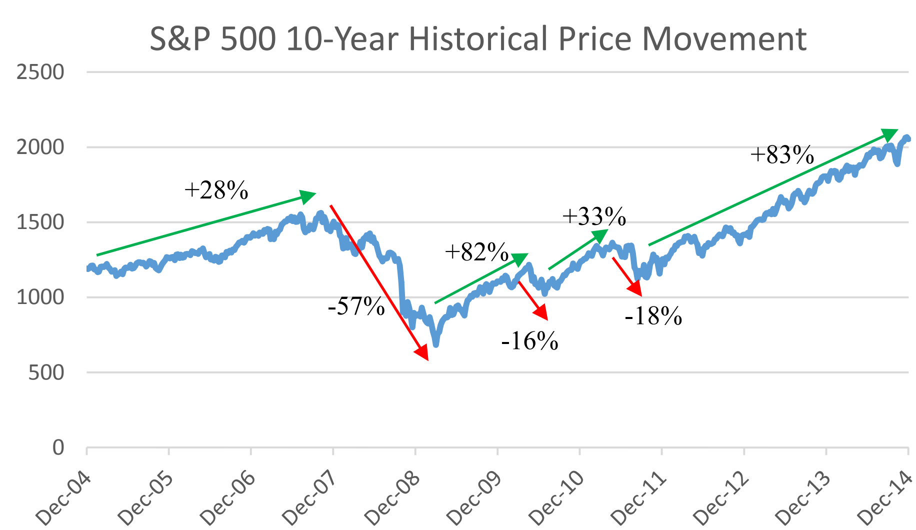
#2 TYPES OF INVESTMENTS

When deciding how to invest, it is important to know the characteristics of each investment vehicle and whether or not it is suitable for your investing objective. Generally, each type of investment will exhibit its own unique risk and return profile which is important in the construction of a well-diversified portfolio. In this section of our Investor Education Series, we will describe four main investment vehicles and shed light on some of their benefits and drawbacks.

Stocks

Companies issue shares of stock to raise capital for financing. If you own one of these shares of **common stock** (also called common equity), you own a percentage of the company. As a shareholder, you are entitled to voting rights on various issues at the company's shareholders meeting and are entitled to receive any profits the company decides to allocate to its shareholders in the form of **dividends**. While stocks that pay dividends typically exhibit lower volatility than stocks that don't pay, equity displays higher volatility than bonds. Along with this higher volatility, however, generally comes higher returns. As you can see from the chart on the left, the S&P 500has exhibited a 72% price return (excluding dividends) over the past 10 years, but within those 10 years there have been large price swings.



There also exists a form of equity called a **preferred stock**. Holders of preferred stock rank higher in the capital structure than common equity owners and they must be paid their dividends before common shareholders are paid.

Both common and preferred stocks trade on stock exchanges (NYSE, NASDAQ, etc). These are basically market places where buyers and sellers can come together and agree on an appropriate price for a company's stock.

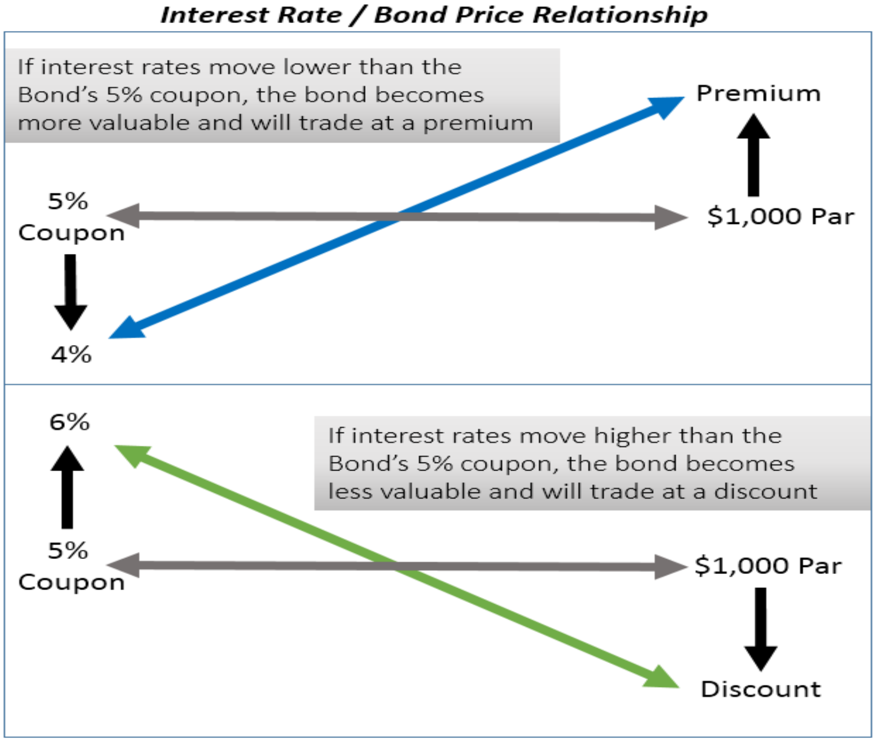
Bonds

In contrast to stocks, which are equity ownership in a company, bonds are debt. If an investor purchases a bond, they become a creditor to the issuing entity. Bonds typically have a **coupon** associated with them, a percentage that informs the investor how much interest they will earn. There is typically a maturity associated with all bonds as well. For example, if an investor buys a bond with a \$1,000 **par value**, a coupon of 5% and a maturity of 10 years they will receive \$50 per year in interest payments (5% x \$1,000). At the end of year 10, the investor will receive their initial \$1,000 investment (also called **principal**) back.

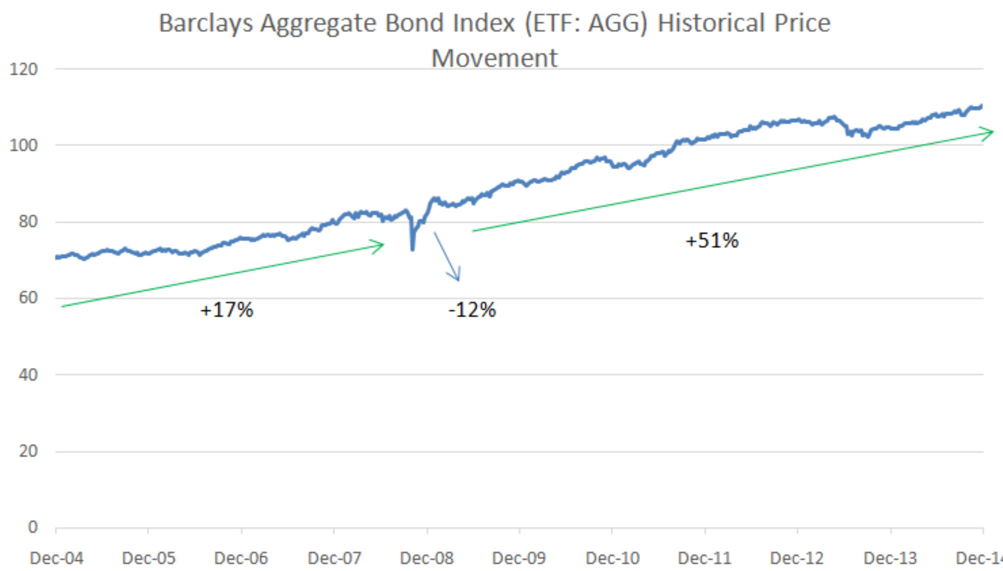
The price of a bond is not to be confused with its par (or face) value. The price fluctuates during the life of the bond in response to a number of variables. A bond currently trading above its par value is said to be selling at a premium, while a bond priced below par value trades at a discount.

Bonds are typically quoted in terms of **yield**. Yield is simply the return you earn from holding a bond, with the basic calculation: yield= coupon $ amount / price. For example, when a bond is issued at face value, let's say $1,000, and has a 5% annual coupon, its yield is 5% ($50 / $1,000). Let us assume that sometime after our 5% bond is issued, interest rates fall to 4%. This means investors would be willing to pay more (i.e. a premium) for our 5% bond than a newly issued bond at 4%. The opposite is true if the current interest rate environment drives rates above 5%. This price/yield dynamic can be summed up by saying that bond prices and interest rates are inversely related (as shown by the chart below).

Interest Rate / Bond Price Relationship



Bonds are not without risk. Non-treasury bonds can have **credit risk**, while all bonds have **liquidity** and **interest rate** risk (also called **duration**). Despite these risks, bonds exhibit less **volatility** (risk) than stocks. As you can see from the chart at the top of the next page, bonds over a 10 year period have returned 56%, less than the stock returns shown on page 1, but the ride has been much smoother with only one meaningful move to the downside.



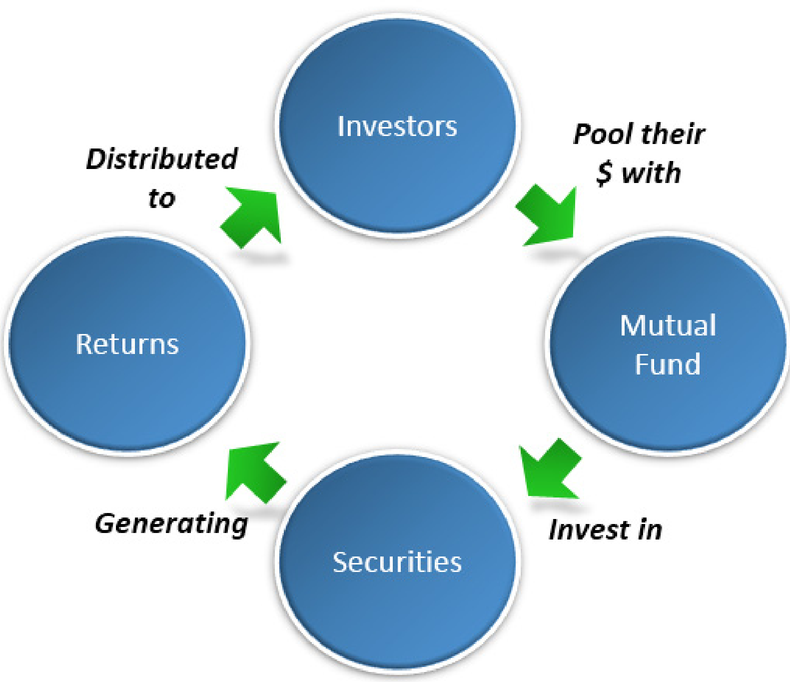
Price Returnfrom 12/1/04 – 12/1/2014: 56%

Standard Deviation: 4.5

In addition, bond holders rank higher in the capital structure which means in the event of a liquidation or bankruptcy, they will be paid before common and preferred equity holders.

Mutual Funds

Mutual funds are vehicles that pool funds from many different investors for the purpose of investing in various types of securities. Pretty much any publically traded instrument can be held in a mutual fund. The structure of a fund is outlined in its **prospectus**. The price of these funds is called the **Net Asset Value** or NAV. The NAV is determined by the total value of securities in the portfolio divided by the total amount of shares outstanding. As such, the NAV is directly related to the performance of the underlying securities in the fund. Unlike stocks, a mutual fund's price or NAV only changes at the end of each trading day, after the value of the underlying securities is tabulated.

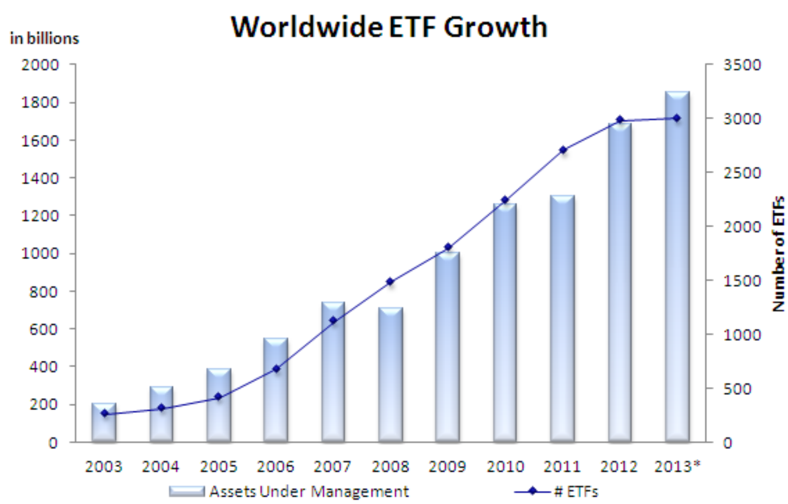


While there are passively managed mutual funds (see ETF section), most are actively managed, with each mutual fund's portfolio management team trying to beat their respective benchmark. This is termed **active management.** One of the main benefits of mutual funds is that they enable investors to gain access to professional investment management at low minimums and reasonably low costs. Mutual funds are also very liquid, with investors able to buy or sell a fund once per day.

Exchange Traded Funds

Exchange Traded Funds (ETFs) are similar to mutual funds in that they are pooled vehicles to hold various assets such as stocks, bonds, commodities, etc. ETFs differ from mutual funds in that they trade constantly on exchanges, just like stocks. This means traders and investors can buy or sell ETFs during the day rather than simply at the end of the trading day. Most ETFs in existence today follow and index strategy, generally termed **passive investing.** This means the manager of the EFF does not try to beat the market but rather generate returns as close as possible to the index or instrument they claim to track.

Two main benefits of ETFs is their low cost and tax efficiency. Because these securities track an index and don't try to outperform it, they incur fewer administrative and trading costs. Also because of their structure (and relatively complex creation), ETFs are less likely than actively managed mutual funds to generate **capital gain** distributions unless they are sold. This makes them very tax efficient. Because of these benefits, the ETF market has experienced massive growth within the past 10 years as shown by the graph below. There are now over 3000 ETFs in existence today with close to $2 billion in assets.



*As of March 2013. Source: Deutsche Bank AG

As mentioned above, ETFs are traded just like stocks, with prices changing intraday. However, because their value is based on an underlying index (e.g. the S&P 500), ETFs exhibit broader diversification benefits than single name stocks. Moreover, ETFs that track major indexes are often extremely liquid, enabling investors to buy and sell without much difficulty. In summary, ETFs are a tool for investors to gain access to a wide variety of asset classes at a relatively low cost.