generally have a minimum purchase of $5000, with interest paid semi-annually or using a sinking fund (Raphaelson).

Preferred Stock

Preferred stocks and convertible securities are corporate isses that hold a senior position to common stock. Preferred stocks are a form of equity ownership; they, along with convertibles, are considered fixed income securities because their level of current income is fixed (Zahorchak). Convertible securities, initially issued as bonds or preferred stocks, are subsequently convertible into shares of the issuing firm's common stock. Preferred stocks are issued and remain as equity, and command preferential claim to income. Preferred stocks derive their investment value principally from their high current yields

(Williams).

Preferred stocks carry a fixed dividend that is paid quarterly and stated either in dollar terms or as a percentage of the stock's par value. Preferred stocks are available in a wide range of quality ratings -- from high-grade investment issues to highly speculative stocks. These securities usually trade on the basis of the yield they offer to investors, they are in fact viewed in the marketplace as fixed income obligations and, as a result, are competitive with bonds (Williams).

There are not nearly as many types of preferred stock issues as bond issues. Most preferred stock issues are classified as one of the following (Widicus):

1. Straight Preferred: Straight preferred stock is preferred stock which has a fixed annual dividend payment. If the corporate directors declare this dividend it is paid; if they do not make this declaration it is not paid. The decision of whether or not to pay a dividend rests entirely with the board of directors of the company. A dividend not paid in any year is not carried over to the next year as a liability of the company. The only advantage that this security has over common shares is that no dividends may be paid on the common until the current preferred dividend has been paid.

2. Cumulative Preferred: Cumulative preferred stock is identical to the straight preferred except that when a cumulative preferred dividend payment is not made, the company continues to

owe this amount to the preferred shareholder.

3. Participating Preferred: Participating preferred shares receive a stated dividend before any dividends may be paid on common stock. If this and the common stock dividend are paid, and if earnings are high enough that further common dividends are justified, the participating feature allows the preferred shares to also receive additional dividends. This arragement gives the preferred share holders the best of two worlds. They receive preferential treatment on dividend payments, and they also may share in any large profits that the company obtains.

4. Convertible Preferred: Convertible preferred stock may have any of the characteristics described above, but in practice most convertible preferred is cumulative. Conversion is normally at the option of the shareholder. However, most convertible preferred is callable so that the company can either retire the issue or force its conversion.

With rare exception, straight preferred stocks are not attractive investments for the average individual (Williams). Their yields are lower than can be obtained on bonds and bonds usually offer less financial and interest rate risk (Bretton). If financial risk is not an over-powering consideration, the investor should consider investment in common stock. In this type of investment he can benefit directly from gains in earnings that are made by the company.

Common Stocks

The ownership in a corporation is vested in the common stock shareholders. While many corporations issue bonds, and some preferred stock, all corporations must issue common stock. Most common stock dividends are cash dividends, but they may take the form of products of the company, other assets of the company, or the stock of the company (Haft). The most common form of dividend payment after cash dividends is stock dividends.

There is much misunderstanding over the value of a stock dividend. Most investors see it as being favorable to their individual position, but a close examination of what takes place when this type of dividend is declared shows that this is not true. A straight stock dividend can have no value to any single shareholder because every shareholder has received a proportional increase in the number of shares he owns. The value or earning power of the corporation has not changed. Each shareholder just has more pieces of paper which evidence his ownership in the company. He doesn't own more of the company (Widicus).

Corporations may issue stock dividends while continuing to pay the same cash dividend per share. The effect of this action is to increase total dividend payments by the percent of the stock dividend. A 5% stock dividend would increase total dividend payments by 5% if the company kept the cash dividend per share at the amount it was prior to the stock dividend. In this situation the market price of the stock would theoretically

remain constant at the price it held before the stock dividend because dividends per share have not changed. The shareholder would obtain a real increase of 5% in the market value of his investment but the increase would result from the increased cash dividend payout rather than the stock dividend.

Corporations may declare a stock-split. A stock-split is similar to a stock dividend in that it also creates new shares. The major difference is that a split creates more shares than a stock dividend. The effect of a split is similar to the effect of a stock dividend -- more shares, with a drop in price per share. The net effect is to leave the value of the investor's common stock holdings unchanged (Haft).

Common stock is generally considered a good hedge against inflation. One reason is that inflation generally increases a firm's selling price and its costs at the same rate, and the increases should raise the firm's earnings. Another reason is that the firm's assets should rise in value at about the same rate as the prices which all items rise with inflation. However, the protection against inflation offered by common stock is not without limit (Willams). Historically, it seems that common stocks can provide a hedge against low inflation rates, but they offer no protection against inflation rates above 10 percent.

Common Stock Ratios:

A number of common stock or market ratios convert key bits

of information about the company into a per share basis and are used to assess the performance of a company for stock evaluation purposes. These ratios tell the investor exactly what portion of total profits, dividends, and equity is allocated to each share of stock (Gitman). Popular common stock ratios include earnings per share, the price/earning ratio, dividends per share, dividend yield, payout ratio, and book value per share. Rather than compute all the financial ratios themselves, most individual investors rely on published reports for such information. A brief description of each ratio is included to help the investor accurately interpret the information in published reports.

Earnings Per Share (EPS):

With stocks, the annual earnings of a firm are usually measured and reported as EPS. Earnings Per Share translates total corporate profits into profits on a per share basis, and provides a convenient measure of the amount of earnings potentially available to stockholders. When compared with dividends per share EPS allows investors to determine how much of the companies earnings are being put back into the company. Earnings per share is found by using the following formula:

$$\text{EPS} = \frac{\text{net profit after taxes - preferred dividends paid}}{\text{number of shares of common stock outstanding}}$$

Price/Earning Ratio (P/E):

This measure is an extension of the earning per share ratio, and is used to determine how the market is pricing the company's

common stock. The P/E ratio relates the company's EPS to the marketprice of its stock; thus allowing the investor to easily compare the company's earning potential with other companies. Price/Earnings ratio is found with the following formula:

$$P/E = \frac{\text{market price of common stock}}{\text{EPS}}$$

Dividends Per Share (DPS):

The principle here is the same as EPS; to translate total aggregate dividends paid by the company into a per share figure. Dividends per share is measured as follows:

$$DPS = \frac{\text{annual dividends paid}}{\text{number of common shares outstanding}}$$

Payout Ratio:

This important ratio provides an indication of the amount of earnings paid out to stockholders in the form of dividends. The payout ratio is found using the following formula:

$$\text{Payout Ratio} = \frac{DPS}{EPS}$$

Book Value Per Share (BV):

Book value is another name for equity (or net worth); it represents the difference between total assets and total liabilities. Book value per share is computed as follows:

$$BV = \frac{\text{stockholders equity}}{\text{number of common shares outstanding}}$$

Dividend Yield:

Dividend yield is a measure of common stock dividends on a relative (%), rather than absolute ($), basis; that is, the dollar amount of dividends received is related to the market price of the stock. As such, it is an indication of the rate of current income earned on the investment dollar. Dividend yield is computed as follows:

$$\text{Dividend Yield} = \frac{\text{annual dividends paid per share}}{\text{market price per share of stock}}$$

Dividends received by investors are subject to federal and state income taxes. One important tax provision that has a bearing on dividend income of stockholders is known as the dividend exclusion feature (Raphaelson). This provision is found in the federal and many state income tax laws, and exempts the first $100 of common stock dividends from taxation (or $200 for a couple filing a joint return). This means that a certain portion of an investor's dividend income is tax free. The provision is particularly important to small investors and especially those who seek high levels of current income. Another tax consideration of interest has to do with the sale of stock holdings. Any profits earned on such transactions are eligible for preferrential long-term capital gains treatment so long as the original shares were held for more than 6 months (Swift).

Certificates of Deposits (CD):

A certificate of deposit is distinguished in that the depositor agrees not to withdraw the funds for specified a period that period may range from 7 days to years. In exchange for the investor's agreeing not to withdraw, CD's typically pay a higher rate of return than either savings or share accounts. Most CD's today are deregulated; which means there is no ceiling on the interest that may be paid (Casey). As a general rule, a deregulated CD should offer a return roughly equal to the interest on a treasury security of comparable maturity.

Variable rate CD's are available to help protect the investor from loss due to changes in interest rate. If an investor purchases a fixed rate CD and the market interest rate rises, he could end up accepting a below market return over part, or all of the CD's life. The investor in this predicament should not redeem the CD without a careful comparison of the loss due to interest rate change and the loss due to the early redeemption penalty.

If a CD is redeemed before its maturity date, a portion of the interest on that account is lost because of a penalty for early redeemption. The extent of the interest lost depends on the original maturity date. For CD's with a maturity of 1 year or less, a penalty of 31 days interest is deducted from the account. On CD's with a maturity longer than 1 year a penalty of 90 days interest is deducted (Dougall). Another disadvantage of CD's is there is no protection from taxes. All CD's which total

less than $100,000 are protected by the Federal Deposit Insurance Corporation

Mutual Funds:

Questions of which stock or bond to buy and when to sell have plagued investors for as long as we have had organized capital markets. Such concerns lie at the root of the mutual fund concept and explain, in large part, the growth mutual funds have experienced. Many investors lack the time, the knowledge, or the commitment to manage their own portflios. Their option is to turn to the professional portfolio management offered by mutual funds.

A mutual fund is a company that combines the investment funds of many people with similar investment goals, and invests the funds of these people in a wide variety of securities (Robinson). The individual investor receives shares of stock in the mutual fund and, through the fund, is able to enjoy much wider investment diversity than they could otherwise achieve. When dividend and interest payments are received by the fund, they are passed on to the mutual fund shareholders and distributed on the basis of prorated ownership or as new fund shares.

A major attraction of mutual funds is diversification. Diversification is beneficial since it reduces the risk inherent in any one investment by speading out holdings to include a wide variety of industries and companies. Mutual funds provide full-time professional management which removes much of the

day-to-day management and recordkeeping chores from the shoulders of individual investors. Still another advantage is that most mutual fund investments can be started with a modest capital outlay and take advantage of dollar cost averaging. Mutual funds also offer many services including automatic reinvestment of dividends, withdrawal plans, exchange privileges, and checkwriting privileges (Bretton).

There are some major drawbacks to mutual funds that should be considered. One is the lack of liquidity that characterizes many mutual funds. That is, selling mutual funds is often a do-it-yourself project (Williams). Since there are usually no commissions on sales, some brokers are unenthusiastic about handling such transactions for investors. Another drawback is that mutual funds are fairly costly to acquire. Many funds carry sizable commission charges, which range from 1/2 to 8 percent of each investment dollar. In addition, a management fee is levied annually for the professional services regardless of whether a profit was made or not.

Both buy and sell transactions are carried out at prices based on the current value of all securities held in the funds portfolio. This is known as the funds net asset value (NAV); it is calculated at least once daily and represents the value of a share of stock in a particular mutual fund. Net asset value is found by taking the total market value of all securities held by the fund, less any liabilities, and dividing this amount by the number of fund shares outstanding.

Mutual funds may be characterized as open-end or closed-end. Open-end means the mutual fund stands ready to sell additional shares to new or existing shareholder. At the same time, the fund is ready to redeem, or repurchase any of its shares from current investors who want to sell (Lohman). One major distinction among open-end mutual funds is how they are sold to investors. Funds that sell shares directly to the public are called no-load mutual funds. Closed-end mutual funds operate with a fixed number of shares outstanding and do not regularly issue new stock shares. They have a capital structure like that of an ordinary corporation, except that the corporation's business happens to be investing in marketable securities (Lohman). The share prices of closed-end mutual funds are determined not only by their NAV, but also by general supply and demand conditions in the stock market.

The return on your investment in a mutual fund can come from three possible sources (Casey). First, part of the return may consist of the dividend the mutual fund pays. Secondly, part of the return may come from capital gains that the mutual fund distributes. Third, part of the return may come from a change in market price of the mutual fund's shares. Mutual fund profits are taxable, but are allowed the dividend exclusion and long-term capital gains tax reduction advantages.

All the investment options discussed have one common characteristic. Risk is a factor in any investment strategy and must be carefully analyzed and taken into account. Many types of

risk must be understood by the investor, if sound decisions are to be made on a consistent basis. The types of risk confronting investors are discussed in the next section.

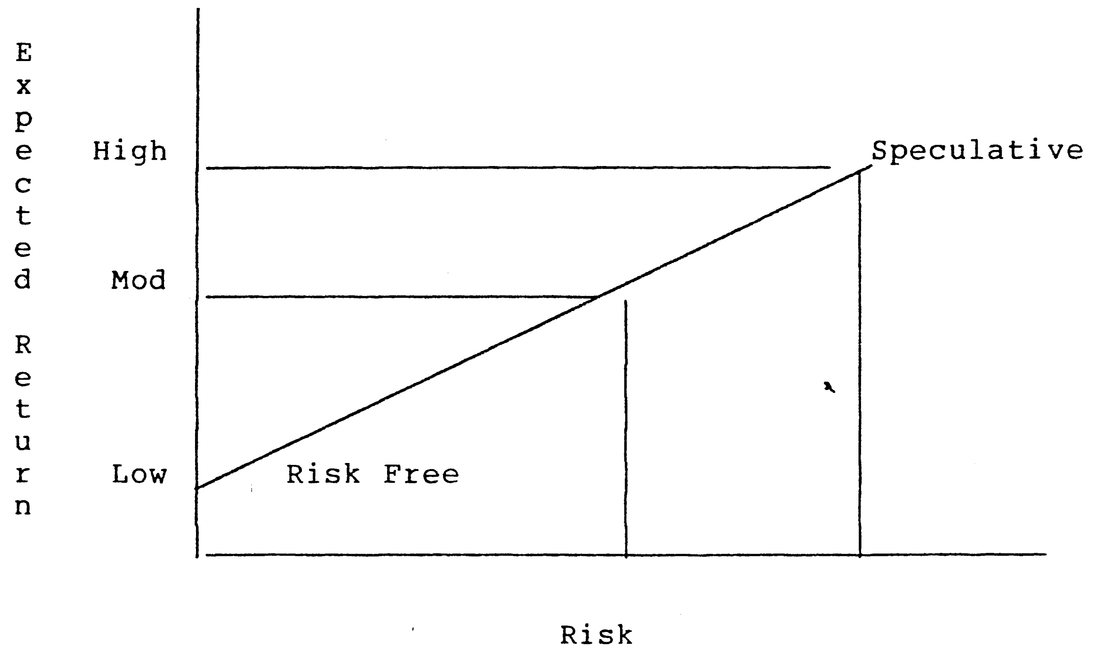
CHAPTER 3

Types of Risk

Chapter two was concerned primarily with the returns to be paid to the investor. While this is a most important consideration to any investor, the issue of risk must also be understood if sound investment decisions are to be made. Risk has many difinitions and most have some merit. A widely accepted difinition of risk is the chance that the actual return from an investment may differ from its expected value (Zahorchak). The risk associated with a given investment is directly related to its expected return. Investors require higher levels of return for increased levels of risk. Figure 2 illustrates the inverse relationship between risk and return. Investors will attempt to minimize risk for a given level of return or maximize return for a given level of risk. An investor may have a small measure of success in reducing risk through a massive research effort, but there is no known method of eliminating the inverse relationship between risk and return. As shown in figure 2, risk free investments, have a correspondingly low rate of return. High returns are expected if the investor is prepared to accept a high level of risk (such as in speculative stocks or commodities). The total risk associated with a given investment may result from a combination of any of a variety of possible sources. The major

Figure 2

Relationship Between Level of Risk and Rate of Return



sources include business risk, interest rate risk, financial risk, purchasing power risk, political risk, and market risk. A brief overview of each type of risk is provided to raise the reader's level of awareness and understanding.

Business Risk

It is possible for a business or property to experience poor earnings and fail as a result. Although bankruptcy is the most severe outcome, in general business risk is concerned with the degree of uncertainty associated with an investment's earnings and ability to pay investors interest, dividends, and any other returns owed them. Much of the business risk associated with a given investment is related to the kind of business. The business risk associated with an investment in the common stock of an aerospace company will differ from the business risk associated with a telecommunications company. Generally investments in similar types of firms of properties have similar business risk, although differences in management, costs, and location can cause similar businesses or properties to have considerably different levels of risk (Swift).

Financial Risk

Financial risk refers to the uncertainty of future returns from a security because of changes in financial capacity of the

organization that issued the security (Harper). Financial risk is dependent on the amount of debt and equity financing used to finance a firm or property. The larger the proportion of the debt used to finance the firm or property, the greater its financial risk. The increased risk results from the fact that debt financing means obligations to make interest payments as well as to repay the debt.

The level of financial risk associated with a given firm will depend on the type of security purchased. Future returns from preferred stocks in general are less certain than those expected from corporate bonds. This is because failure to meet the bond obligations will result in a default, whereas inability to pay preferred dividends has much less severe consequences. Common stockholders are residual owners, which means they are entitled to payments only after the other security holders have had their claims satisfied. This is especially true if the firm itself is not expecting continuous prosperity.

Purchasing Power Risk

When an individual invests in a market, he is looking for increased purchasing power. Puchasing power risk is defined as the uncertainty of the purchasing power of future returns due to changes in price levels (Widicus). Because of inflation a smaller quantity of some commodity can be purchased with a given number of dollars than could have been purchased in the past.

Investments having constant returns are most subject to the perils of inflation. Fixed income securities are thus the lowest grade with respect to purchasing power risk. Issues that offer opportunity for increasing returns are rated high grade. Because bonds, both government and corporate, promise stated and fixed returns of interest and principal over their life, they represent the high risk securities. Preferred stock, which usually pays a constant amount of dividends over time, would also be low grade. Since common stock offers investors the opportunity to share in the earnings of the company, they are usually considered as having relatively low purchasing power risk as a result of changes in the price level (Martin).

The smaller the degree of financial risk taken the greater the degree of purchasing power risk the investor assumes. To reduce financial risk the investor must purchase longer term securities, which increases the effect of inflation on the investment returns.

Interest Rate Risk

Interest rate risk is defined as the uncertainty of future returns due to changes in market rates of interest (Lohman). Securities that offer purchasers a fixed periodic return are especially affected by interest rate risk. As interest rates change, the prices of these securities fluctuate, decreasing with increasing interest rates and increasing with decreasing interest

rates. Increases in price due to declining interest rates result from the fact that the return on a fixed income security is adjusted downward to a competitive level by upward adjustment in its market price. The actual interest rate changes causing the market price adjustments result from changes in the relationship between supply and demand for money. All investment vehicles are subject to interest rate risk. Although fixed income securities are most directly affected by interest rate movements, other vehicles such as common stock and property are also influenced.

Market Risk

Market risk is the uncertainty of future prices because of changes in investor attitudes (Martin). The risk tends to be caused by factors independent of the given security or property, such as political, economic and social events, or changes in investor tastes and perferences. For example, inspite of the fact that a real estate investment is well managed, a major shift in consumer housing preference could adversely affect its market value and therefore the actual return realized. There is wide spread belief that investor expectations cause price movements (Harper). Waves of optimism and pessimism sweep investors minds; this dimension of influence can be identified by observing the price movements of securities while they are being traded. If an optimistic view is prevailing the market may experience a sharp increase in price. If a pessimistic mood is controlling the

market companies whose outlook is not at all bleak may be dragged down by the general fears that are prevailing.

Political and Social Risk

Political and social risk are interrelated, but have some important differences (Haft). Political risk is dependent on social risk because the mood and preferences of society can have a major influence in political decision making. On the other hand, politics influences social risk through the impact of laws and economic legislation on the public. Popular changes in the law will have a positive affect on the consumer's spending and investing decisions. Unpopular decisions and legislation could easily have a crippling effect on any given investment market, as well as investment vehicles across the board.

Political and social risk can be quite independent under some circumstances. A situation would be politically independent if a country devalued its currency, both good and bad effects will result to the financial capabilities of different organizations. A more serious development is the nationalization of facilities, which is usually quite damaging to companies whose assets are seized.

A shift in public attitude which is unrelated to any political action is always a possibility. Examples may be found in the increasing concern about the quality of man's environment. Pollution and population control movements have substantial

impacts on some lines of business. An increasing social awareness may cause shift in consumption patterns. For the most part, social changes are slow to evolve. This provides investors with sufficient time to react. Political change often takes place literally overnight. This latter risk can be taken into account by investors, but both of these types affect a rather limited segment of investment alternatives.

Risk Acceptance/Rejection

Because of differing investor preferences, it is impossible to specify a general acceptance level of risk. Each investor must select the level of risk which is compatible with his personality and state of mind. Understanding the various types of risk and the factors which influence each is essential in matching risk level to state of mind. An uninformed investor could receive devastating loss of capital and as a result experience extreme mental anguish.

Many investors use the advice of financial market experts. There is a certain amount of risk that is inherent in selecting a source of advice. Sources of information and advice are discussed in the next chapter to assist the investor in reducing the risk associated with gathering advice.

CHAPTER 4

Sources of Information

An understanding of where to find useful investment information and sound investment advice is paramount in becoming an intelligent investor. Careful consideration of available information does not guarantee profits, but there are few, if any, successful investors who have not studied each situation before they made commitments. In order for individuals to make sound investment decisions, it is important that they become familar with the workings of the economy, the market, specific investment vehicles, and other facts that have a bearing on an investment transaction.

There are three major inputs to any investment decision process (Williams). The first pertains to the capacity and limitations of the investor himself. Financial planning and risk considerations are key elements in this first input. The second input involves characteristics of different types of securities. Rate of return, liquidity, tax liability and risk are some of the characteristics of concern in this input. The third area consists of historical data about particular securities and markets in which they are bought and sold. Evaluation techniques, market listings, financial news, brokers, and other sources of information provide the data necessary for this input. The first two inputs refer to knowledge about the investor, the

investment alternatives, and their accompanying risks. The first three chapters cover these areas in detail. This chapter provides the investor with information on where to get investment advice.

Investment information can be conveniently broken into five types, each concerned with an important aspect of the investment process (Dreman).

1. Economic and current event information provides background as well as forecast data related to economic, political and social trends on a domestic as well as worldwide basis.

2. Industry and company information provides background and forecast data on specific industries and companies. This type of information is used by investors to assess the outlook in a given industry or specific company. Because of its company orientation, it is most relevant to stock, and bond investments.

3. Stock exchange quotation and explanatory notes provide a wealth of current information. Of the greatest interest to an individual investor is probably the prices that summarize the most recent market price behavior of the stock.

4. Information on personal investment strategies provides recommendations on investment strategies and/or specific purchase or sale actions. This information is usually based on Fundamental, Technical, or Randon Walk analysis techniques.

5. Determing the reliabilty of investment advice and information

is very important. The National Association of Securities Dealers and the Securities Exchange Commission provide much information on all aspects of investment markets.

The investor must have a thorough understanding of each type of investment information if he is to be successful in the investment market. Each area of information will have an affect on the decisions made and the results experienced by the investor.

Economic and Current Event Information

It is clearly important for all investors to stay abreast of major economic and current events. An awareness of such events, coupled with the ability to relate them to the behavior of various investment vehicles, should translate into better decisions. The more popular sources of economic and current event information among individual investors are the financial news, business periodicals, and special subscription services (Harper).

The most popular source of financial news is the Wall Street Journal. It is published daily and has a circulation of over 2 million (Martin). In order to provide regionally based articles and timely distribution, it is published in a number of locations around the country. In addition to giving daily price quotations on thousands of different types of investment vehicles, it

reports world, national, regional, and corporate news. A second popular source of financial news is Barron's, which is published weekly. Articles in Barron's tend to be directed more at strictly financial types of issues than those of the Wall Street Journal. Current price quotations as well as a summary of statistics on a wide range of investment vehicles are included in each issue. Another convenient source of financial news is the local newspaper. Major metropolitian newspapers such as the New York Times and Chicago Tribune provide investors with a wealth of financial news. Reading the financial pages is an inexpensive way of staying abreast of key financial developments.

Business periodicals range in scope from those presenting general business and economic articles, to those devoted to security markets and related topics. Regardless of the subject matter, most business periodicals present descriptive information, although some include analytical information. But they rarely offer recommendations (Harper). General business and economic articles are found in periodicals such as Newsweek, Time, and U.S. News and World Report. A number of strictly business and finance oriented periodicals are also available. These include Business Week, Fortune, Dun's Review, and Nation's Business. Securities and marketplace articles can be found in a number of financial periodicals. The most popular include Forbes, Changing Times, Money Magazine, and Fact. Forbes, which is published every two weeks is the most investment oriented (Martin). Each January it publishes an " Annual Report on

American Industry", which compares the growth and performance of key industries over the past five years. In August of each year Forbes also publishes a comparative evaluation of mutual funds.

In addition to the broad range of financial news and business periodicals, special subscription services are available for those who want additional insights into business and economic conditions. These reports tend to include business and economic forecasts and give notice of new government policies, union plans and tactics, taxes, prices, wages, and so on. One of the more popular services is the Kiplinger Washington Letter.

Industry and Company Information

There are a number of major publications and many small newsletters that cover the stockmarket. Of special interest to security investors is information on industries and companies. After choosing an industry investors typically will start to analyze specific companies in order to select a suitable investment vehicle. Popular sources of industry and company information include stockholder's reports, subscription services, brokerage reports and investment letters. Typically, they review recent performance, current status, and future prospects of each industry or company (Raphaelson). Stockholder's reports provide an excellent source of recent operating data on an individual business. These reports are published annually and provide a wide range of information, including financial statements for the

most recent period of operation, along with summarized statements for several prior years. In addition to the stcokholders report investors may review Form 10-K, which is a statement that firms having securities listed on an organized exchange or traded in the Over The Counter (OTC) market must file with the Securities Exchange Commission (SEC).

Subscription services are paid a fee by interested investors for information on specific industries and companies. Subscription services provide both descriptive and analytical information. They do not offer recommendations, but do periodically up-date their information. Subscribers to these services include corporations, banks, insurance companies, brokerage firms, libraries, and individuals (Martin). The dominant subscription services are those offered by Standard and Poor's Corporation, Moody's Investor Services Inc., and The Value Line Investment Survey. Most individual investors, rather than subscribing to these services, gain access to then through their stockbroker or at a public or school library.

Brokerage firms provide investors with many sources of information, through reports from various subscription services and through prospectuses for new security issues. A prospectus is a document describing in detail the key aspects of the issuer, its management and financial position, and the security to be issued (Raphaelson). Brokerage firms also provide research reports, which include analysis of and recommendations on current and future prospects for the security markets, specific

industries, or a specific security. Usually a brokerage firm will
publish lists of securities classified as either "buy" or "sell", depending upon the research staff's analysis of their data (Robinson).

Stock Exchange Quotations

When most people talk about the stock market they are referring to the secondary market. The primary market only sells new issues and is much smaller than the secondary market (Lohman). Secondary market transactions involve a shareholder who decides to sell a particular stock and a prospective investor who decides to buy that stock. The corporation has no involvement in the transaction, nor does it receive any of the proceeds. A stock's price on any day reflects the supply and demand for that stock at that time. Price quotations are readily available for actively traded securities and provide a picture of the security's behavior in the marketplace. Price quotations for stocks, bonds, listed options, commodities, financial futures, mutual funds, and other popular forms of investments are available. Figure 3 shows a typical stock quotation as presented in the Wall Street Journal. Hilton stock price has ranged from 73 1/2 high to 55 3/4 low over the last 12 months. The annual dividend in dollars is 1.80 over the same 12 month period. Next is the stocks current dividend yield at 2.7 percent. In the next column is the stocks P/E ratio at 17, based on its current

Figure 3

Typical Stock Listing

New York Stock Exchange Composite Transactions

Tuesday, February 25, 1986

High	Low	Stock	Div	Yield	PE	Sales/100's
34 1/4	22 5/8	Heinz	.90	2.7	16	1627
44 5/8	28 3/4	Hewlpk	.22	.5	22	6284
73 1/2	55 3/4	Hilton	1.80	2.7	17	517
41 5/8	26 1/2	Hitach	.36	.9	11	599
86 1/2	54 1/4	Honwel	2.00	2.5	13	2079
31	22 1/4	HouInd	2.64	8.6	7	3535

	Price			
Stock	High	Low	Close	Change
Heinz	33 7/8	33 1/8	33 3/8	-3/8
Hewlpk	43 3/4	41 1/4	42	-1 3/8
Hilton	68 5/8	67 3/8	67 3/4	+3/8
Hitach	41 1/4	40 5/8	40 7/8	-3/4
Honwel	79 1/2	78 1/2	79 1/4	+5/8
HouInd	31	30 1/2	30 5/8	-1/4

closing price and its most recent annual EPS. The current day's sale in hundreds is 517. The highest price of the stock for the current day is 68 5/8 with a low price of 67 3/8. The stock closed at 67 3/4, which was 3/8 higher than the previous day's close. Price quotations lists for the other types of investments are similar to those for stocks.

Information on Personal Investment Strategy

Whether investors conduct research of prospective investment securities or hire the services of an investment advisor, some in-depth analysis must be accomplished. One school of thought believes that technical analysis will identify definite patterns and flows in the investment markets. Followers of the school of technical analysis believe that a careful study of historical price and volume patterns will provide definite clues to the future direction of prices (Widicus). Another school of thought, called Fundamental Analysis, believes that analyzing the underlying factors will provide the insight necessary to identify stocks with the most promise. This group focuses on the current status of a company, rather that the past performance in predicting future prospects of the company (Robinson). Still another school of thought holds that stocks may be selected randomly and that on the average gains will match or exceed those of the Fundamental Analysis or Technical Analysis techniques (Lang). Which approach to use will depend on the

individual investor and the time available for research. The Technical and Fundamental Analysis techniques will require a considerable amount of time to analyze the large quantity of data available. Brokers have equipment and staffs to assist in digesting these large amounts of data and would be helpful to many investors if the Technical or Fundamental Analysis techniques are favored. Investors who like to take higher levels of risk may find the Random Walk technique satisfactory (Widicus).

Determining the Reliability of Investment Advice

Investors who use the services of financial or investment advisors typically don't care which form of investment strategy is used if they get results (Zahorchak). However, there is no guarantee of success when you take the advice of your advisor. Investors have three sources of information about potential investment advisors. First, there is the past performance records of the firm in question. Previous clients are a good source of information on the company's professionalism, competence, and reliability. Another source of information on an industry or company is a self-regulated body, such as the National Association of Securities Dealers. This body develops and enforces procedures and ethical practices in the security industry. This body's rules are not binding on non-member advisors, but has been instrumental in maintaining the integrity

of its memebers (Robonson). The Securities Exchange Commission is more effective in providing protection to investors because its rules carry the force of law. This federal agency administers various federal acts and oversees the operation of all security markets in the United States. Professional advisors are required to register and file reports with the SEC periodically.

Investment advisors are commonly stockbrokers, bankers, subscription services, or individual advisors and advisory firms. Most are reputable, but many are not. Investors should take the time to investigate potential advisors for their own safety.

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