Investment Alternatives

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Risks Associated With Investing

Investments involve many types of risks. Let’s consider two: investment risk and purchasing power risk.

Investment risk is the probability that the actual return on an investment will be different from what you expect. This is the type of risk you usually think of when considering investments. For example, certificates of deposit (CDs) and EE savings bonds are considered safe investments because the probability that the actual return on your investment will be what you expect is 100 percent since the return is guaranteed. On the other hand, stocks are considered more risky because you have no guarantee about the return.

A second type of risk associated with investments is called purchasing power risk. It is the risk that the value of the money you invest will not keep up with inflation. In general, this risk is greatest with those investment alternatives with a set, guaranteed rate of return. So while CDs have a low investment risk, they have a high purchasing power risk.

Think about your various investment alternatives as being on stair steps with those on the lowest step having the least amount of risk. As you climb the stairs, your investment risk increases (Figure 1). It’s generally true that as your risk increases so does your potential rate of return. If you want higher potential returns, you must

Figure 1. Steps to investment alternatives.
accept greater risks. Figure 1 is a guide to the relative risks and returns of various investments. As you move up on the chart, risk and the potential return on your investment increase.

**Investment Alternatives**

**Step 1**

Investments on the first step have the lowest investment risk but the highest purchasing power risk. These include insured savings accounts, EE, HH and I savings bonds, money market deposit accounts, and Certificates of Deposit (CDs).

**Insured Savings Accounts**

Passbook savings accounts, credit union shares, and interest-bearing checking accounts such as NOW accounts, generally are insured savings accounts. Advantages of these accounts include money is instantly available; funds can be used as collateral for a personal loan; and funds are extremely safe if kept in a federally insured institution. However, any interest earned is subject to federal and state income tax law.

**Savings Bonds — EE, HH, and I**

Series HH bonds were sold at face value but are no longer issued by the U.S. Treasury. Series EE bonds are an accrual-type security, which means interest is added to the bond monthly and paid when you cash in the bond. Series EE bonds sold after May 2005 earn a fixed rate of interest based on current market rates.

Paper bonds are sold at half the face value, for example, you pay $25 for a $50 bond. This means they take longer to mature than electronic bonds as their value is based on interest rates. They are guaranteed to reach face value in 20 years. Paper bonds can be purchased in denominations of: $50, $75, $100, $200, $500, $1,000, $5,000, and $10,000. Electronic bonds purchased via Treasury Direct are sold at face value, for example, you pay $25 for a $25 bond. Electronic bonds can be purchased to the penny for $25 or more. You must hold EE bonds for at least one year, but they can earn interest for up to 30 years. If redeemed before five years, a penalty of the most recent three months’ interest will be assessed. Interest earnings are exempt from state and local income taxes but are subject to federal income tax (unless used to finance education).

Series I bonds earn interest while you own them and protect you from inflation. I bonds have an annual interest rate that reflects the combined effects of a fixed rate and a variable semi-annual inflation rate (based on the Consumer Price Index for all Urban Consumers [CPI-U] for May and November). They are an accrual-type security. Interest is added to the bond monthly and is paid when you cash the bond. I bonds are sold at face value, for example, you pay $50 for a $50 bond. Electronic I bonds can be purchased to the penny for $25 or more. Paper I bonds can be purchased in $50, $75, $100, $200, $500, $1,000, or $5,000 denominations. You must own an I bond for one year, but it can earn interest for up to 30 years. If redeemed before five years, you will forfeit the interest from the three most recent months as a penalty. Income tax is the same as for the Series EE Bonds.

What is the difference between I bonds and EE bonds? The biggest difference is the rate you receive on your bonds. Rates for EE bonds are calculated as 90 percent of six-month average market yields of five-year Treasury Securities, while rates for I bonds are calculated by combining fixed rates of return and variable semi-annual inflation rates based on the CPI-U for May and November. The Consumer Price Index is a measure of the average change in prices of goods and services purchased by households over time.

**Money Market Deposit Accounts**

Available from financial institutions, money market deposit accounts give the smaller investor an opportunity to get in on treasury securities. The institution buys a variety of treasury securities with the money you invest. The rate of return changes daily, and services such as check-writing may be offered.

**Certificates of Deposit (CDs)**

Money in a CD is tied up for a few months to six years or more depending on the terms of the specific CD you buy. Before you buy a CD, ask to see the maturity date in writing. Some CDs are callable, meaning the institution issuing the CD has the right to terminate or “call” the CD after a set time. A notice of withdrawal is required and a penalty imposed if you withdraw money before the CD matures. Interest is higher than on insured savings accounts. Generally, the longer you tie up money in a CD, the higher the interest rate. Interest is paid at maturity. In most cases, the more money you invest, the higher the rate of interest. All earnings are subject to income tax. CDs are available from banks, savings and loans, credit unions, and from brokerage firms and independent salespeople known as deposit brokers. Purchase CDs from federally insured depository institutions. No purchase fees are charged.
Step 2

Investment alternatives on the second step include life insurance, fixed annuities, government securities (Treasury or T-bill, T-notes, T-bonds, and Treasury Inflation-Protected Securities or TIPS), and money market mutual funds. They have slightly more investment risk and slightly less purchasing power risk than those on the first step.

Life Insurance (Investment Component)

The traditional purpose of life insurance is income protection for dependents in the event of death of a breadwinner. There are forms of life insurance (for example, annuities and various forms of whole life universal life insurance) that combine this traditional purpose with various investment programs. Some let you choose where your money will be invested. The investment risk and purchasing power risk depend on the investments chosen either by the company or by you, and the stability of the particular life insurance company. Be sure to check insurance company ratings with services such as A.M. Best, Moody’s, or Standard and Poor’s. Commissions, management fees, and surrender charges (fees assessed for cashing out early) can all be a part of insurance investment options that should be seriously considered if using any of these investments.

Government Securities (T-Bills, T-Notes, T-Bonds, TIPS)

These government securities are issued only in electronic format. T-bills represent short-term debt of the US government and are sold in multiples of $100 up to $5,000,000 for 1 to 12 months. T-bills are sold at a discount and pay interest only at maturity. The interest rate is equal to the face value minus the purchase price. Treasury notes (T-notes), or intermediate debt, are sold in multiples of $100 to $5,000,000 for 2, 3, 5, 7, or 10 years. T-notes pay interest every six months until they mature. When a note matures, you are paid its face value. Treasury bonds, which represent long-term debt of the government, are sold in multiples of $100 to $5,000,000 for 30 years.

TIPS provide protection against inflation. The principal of TIPS is adjusted by changes in the Consumer Price Index. When inflation (a rise in the index) occurs, the principal increases. With deflation (a drop in the index), the principal decreases. This relationship affects both the sum you are paid when the TIPS mature and the amount of interest that TIPS pays you every six months. The fixed rate of interest is applied to the adjusted principal, so as the principal goes up with inflation so does the interest payment. As the principal declines with deflation, so does the interest payment. When TIPS mature, you receive the adjusted principal or the original principal, whichever is greater. This provision protects you against deflation. TIPS are issued in terms of 5, 10, and 30 years. The interest rate is determined at auction. TIPS are sold in increments of $100 up to $5 million.

These securities can be purchased from a broker or financial institution or directly from the Federal Reserve. Yields are usually higher than that paid for savings bonds. Interest earned is not subject to state or local taxes, but federal income tax must be paid. Treasury securities can be sold at any time in a secondary market, but their value rises and falls with fluctuations in interest rates until the time they mature.

Money Market Mutual Funds

These contain high-quality, short-term debt instruments such as T-bills or short-term corporate IOUs or bonds. These funds are professionally managed and a management fee is charged. They offer market-based rates and are quick to respond to changing conditions because the average maturity of securities in the portfolio is 90 days or less. The minimal initial deposit ranges from $250 to $25,000. They can be purchased directly from investment companies or with the help of financial advisers. Unlike bank-sponsored money market deposit accounts, there is no FDIC insurance if a money market mutual fund fails to maintain a $1 share price. Failures have happened very infrequently in the last 20 years, however, and most investment firms have shored up the funds prices with other company assets to avoid a loss of principal by investors. Limited check writing is generally available. Investors seeking safety of principal and tax advantages can select tax-exempt money market mutual funds that include short-term securities issued by state and local governments. Other conservative choices are funds that invest solely in T-bills or debt of federal government agencies.

Step 3

Investments on Step 3 include high quality stocks, bonds, and mutual funds. Higher investment risk and lower purchasing power risk are represented by these investment alternatives.

Stocks

When you buy stock shares you are buying a part of a company. The return on a share of stock comes from either dividends and/or appreciation in the share price.
Dividends are the distribution of a company's profit or earnings back to the company's shareholders (those who have purchased the company's stock). Dividends are usually distributed quarterly and can be in the form of cash or more stock. Since the end of World War II, dividends have accounted for about 40 percent of the stock market's total return while price increases in the stock account for the remaining 60 percent.

There are two types of stock shares: preferred and common. Preferred stock is so named because preferred stockholders are paid dividends before common stockholders and they are also given preference in assets in the case of liquidation. Common stock shareholders are really residual owners of the company, as they are entitled to their prorated share of the company's earnings and dividends only after all the other obligations of the firm have been met. Common stock shareholders have no guarantee that they will ever receive any return on their investment.

There are many companies that offer stock investments. If you are interested in buying stock, research the industry and the specific company in which you might invest. Reading a company's annual report is a good place to start. Determine the company's financial health by looking at its current ratio and debt-to-equity ratio. Also look at the company's price/earnings (P/E) ratio, a measure of investor confidence and expectations for the stock. The higher the P/E ratio, the more confidence investors generally are presumed to have in it and the more speculative it may be. A low P/E ratio tends to indicate a more conservative investment. Return on equity (ROE) reflects the overall profitability of a company. ROE shows the amount of success the firm is having in managing operations, capital, and assets. Look for a stable or increasing ROE, as it indicates a stronger financial condition and competitive position.

Stocks are generally divided into separate classes depending on how they perform. Growth stocks are those companies that are expected to increase in value. They have had a rapid growth in earnings and are considered riskier because their price can decrease just as quickly as it increased. Technology stocks have been a recent example of growth stocks. Income stocks are expected to pay regular, relatively high dividends. Well-established companies (typically referred to as blue chip) tend to produce income stocks. Utilities and financial institutions are examples of income stocks.

Bonds

If you invest in a bond, you are actually loaning money to the issuer. Corporate and municipal (government) bonds pay a stated rate of interest called a coupon rate. Usually, when an individual invests in a bond, he or she receives a known interest return, typically paid every six months, plus the return of the principal (face) value of the bond at maturity. Corporate and municipal bonds are usually sold by brokers, who receive a sales commission. Bonds have a call risk which means the issuer can retire them before maturity and reissue them (usually at a lower interest rate).

National interest rates also affect bond prices. Usually when interest rates rise, bond prices fall. For example, a bond bought for $1,000 paying 4 percent today would not be worth $1,000 tomorrow if interest rates went up to 6 percent. Few people would want to buy a $1,000 bond paying the lower interest rate when they can get one paying the 6 percent rate. If you want to sell the $1,000 bond now, you would have to sell the bond for less than $1,000 to make up for the higher interest rate now being paid on current bonds. Before buying a bond, check the issuer’s ability to repay the debt using Moody’s or Standard and Poor’s. (These resources are available at larger libraries.)

Interest earned from municipal bonds is exempt from federal income taxes and from state and local taxes if bonds are issued by your state and city. Corporate bonds are issued by companies needing money for operations or to expand. Corporate bonds pay higher interest rates than municipal bonds and their interest is taxable. Investing in a corporation is a greater risk than investing in a government because the government can raise revenue (needed to pay back the bonds) through taxes or fees. The least risky of all corporate bonds is a mortgage bond because it is backed by a company’s land and buildings. This would be called a secured bond because it is backed by collateral that the issuer can sell to repay you if the bond is defaulted on at maturity.

Unsecured bonds, called debentures, are backed by the promise to repay any future earnings of the bond’s issuer. Convertible bonds may be exchanged for other securities (e.g. stock) from the issuing company under specified conditions. Zero coupon bonds have no coupons. They are sold at deep discount from their par value and then increase in value over time so that at maturity they are worth much more than their initial investment. Zero coupon bonds pay no interest until they mature, yet they are taxed on the interest annually. For this reason, it is sometimes recommended that zero coupon bonds be used only in tax-sheltered investments such as individual retirement accounts (IRAs).
Mutual Funds

A company that invests in a diversified portfolio of securities is called a mutual fund. In turn, investors buy shares in the mutual fund and become part owners of the fund’s securities portfolio. Mutual funds are managed by a professional or group of professionals. Investors usually pay a fee (load funds) when they buy (front-end load) or sell (back-end load) shares in the fund. Those fees, in part, pay the salaries and expenses of the professionals who manage the fund.

You also may buy so-called no-load funds (no sales charge). With these funds, there is no professional advice; you are responsible for understanding the investment. There are also annual management fees for each fund. Be sure and compare these fees when researching potential mutual fund investments. Also consider tax consequences of each fund. A mutual fund that trades frequently pays more taxes than one that buys and holds investments. Unless your mutual fund is invested as a tax-exempt account (for example, Individual Retirement Account), you have to pay taxes whenever the fund sells holdings and makes a profit.

There are many types of mutual funds for investors to consider. Aggressive growth funds invest in new companies without a track record or their fund managers may use risky trading actions. Emerging markets funds invest primarily in stock of developing countries. Equity-income funds invest in the stock of companies that are known for their payment of above-average dividends. Focus funds invest in a small number (e.g. 20-30) of stocks instead of 100+ in most funds. Global funds invest in stocks worldwide, including those issued by companies located within the U.S. Gold funds invest in gold mining companies or related securities (for example, precious metals). Growth funds invest in stock of well-established companies with an objective of capital appreciation. Index funds include stocks that mirror one of the market indexes like the Russell 2000. International funds invest in stocks issued outside the U.S. Momentum funds invest in companies that are “hot” on the market at the moment, but tend to be volatile as share prices change. Regional funds concentrate on companies located in one part of the world (for example, Europe). Sector funds invest mainly in one single economic section (for example, technology). Socially conscious funds screen out certain securities based on designated social priorities (for example, eliminating companies that sell tobacco or alcohol). When deciding which type of mutual fund is right for you, consider your investment goals and tolerance for risk, then choose accordingly.

Step 4

Investments on Step 4 include real estate and limited partnerships. More investment risk and less purchasing power risk are involved with these options than with those on the previous steps.

Real Estate

Investing in real estate can take many forms, from buying land to limited-partnership shares in commercial property. The returns on real estate can come from rents, capital gains, and certain tax benefits. Understanding risk and return on real estate investments can be difficult and usually requires expert advice, especially when it comes to income tax implications. There are many fees and expenses associated with real estate purchases and ownership. Costs involved with buying real estate include commissions (affect the total cost of the property), transfer and recording fees, attorney fees, title search fees, appraisal fees, surveying fees, and sometimes inspector fees. Expenses involved in owning real estate include maintenance, insurance, and taxes.

Limited Partnerships

A limited partnership is a type of ownership in which the general partners’ liability is unlimited and the investors’ (limited partners) liability is limited to the amount of their initial investment. As an investor, you own part of what the partnership owns. For example, investors in real estate limited partnerships own shares in all property (such as land or commercial real estate) owned by the partnership. Rental income is passed on to investors as taxable income. When a property is sold, profits are distributed to investors as capital gains.

Another form of investing in real estate through a limited partnership is through a real estate investment trust (REIT). Most REITs are traded on major exchanges, so an investor can easily buy or sell their share; buying or selling units in a limited partnership can be harder. REITs are companies that are professionally managed and usually include such properties as apartments, office complexes, and warehouses. A large portion of a REIT’s taxable income must be paid to investors as dividends. Shareholders pay taxes on these dividends as well as any capital gains. Investors usually can invest in a limited partnership with a minimum investment between $1,000 and $10,000. Stockbrokers, financial planners, commercial real estate brokers, and financial newspapers offer ways to invest in limited partnerships.
Step 5

Investments on Step 5 include junk bonds, aggressive growth stock (speculative stocks), and aggressive growth mutual funds. Investments on this step represent an increased investment risk and lower purchasing power risk than on the previous steps.

Junk Bonds

So-called junk bonds are highly speculative securities issued mainly by corporations with low ratings from bond-rating agencies like Moody’s and Standard and Poor’s. These potentially high-yielding bonds carry a large amount of risk for investors. Junk bonds should only be used by investors who are thoroughly familiar with their risk and who are comfortable with that risk.

Speculative Stocks

Speculative stocks have potential for higher future earnings or price gains as well as a greater potential for larger losses. They usually don’t pay dividends and their prices may fluctuate widely. Penny stocks that sell for $5 per share or less are an example of speculative stocks. Penny stock prices may be low because they are an initial offering (just being offered to the public to buy) or because the company may be experiencing financial trouble. If you invest in penny stocks, you should be prepared to lose all of your money.

Aggressive Growth Mutual Funds

Aggressive growth mutual funds invest in junk bonds and speculative stocks from companies without a history or with risky trading actions or financial problems.

Aggressive growth stock and mutual funds are also highly speculative; meaning your risk of losing what you invested is high. Investors who invest in junk bonds, aggressive growth stocks, and aggressive growth mutual funds are generally looking for a high rate of return and are willing to live with the high risk of losing their initial investment.

Step 6

Investment alternatives on this step include those with the highest investment risk and the lowest purchasing power risk. Alternatives on this step include commodities, futures contracts, collectibles, options and derivatives, and precious metals.

Commodities and Futures Contracts

Commodities include grain, copper, cattle, coffee, etc. and are traded as contracts. Producers create the contracts when they think the prices of their products might drop in the future. Contracts specify quantity, quality, delivery method, and date the commodity will be delivered. These contracts are then available to be actively traded. Investors who want to make money with commodities are speculating on their price swings. Investing in commodities involves a considerable amount of speculation and very high risk.

Because commodities deal with the future delivery of a product, they are also known as futures contracts. The life of a futures contract is usually one year or less. Futures contracts are also available on financial instruments like foreign currency, Treasury bonds, and stocks. The key to success with futures is the ability to correctly predict the future course of the market. An investor needs to be able to afford the loss of an entire investment, which can happen quickly.

Collectibles

Coins, stamps, artwork, antiques, and many more items are collected by people all over the world. To make money on collectibles you need items in top condition and you must have a willing buyer. Costs of collecting may include regular maintenance, insurance, and storage. Generally collectibles do not provide regular income. When you sell an item, you see the gain or loss in value. Selling the item may involve hiring an appraiser and possibly using an auction house. Unless you are an expert, collectibles are a risky investment and considered highly speculative.

Options and Other Derivatives

An option is a type of contract that lets an investor buy (a call) or sell (a put) a specific security or financial instrument (stocks, currency, commodities, stock indexes, T-bills, and bonds) within a specified period of time. Stock options are the most popular. When you buy stock options, you do not buy the stock itself. You buy a negotiable instrument that gives you the right to buy or sell at a specific price for a designated period (usually eight months or less). Potential for gain — and for loss — can be quite high.

Derivatives are financial instruments whose value is determined by the price of something else (the underlying). It is an agreement between two parties that is contingent on a future outcome of the underlying. Besides options, futures and swaps are also derivatives.
Precious Metals

With a high investment risk and low purchasing power risk, precious metals like gold and silver and gemstones such as diamonds take a great deal of knowledge as an investment alternative. While they may be considered a hedge against inflation, precious metals and gemstones are complex investment options that may require help from investment professionals and a great deal of research to determine if they are right for your investment portfolio.

Resources

Treasury Direct, U.S. Treasury at www.treasurydirect.gov


National eXtension personal finance website at http://www.extension.org/personal_finance