Investing 101

Making Investing More Accessible for Everyone

Presented by Rico Otway

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What We Will Cover

- Section 1: Overview
- Section 2: Types of Investment Accounts
- Section 3: Types of Investment Assets
- Section 4: Asset Classes
- Section 5: Key Things to Consider When Investing

Section 1: Overview

Key Things to Understand

- Having a plan is a necessary starting point for success
- Key Component of the Plan is Asset Allocation
  - Investing is about maximizing return for a given level of risk.
  - Diversification among non-correlated asset classes can allow you to increase returns and reduce risk in some cases.
- Most investors would be best served to invest in Index Funds
  - They are very unlikely to beat the markets themselves
  - Fees make it very hard for active funds to best passive ones.
- Start Early, time/compounding is your friend.

A Few of the Biggest Mistakes People Make

- Not having a plan
  - Most people don't have a plan.
- Not spending enough time on an appropriate asset allocation
  - Long-term investment performance is driven by an investor's asset allocation, but most people spend little of their time thinking about this and far too much time focused on choosing individual assets.
- Overestimating tolerance for risk
  - This causes many investors to sell at exactly the wrong time (when the market is at a downturn) and then only buy back in once the market has recovered and is back up.
- Lack of diversification
- Excessive trading
  - Increases costs and taxes, which decrease actual returns.
- Not starting early enough. Compounding is a powerful advantage.

Section 2: Types of Investment Accounts

Types of Accounts

- Taxable Accounts
  - These are your typical brokerage accounts where you pay taxes when you buy and sell assets.
- Tax Deferred
  - Money you put in is typically pre-tax (although it doesn't have to be).
  - Earnings grow tax deferred until you withdraw them.
  - Money you withdraw is taxed at normal income tax rates.
  - There are usually age restrictions on when you can start withdrawing the money without incurring penalties.

Types of Accounts

- Tax Deferred
  - For-Profit Company Plans
    - 401K
      - Limits change periodically, but for 2018 it's $18,500 or $24,500 if you are over 50
      - Employers can optionally match some or all of your contributions
      - Sometimes the match requires vesting. Vesting means that you have to stay, a certain period of time with the company to get a portion or all of your employer's contributions.
      - Money is typically withdrawn directly from your paycheck pre-tax.
      - Companies have hire someone to administer their plan and usually provide plan participants with a pre-determined amount of funds they can choose to invest in. Company stock is sometimes an option as well.
      - Withdrawals made before the age of 59 ½ are subject to a 10% penalty in most cases.
      - Loans are allowed in certain 401K plans, but they must be repaid. If they aren't then you will be both penalized and tax on the loan amount.
      - Required Minimum Distributions start at 70 ½.

Types of Accounts

- Self-Employment Plans
  - SEP (Simplified Employee Pension)
    - Can contribute up to 25% of earnings with an annual maximum limit of $55,000.
    - Can be used as an alternative to a 401K Plan for Smaller Companies and Employers.
    - Money can only be contributed by the employer. Business Owners can contribute on their own behalf.
    - Employer has the flexibility to choose to contribute or not in any given year.
    - Distribution and taxation rules are the same as a Traditional IRA.
  - SIMPLE
    - Another Plan available for Smaller Companies and Employers.
    - Funded primarily through employee contributions, but requires an employer match.
    - Limits are less than those of a 401K. For 2018, Limits are $12,500 or $15,500 if you are over the age of 50.
    - Employers can choose to either match up to 3% or can op to make a 2% contribution regardless of employee participation.
    - Distribution and taxation rules are the same as a Traditional IRA.

Types of Accounts

- Self-Employment
  - Independent 401K
    - Works just like a traditional 401K, but is set up for an individual running a sole proprietorship or a small business with a spouse or immediate family member.
    - For 2018, you can contribute an annual maximum limit of up to $55,000 or $61,000 if you are over the age of 50.
- Non-Profits
  - 403(b)
    - Incorporates the same principles as a 401K plan, but is only set up for certain types of non-profits such as schools, hospitals and religious groups and organizations.
- Federal Government
  - Thrift Savings Plan
    - Incorporates the same principles as a 401K plan, but is only set up for federal government employees as well as civil service employees and members of the military.
- State and Local Government
  - 457
    - Incorporates the same principles as a 401K plan, but is only set up for state and local government employees.

Types of Accounts

- Traditional IRA
  - Comes in two types, deductible and non-deductible.
  - If you are covered by an employer retirement plan, you can still make contributions to a traditional IRA, but depending on your income, they may qualify as partially tax-deductible or totally non-tax-deductible IRA contributions.
  - Annual contributions are limited to $5,500 or $6,500 if you are over the age of 50.
  - Early withdrawals incur a 10% penalty before the age of 59 ½.
  - Mandatory Required Minimum Distributions start occurring at the age of 70 ½.
  - Withdrawals are taxed at your income tax rate.
  - Typically held in a brokerage account and can be invested in whatever you want.

Types of Accounts

- Tax Free
  - Two main differences between tax deferred and tax free accounts
    - Withdrawals are tax free on contributions made with after tax dollars (like a non-deductible IRA)
    - Contributions may actually be withdrawn without penalty prior to turning the age of 59 ½, but not earnings made on these contributions.
    - There are no required minimum distributions at the age of 70 ½.
    - There are income limits on whether you can participate in a Roth IRA. For 2018, the AGI phase-out range for taxpayers making contributions to a Roth IRA is $189,000 to $199,000 for married couples filing jointly.
  - Two Types of Tax Free Accounts
    - Roth IRA and Roth 401K.
    - The 401K is offered through an employer while the IRA is an individual plan.
    - If your employer offers both Roth and Regular 401K options, you can participate in both, but the total contribution limit for the year 2018 is still $18,500.
    - One advantage of the Roth 401K is that it doesn't have the income limits for eligibility that the Roth IRA does.

Section 3: Types of Investment Assets

Primary Asset Types

- Stocks
- Bonds
- Mutual Funds
- ETFs

Stocks

- Stocks represent actually ownership in a company.
- Stocks generate returns through capital appreciation (increase in the price of the stock) and income (dividends paid).
- There are two types of stock, common and preferred.
  - Most people buy common stock and have not heard of preferred stock.
  - Preferred stock is a sort of hybrid between a stock and a bond. It typically pays a higher dividend than that of common stock and often trades in line with the bond market.
  - Preferred stocks can be perpetual or they can have call features like a bond. A call feature means that after a certain date the company who issues the shares of stock, can choose to eliminate the shares by paying shareholders the amount equal to the original price of the issue. They are not forced to do this, but they have the right to. This typically limits the capital appreciation potential of preferred stock.

Stocks

- Typically broken into segments
  - Geography: US, Developed Foreign Markets (France, Japan), Emerging Foreign Markets (India, China, Brazil)
  - Size: Large Cap ($10Billion+), Mid-Cap ($2Billion - $10Billion), Small-Cap (Less than $2Billion)
  - Style: Growth vs Value.
    - Value tends to be slower growing companies where investors look for certain key metrics that suggest the company is trading for less than its intrinsic value. Benjamin Graham is the father of value investing and his books, Security Analysis and The Intelligent Investor, are considered the bibles of this discipline.
    - Growth tends to focus on companies that are rapidly growing their earnings and revenue. Investors tend to pay more of a premium for this growth. The trick is to find companies whose actual growth will continue to exceed expectations.
  - Industries/Sectors: Technology, Healthcare, Financials, Industrials, etcetera.

Stocks

- The two primary exchanges in the United States are the NYSE and NASDAQ.
- U.S. investors can also invest in many large foreign companies on U.S. Exchanges through ADRs (American Depository Receipts).
- Very small companies trade on the OTC (Over the Counter) market. We will not focus on this as most investors shouldn’t be speculating in penny stocks.
- U.S. investors are also increasingly able to trade directly on foreign exchanges through major brokerage firms. Once again, this will not be a focus for us as the difficulty of researching foreign companies and a lack of foreign accounting standards make these options unsuitable for most investors.

Common Measures Used to Value Stocks

- Price/Earnings
- Price/Book
- Price/Sales
- Price/Earnings Growth
- Earnings Yield

Buying Stocks

- Stocks are typically bought through a brokerage firm, although some large companies will let you buy directly through them.
- Stocks are priced using a bid and ask system.
  - If you want to buy, you pay the ask price.
  - If you want to sell, you will the price of the bid.
  - The difference between the two is kept by the company facilitating the transaction.
- Example:
  - IBM Bid: 102.40 Ask: 102.42 Last: 102.41
  - If you sell 100 shares at market price, you would get 100 x 102.40 – Any Commission.
  - If you bought 100 shares at market price, you would pay 100 x 102.42 + Any Commission.
- In the example, we used a Market Order. Limit Orders are the other most common order type. They work the way you would expect. You say I will buy or sell X amount of shares at Y price. Your order only gets executed if someone is willing to buy or sell to you at the specified price. In contrast, Market Orders always get executed at whatever price the market dictates when your order arrives.
- The positive side of a Limit Order is you know the price you will either pay or receive if your order is executed. The potential downside is that your order may not ever be executed.

Stocks Miscellaneous

- Trade Settlement
  - When you buy or sell a stock, there is something called a settlement period. This is typically two business days. The current owner remains the owner of record until the trade is settled. This is really only important in regards to dividends.
- Dividends
  - Some corporations choose to pay their investors a dividend.
  - Dividends don't have to be at regular or fixed intervals, however quarterly paid dividends are usually the most common.
  - The two dates associated with a dividend payment are the ex- date and the payable date.
    - Because of the time it takes to settle a trade, you must buy a stock the day before the ex-date in order to be the official owner by the record date and get paid the dividend. This also means you can sell on the ex-date and still get that quarter's dividend.
    - The payable date is when you actually receive the dividend.

Stocks Miscellaneous

- Splits
  - A stock split (or a reverse split) has no impact on how much your shares are worth.
  - When a stock splits, the number of shares are increased by the split amount and the price per share is decreased by a corresponding amount.
  - Reverse splits do the exact opposite, they decrease the number of shares and increase the price per share.
  - Companies often do a stock split to keep the price per share at an affordable point for the mainstream investor.
  - Companies typically do a reverse split to stay above the minimum price point required to be listed on an exchange.
  - Example:
  - Investor owns 100 shares of Oracle at $30 per share. Oracle executes a 3:2 stock split. Before the stock split, my shares are worth $3,000. After the split, I will own 150 shares at $20, which is also worth $3,000.

Bonds

- Loans to a company or government where the investor is paid a certain rate of interest per year (usually in two 6 Month installments). There is a maturity date when the investor's original principal is returned and there is optionally a call date where the issuing entity has the right to retire the bond earlier than the maturity date and return the investor's principal.
- Bond pricing is somewhat different than that of stocks. Par Value for a bond is 100, but that actually represents $1,000 and bonds are usually sold in increments of $1,000 at Par.
  - Example:
  - I own 10 bonds priced at 98.2. I really own $9,820 of the specified bond.
  - Bonds come in a taxable and non-taxable categories.
- Non-Taxable Category
  - US Government bonds are free of state taxes but still require you to pay federal taxes.
  - Municipal Bonds are free from federal taxes and are also free from state taxes for owners who live in the state where they were issued.

Bonds

- The taxable category of bonds mostly consists of corporate bonds.
- Interest rates for bonds are driven by two primary factors, the rating of the bond and the duration of the bond.
  - Bonds are rated by several outside ratings agencies based on the credit worthiness of the underlying entity. These ratings affect how much interest an investor demands as compensation for the risk they are taking.
  - U.S. Government bonds are typically considered the safest of all of the bonds as they are backed by the U.S. government.
  - The longer the duration of the bond, the more interest rate risk is involved and therefore the coupon rates are typically higher.

Bonds Types

- U.S. Government - Treasuries
  - Treasury Bills are short term instruments and are often considered a proxy for the rate of return for cash.
  - Treasury Notes are intermediate term bonds, with maturities between one and ten years.
  - Treasury Bonds are long-term bonds, with maturities of over ten years.
  - TIPs (Treasury Inflation Protected Securities) are a treasury security that is indexed to inflation in order to protect investors from the negative effects of inflation.
- US Government – Agency Bonds
  - Issued by agencies of the US Government rather than the U.S. Treasury and have the same characteristics as treasuries.
  - Common issuers are Freddie Mac, Fannie Mae, Ginnie Mae and the TVA.

Bond Types

- Municipal Bonds
  - Issued by a state, county, city or local municipality.
  - They are used to finance projects within a state such as schools, highways, hospitals, infrastructure, etcetera.
- Corporate Bonds
  - Issued by a company.
  - Typically broken into high quality and junk categories based on the bond's credit rating.
- Mortgage Backed Securities (MBOs) and Collateralized Mortgage Obligations (CMOs)
  - Not very likely to be bought by individual investors, but can however be bought through a fund.
  - The basic premise of the securities is to package a whole lot of loans of a certain type (mortgages, car loans, student loans, etcetera) and turn them into a single security that someone can invest in.
  - The collateral is the underlying assets behind the individual loans.

Primary Bond Risks

- Inflation risk
- Interest rate risk
- Call risk
- Credit risk
- Liquidity risk
- Market risk

*** Bond prices and yields are subject to change based upon market conditions and availability. If bonds are sold prior to maturity, you may receive more or less than your initial investment. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.**

Mutual Funds

- A mutual fund is an investment vehicle made up of a pool of moneys collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and other assets. Mutual funds are operated by professional money managers, who allocate the fund's investments and attempt to produce capital gains and/or income for the fund's investors.
- Investors are charged an ongoing management fee for this service
- Mutual funds also charge a variety of other types of fees
  - No Load Fees vs Front Load Fees
    - A Front Load Fee is a one-time fee paid upfront when you purchase the mutual fund where a No Load Fee is only paid on the backend when you sell a mutual fund before a specified period of time goes by.
  - 12B-1 fees are marketing fees passed along to the investors.
  - Administrative Fees
  - Operating Expenses
  - Trading Costs – These are typically not disclosed anywhere, but the investor does pay the costs associated with any trade, so the higher the funds turnover rate, the higher this cost will be to the investor.

Mutual Funds

- Mutual funds cover a huge variety of asset types and investment strategies.
- Two core approaches are passively managed funds and actively managed funds.
  - Passive funds tend to pick an index they wish to mirror and simply invest according to the makeup of that index.
  - Active funds invest according to the manager's beliefs and usually have a stated goal of outperforming the index that is the most closely correlated to their investment charter.
- How is a Closed End Fund different? Like a mutual fund, a closed-end fund is a pooled investment fund with a manager overseeing the portfolio; it raises a fixed amount of capital through an initial public offering (IPO). The fund is then structured, listed and traded like a stock on a stock exchange.
  - Closed End Funds have a fixed amount of shares.
  - They trade like stocks throughout the day.
  - Because they have a fixed number of shares, they can actually trade at a premium or a discount to the value of their underlying assets.

Exchange Traded Funds (ETFs)

- ETFs are a relatively new type of investment.
- They are very similar to mutual funds, except they are traded throughout the day like stocks. Mutual funds only trade once per day and you either buy or sell based on the day's closing price.
- Historically, ETFs have been mostly classified as passive investments in nature, which have lower fees than corresponding mutual funds.
- Part of the theory for why you don't see more actively managed ETFs is that mutual funds only have to disclose their holdings once every 6 months, whereas ETFs are required to disclose them every day.
- Since this is a nascent investment vehicle, only time will tell if more managers choose to offer an ETF version of their investment products. Recent trends indicate this may happen relatively soon.

*** ETF shareholders should be aware that the general level of stock or bond prices may decline, thus affecting the value of an exchange-traded fund. Although exchange-traded funds are designed to provide investment results that generally correspond to the price and yield performance of their respective underlying indexes, the funds may not be able to exactly replicate the performance of the indexes because of fund expenses and other factors.**

Section 4: Asset Classes

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Asset Classes

- Investments are categorized in different classes.
- These classes can be very broad, like equities and fixed income, or very specific, like Small Cap U.S. Value Stocks and Sovereign Emerging Market Debt.
- Asset classes are used by investors to create a strategic plan called asset allocation, in which they will construct their portfolio around.

Catalog of Asset Classes

- Equities
  - Geography: U.S./Developed International/Emerging Markets
  - Market Cap: Small, Mid, Large
  - Style: Value vs Growth
- Fixed Income
  - TIPs
  - Treasuries
  - Municipal Bounds
  - Corporates
  - High-Yield
  - Foreign Bonds
  - Preferred Stock
- Alternatives
  - Real Estate
  - Commodities
  - Forex
  - Long-Short
  - Private Equity
  - Hedge Funds

Section 5: Key Things to Consider When Investing

Asset Allocation

- Asset Allocation is a very important factor when it comes to long-term investments.
- The purpose of asset allocation within a portfolio is about lowering risks for a given level of return or maximizing returns for a given level of risk. This is accomplished by diversifying among different classes of assets that don't all move the same way at the same time.
- Modern Portfolio Theory (MPT) is the dominant current philosophy of Asset Allocation.
  - The theory was introduced by Harry Markowitz's in his "Portfolio Selection" essay which helped to influence William Sharpe's "Capital Asset Pricing Model" and Eugene Fama's "Efficient Market Hypothesis".
  - The theory suggests that it is possible to construct an "efficient frontier" of optimal portfolios, offering the maximum possible expected return for a given level of risk. It suggests that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification, particularly a reduction in the riskiness of the portfolio. MPT quantifies the benefits of diversification, also known as not putting all of your eggs in one basket.

Risk vs. Reward

- The general principal is that taking more risk is compensated by the potential for greater reward over longer periods of time.
- Risk is most often associated with volatility in the investing world.
- Beta is a concept that measures whether an asset is more or less volatile than the overall market with a value of 1 equaling the volatility of the market.
  - An S&P 500 Index Fund would probably have a Beta of 1. A Utility Company Stock may have a Beta of .50 and a High Growth Tech Stock might have a Beta of 1.5.
  - What this means is that for every $1 that the market goes up or down, you would expect the Utility Company Stock to go up or down $0.50, while the High Growth Tech Stock would move up or down by $1.50.
- Alpha is a concept used to measure whether or not you are outperforming your target benchmark. Index funds would expect to have an Alpha of 0, which means their returns would be in line with their benchmark. Alpha is measured as a percentage. For example, if my Large Cap Stock Portfolio is generating an Alpha of 2% over the S&P 500, this means I am earning 2% in excess of what the S&P 500 is doing.
- The Sharpe Ratio is intended to take risk into consideration when measuring the effectiveness of an investment. A higher Sharpe Ratio equates to a better risk adjusted return between two investments that use the same benchmark.
- Some other ratios with similar purposes to the Sharpe Ratio you might encounter are the Soretino Ratio, Traynor Ratio and Jensen's Alpha.

Performance Methods

- Two primary mechanisms people use for measuring performance are:
  - Time Weighted Returns
    - Measurement of performance over time independent of the amount of money invested or withdrawn.
  - Money Weighted Returns
    - Measurement of financial performance based on a series of cash flows such as money deposited, varying investment returns and money withdrawn over a defined period of time.

Performance Methods

- Time Weighted Returns are what is mainly used by investment managers, because they are trying to grasp a more accurate understanding of how their investments actually performed. The reason for this being, is that when investors chose to add or withdraw money from a fund or portfolio, it could heavily influence the money weighted return of an investment and is a result that is totally out of the control of the investment manager.
- Because Money Weighted Returns take contributions and withdrawals into account, the timing of these events can greatly influence the result and makes it harder to understand how you really performed from an investment selection perspective.
- The majority of Investor Statements use Money Weighted Returns as a measurement of performance.

Minimizing Costs

- All else being equal, costs can have a significant impact on your portfolio over time. This being said, it is very important to understand the costs associated with an investment.
- For example:
  - You buy $100,000 of a Mutual Fund instead of an ETF and pay an extra 1% Management Fee.
  - Both funds perform exactly the same for the next thirty years and you earn a total of 8% before the fees are taken out.
  - At the end of the period, you would have a total $1,000,000 in the ETF and only $750,000 in the Mutual Fund.

*** This example is for illustrative purposes only and does not represent an actual investment. Actual investor results will vary.**

Inflation and Investing

- People don’t often truly understand the impact of inflation on their money and or investments.
- Historically, inflation has averaged about 2.7% per year.
- This means that every twenty years or so, you will need to have twice as much money accumulated to have the same spending power as you do today.
- Inflation can be the biggest enemy of the conservative investor and although having your money sit in a Savings Account can be considered as a safe option, over time it can do some damage to the value of that money.

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