




What You Should Know About...

Investing

- ▶ INVESTING STRATEGIES
- ▶ STOCKS AND BONDS
- ▶ MUTUAL FUNDS



YourMoneyCounts™



You can invest in many ways. You invest in yourself by learning new skills or taking new opportunities. You invest in a small business by purchasing better equipment or offering more products and services. And, equally important, you can invest money you already have to help you meet the financial goals you have for the future. But remember, when you invest, there are no guarantees. You have to be willing to accept the possibility that you won't achieve everything you set out to accomplish.

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Saving and investing

You're already comfortable with the importance of saving. Putting money into a bank account on a regular basis allows you to build up a cash reserve. You can use that reserve to pay for things that are outside your everyday budget, such as a family vacation or the down payment on a new car or a home of your own. Your savings can also provide an emergency fund that you can draw on to cover unexpected costs that can crop up—such as car repairs or having to miss work and losing income because of illness or injury.

Getting started

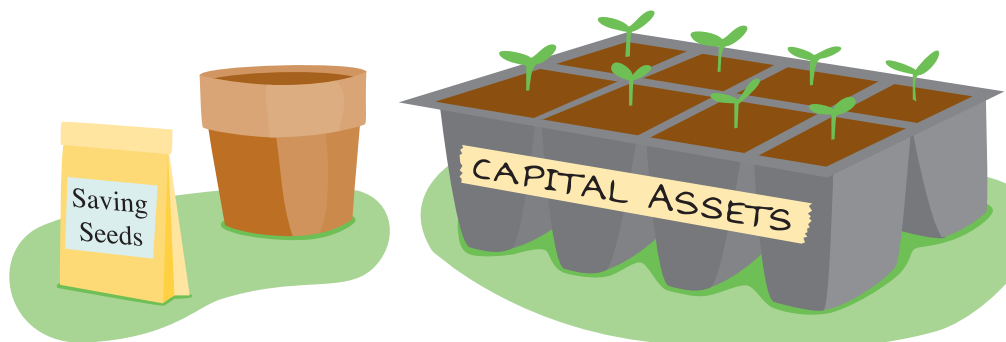
Some people—perhaps you included—may not be as comfortable about being investors as they are about being savers. That may be the case because many people

aren't exactly sure where to start or how much money they need to begin. But as more and more people join the ranks of investors—by putting money into retirement accounts at work, for example—they're increasingly interested in how to make investing work for them.

Investing means buying things of value, sometimes called **capital assets**, because you expect them to:

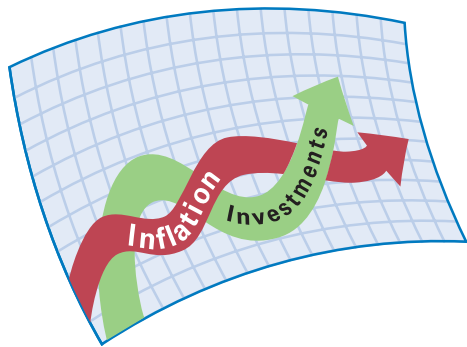
- Become more valuable over time
- Provide a source of additional income
- Both increase in value and provide income

If your assets increase in value and you can sell them for a profit if you need the money, and if you have investment income in addition to what you earn, you can consider yourself a successful investor.



Investing to meet goals

The best reason to invest is that owning capital assets can help you meet your mid-term and long-term financial goals. Even if you plan on earning more income in the future than you do now, most people can't pay for big expenses—like college tuition or starting a business—out of their everyday earnings. And when you retire, you're likely to be earning less.



Beating inflation

Unlike money in savings accounts, which over time is vulnerable to the effects of **inflation**, or gradual loss of buying power, money that's invested has the potential to be worth more as time goes by. This is true usually because investing involves taking on more risk than saving does—with higher rewards paid in the form of better rates of return. One reason this is true is

the result of **compounding**, which occurs when your investment earnings are reinvested, or added to your principal to form a new, larger base on which future earnings may accumulate. Reinvesting your earnings by putting them directly back into your account is often easier than finding new money to invest.

Comparing results

The way that a compounding investment differs from a compounding savings account is the average rate at which earnings are added. For example, if you deposit \$10,000 in a **certificate of deposit (CD)** that provides an annual percentage yield (APY) of 3%, your account will be worth \$11,593 after five years if it compounds annually. But if you invested \$10,000 in a diversified portfolio with an average annual return of 8%, your investment will be worth closer to \$14,693 after five years. In both cases, the assumption is that you're not taking any money out to pay taxes that may be due.

And the longer your investment account continues to compound, the more potential it has to grow. The same \$10,000 investment with the same average annual return of 8%, compounded annually, will be worth \$100,627 after 30 years.

Risk and return

Unlike most savings accounts, investments are not insured or guaranteed, which means your results are not predictable. While investment markets have some very good years—which in the world of investing is measured by **total return**—they also have years that aren't so good, and even an occasional year or two that are bad.

For example, in the 20 years between 1985 and 2004, the 500 stocks in the Standard & Poor's 500 Index, as a group, went up in value in 16 years and down in value in four years. The best year was 1997, with a total return of + 33.36%. The worst year was 2002, when the total return was

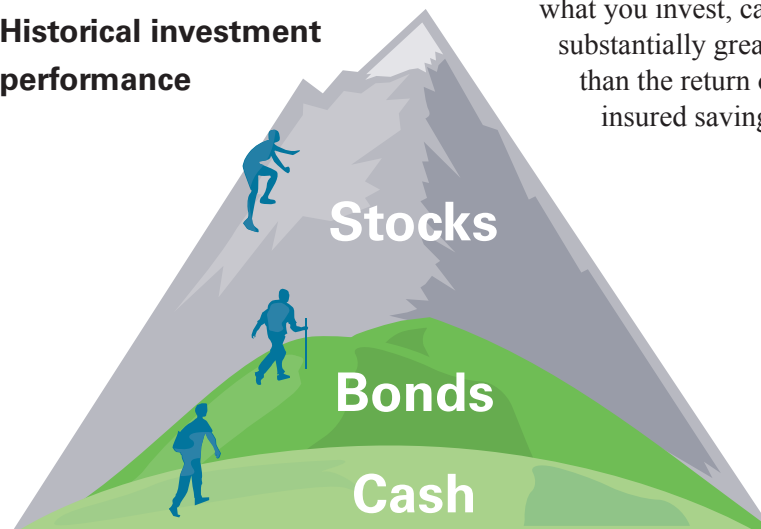
– 22.10%. And the average annual return for the period was + 13.23%. Long-term government bonds also had four losing years in that same 20-year span, though they weren't the same years that stocks lost value, and the difference between the best and the worst years was less dramatic.

The part risk plays

The unpredictability of the year-to-year return means when you invest, you take some **risk** that your results could be disappointing or even that you could lose some amount of **principal**, or money you're investing.

So why would anyone put hard-earned money at risk? The reason is that investment **return**, or what you get back in relation to what you invest, can be substantially greater than the return on insured savings.

Historical investment performance



Here’s a look at the average annual total returns of different types of investments since 1926. The investments with higher returns are also those that have posed a higher risk of losing money in some years:

| | |
|----------------------------|-------|
| Large-company stock | 10.4% |
| Small-company stock | 12.7% |
| Long-term corporate bonds | 5.9% |
| Long-term government bonds | 5.4% |
| USTreasury bills (= cash) | 3.7% |

One key to making investing more successful is to approach it as a longer-term strategy. By choosing investments carefully and riding out the downturns, you help reduce the impact of a bad, one-year return on your portfolio.

Investment variety

The investment universe is made up of a number of **asset classes**, or investment categories, each of which puts your money to work a little differently.

Stocks, bonds and cash equivalents are the asset classes you’re most likely to hear about. There are a number of reasons for their popularity, including:

- They are easy to buy and sell
- They’re available at a wide variety of prices
- They have a history of providing positive returns—though the returns aren’t guaranteed and they’re not positive every year

You can buy and sell these investments through a brokerage account that you establish at your bank or brokerage firm. When you give an order, typically online or over the phone, your broker carries out your instructions, and



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you'll typically pay a commission on each transaction. In some cases, you can buy and sell directly through the company or government that offers the investments for sale. For example, you can use **direct purchase plans (DPPs)** to buy stock directly from some companies.



The fund approach

You can also invest in stocks, bonds and cash by purchasing mutual funds or exchange-traded funds (ETFs). Both types of funds own a pool, or collection, of investments of a particular type. Every fund indicates the type of investments it makes in the **prospectus** and other official documents that it provides to investors. Some mutual fund companies sell shares directly to investors, and other funds as well as ETFs are available through banks or brokerage accounts.



Buying property

Real estate is another well-known asset class, and it's often the first one that a person invests in. That's evident in the fact that more than 68% of the people in the United States own their own homes instead of renting. Like other asset classes, real estate can play a role in meeting your financial goals

because it often becomes more valuable over time or provides a source of income or profit when you sell.

At the same time, real estate is an unusual asset class because most people who buy a home buy it first as a place to live and only secondarily as a way to make money. Sometimes, real estate isn't very **liquid**, especially in a slow market. That means it can be hard to sell quickly, or you may not get the price you want.

What's a security?

Stocks and bonds are securities. That term once referred to the certificates that companies issued to investors to provide evidence of their holdings. Today almost all investment transactions are recorded electronically rather than on paper. But the term securities is still used.

Stocks

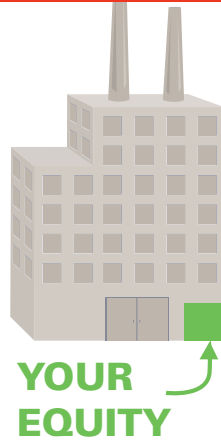
Stocks are **equity** investments, which means that when you buy stock in a corporation you become a **shareholder** and actually own a part of that corporation. Of course, your equity, or ownership, in a corporation which may issue millions of shares is much smaller than the equity you have in real estate you purchase.

What's similar is that you own something that you have the right to sell or hold onto, as you choose.

There are two main reasons to buy stocks:

1. You expect the price per share to increase so you can sell your shares in the future and make a profit.
2. You expect the stock to generate income in the form of **dividends**.

Some stocks tend to do one or the other, and some stocks do both.



YOUR EQUITY

The reason that stocks are popular investments despite the fact that they can be **volatile**, or change value rather quickly within a short time, is because historically stocks in general have provided stronger returns than other securities.

Measuring return

You can use the amount of dividend income plus the increase (or decrease) in value to calculate your **total return**. That's an important measure of how profitable your investment has been.

For example, suppose you bought a stock one year ago at \$20 per share, which paid a 50-cent per share dividend, and now sells for \$21.75. Your total return for the year would be 11.25%, calculated by adding the \$1.75 per share increase in price and the 50-cent per share dividend and then dividing by the original purchase price ($\$21.75 - \$20 = \$1.75 + 0.50 = \$2.25 \div \$20 = 0.1125$ or 11.25%).

| |
|--|
| $\frac{\text{Dividend income} + \text{change in value}}{\text{Share price}} = \text{Total return}$ |
| $\frac{\$2.25}{\$20} = 11.75\% \text{ Total return}$ |

Determining stock value

Stocks don't have fixed values. A stock's price is ultimately determined by what investors are willing to pay to buy shares. Among the factors that affect the price of a stock are:

- The company's sales or revenue growth, sometimes called top-line growth
- The company's earnings growth, sometimes called bottom-line growth
- The way the company is managed
- The quality or advantage of the products or services it offers
- The condition of the economy and the financial markets
- The particular industry in which the company operates

becomes more valuable because there is a high demand for it.

The reverse is also true. If the company that issues Stock A doesn't live up to the expectations that investors have for it, demand for the stock is likely to drop. That can prompt shareholders to sell their shares, increasing the supply and driving the price down.

If you invest in individual stocks, you have to be prepared for that ebb and flow, and should consider having a plan in place for how long you'll hold your shares if they lose value. One approach some investors use is sell a stock when it has lost 15% or 20% of the price at which they purchased it. Similarly, these same investors might sell a stock when it has increased 15% or 20% in value, and put the principal plus profit into another investment.

Changing prices

Stock prices change according to the basic rules of supply and demand. For example, if a large number of investors buy Stock A, its price will be driven up because there are only a fixed number of shares available in the marketplace. The stock



The impact of size

You can subdivide stocks into many different categories as you attempt to assess the potential return they'll provide and the potential risk they pose to you and your investment portfolio.

One of the most widely used categories is **market capitalization**, or company size, sometimes shortened to market cap. You calculate market cap by multiplying the current price per share times the number of shares a company has outstanding. In a simple example, a company that has a million shares in the marketplace that sell for \$20 a share has a market cap of \$20 million.

| | | |
|---|-------------------|--|
| | Price per share | |
| x | Number of shares | |
| = | MARKET CAP | |

What's the cap?

Large caps are the biggest companies. They are the most likely to pay dividends. They usually have more financial assets that can help them survive a market downturn. Their market cap is usually over \$10.9 billion.

Mid caps are medium sized companies. They may or may not pay

dividends, and they may have more potential for growth than large caps. Their market cap is usually between \$2.3 billion and \$10.9 billion.

Small caps have a market cap of less than \$2.3 billion—sometimes much less. These companies usually don't pay dividends. While their shares may increase more quickly in price, they may also expose you to a greater risk of loss because they often have fewer financial resources to see them through a market downturn.

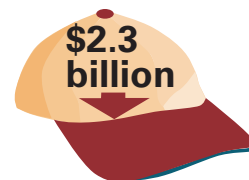
Large cap

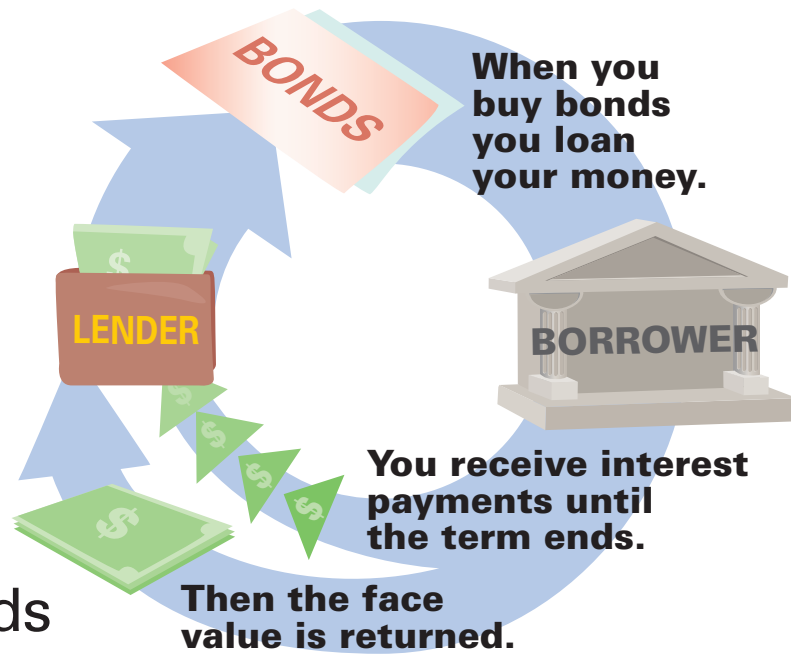


Mid cap



Small cap





Bonds

Did you ever think you'd make a loan to a huge corporation, the city where you live, or even to the US government? That's exactly what you're doing when you invest in corporate, municipal or government bonds.

Bonds are **debt investments**. When you buy a bond, you're lending your money, the **principal** you invest, to an issuer that needs cash. Most of these loans are for a specific period of time, called the bond's **term**, which can range from less than one year to 40 years or more.

How you make money with bonds

During a bond's term, you earn interest on your loan, which is the

amount you invest to purchase the bond, just as you do on the money you deposit in a bank savings account. This is the bond issuer's way of compensating you for its use of your money. The interest is typically paid twice a year, though it may be on a different schedule.

The rate at which the interest is paid is usually fixed when you buy the bond and stays the same for the term, with longer-term bonds paying higher rates. This is to compensate you for lending money over a longer period of time. When the bond **matures** at the end of its term, the issuer promises to pay back your principal and any remaining interest.

The risk of default

One risk of buying bonds is that the issuer may not be able to meet its obligations to pay interest or repay principal. If that occurs, the issuer is in **default** and you could lose money. You can avoid bonds with the greatest risk of default by buying only those described as **investment grade** by the major bond rating companies. That includes bonds rated BBB or higher by Standard & Poor's and Baa or higher by Moody's Investor Services. Bonds issued by the US Treasury aren't rated because they're considered essentially free of default risk.

You may hear bonds described as having short, intermediate, or long terms. In most cases, short term means one year or less, intermediate term means between two and ten years, and long term means more than ten years.

Trading bonds before maturity

Bonds are also known as fixed-income securities because the income that they generate each year is set. Some investors buy bonds primarily for the stability of this income stream, while others buy

and sell bonds similar to the way they might buy and sell stocks.

If you trade bonds, you'll be aware that while the interest a bond pays remains fixed, its **market value** changes over time. Sometimes it sells for more than its **face value**, or **par**, which is usually \$1,000, and sometimes it sells for less than face value. That may happen for several reasons, including:



- Interest rates may go up after a bond is issued, driving its price down. That happens because investors are willing to pay less than face value for bonds paying less than the current interest rate.
- Conversely, interest rates may go down, which means existing bond prices will go up. That happens because investors are willing to pay more than face value for bonds paying more than the current interest rate.
- The bond's rating is reduced because the issuer is having financial problems, and so its price falls below face value because investors are taking more risk in buying it.

Of course, if you hold onto a bond from the date of issue to the date of maturity, changing market prices don't affect you.

Types of bonds

Like many people, companies and governments sometimes need to borrow money to fund a project or to grow. That means you have different bond issuers to choose from, including corporations, the US Treasury, cities and states, as well as federal, state and local government agencies. Most bonds have a **face** or **par value**, or issue price of \$1,000 per bond, but you often must buy more than one.

US savings bonds

You may also buy US savings bonds, which are issued by the federal government and pay interest on the amount you invest. They're sold in smaller denominations than Treasury notes or bills, and are sometimes available for purchase where you work. You can also buy them directly from the government through a program known as Treasury Direct. But they aren't **negotiable**, which means you can't sell them in the marketplace as you can other bonds.

| Type | Terms | Issuer | Risk of default | Tax treatment |
|-----------------------|----------------------|----------------------------------|-----------------|--|
| Corporate | 1 to 100 years | Publicly traded companies | Variable | Taxable |
| Municipal | 1 to 50 years | States, counties and cities | Variable | Tax-exempt, though may be subject to alternative minimum tax |
| Agency | 1 to 20 years | US and state government agencies | Limited | Some are taxable and others tax exempt |
| Treasury notes | 2, 3, 5 and 10 years | US Treasury | Very low | Federally taxable only |
| Treasury bills | 4, 13 and 26 weeks | US Treasury | Very low | Federally taxable only |

Cash equivalents

Cash equivalents, or **cash investments**, are short-term investments on which you earn interest. The interest is calculated as a percentage of your principal, as it is with bonds, and may be **compound** or **simple**, depending on the type of investment you make.

Types of cash investments

The four major types of cash investments are:



1. Certificates of deposit (CDs), which are federally insured bank products.



2. US Treasury bills (also known as T-bills), which are backed by the full faith and credit of the US government.



3. Bank money market accounts, which are federally insured.
4. Money market mutual funds, which are not federally insured but seek to maintain their value at \$1 per share.

Liquid assets

One key characteristic of cash investments is their **liquidity**, which means they can be converted to cash quickly and easily with little or no loss of value. For example, if you put \$1,500 into a money market account, you can easily and quickly withdraw that amount of cash if you need it. In contrast, if you were to invest \$1,500 in a stock mutual fund, you might be able to sell your shares for more than that amount—but you might also have to sell for less if you needed the money at a time when the fund shares had lost value.



Additionally, because cash investments don't fluctuate in price, you can be comfortable using them as part of your emergency fund to cover unexpected expenses.

Lower rates

In general, though, the interest rates you earn on these investments is several percentage points lower than what you could earn on different investment classes. While many people should have *some* amount of cash investments in their portfolios, money you hold in these investments is likely to lose buying power over the long term as a result of inflation.

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For example, if your five-year CD is paying 3% interest while inflation is averaging 2%, your **real return** is just 1% before income taxes.

One approach is to use cash equivalent investments as you

would savings accounts—to hold money you expect to use in the near future—and to invest for long-term goals with assets that have a greater potential to increase in value.

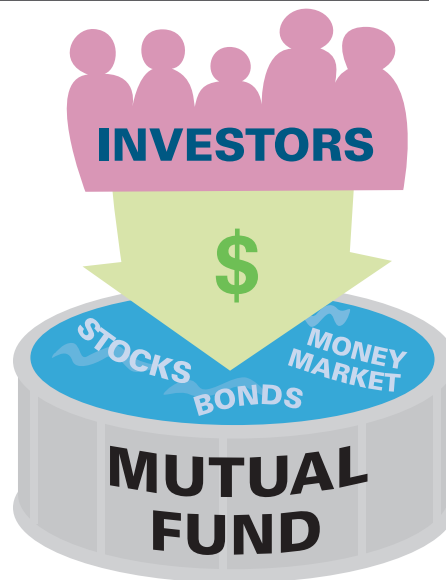
Mutual funds

When you invest in a mutual fund, your money is pooled with money from other investors to buy a **portfolio**, or group of stocks, bonds or other investments. Most mutual funds are **open-end funds**, which means they typically sell as many shares as investors want to buy and repurchase any shares that investors want to sell.

There are three major groups, or types, of mutual funds:

- **Stock** funds buy shares of corporate stock
- **Bond** funds buy bonds issued by corporations, governments or agencies
- **Money market** funds buy very short-term bonds and other loans

Each fund group has a number of subcategories, based on narrower distinctions in the way the fund invests. For example, some stock funds invest almost exclusively in



small-company stocks and other funds focus on large-company stocks.

Goal-oriented investing

Each fund has a specific **investment objective**, which is the goal it strives to meet by making particular types of investments. For example, a stock fund whose objective is to provide a combination of gradually increasing prices and



regular income might buy stock issued by large companies with strong reputations for success and a history of paying regular dividends.

As an investor, you need to be aware that funds with different investment objectives have different levels of risk. A stock fund that invests primarily to benefit from increasing stock prices is much more likely to move up and down in value relatively quickly than a bond fund that invests for regular fixed income.

You can find an assessment of the risk a fund poses as well as its investment objective in its **prospectus**, an official document that also states the fund's investment objective, fees and past performance. You should become familiar with a fund's prospectus before you invest any money in that fund.

Advantages of mutual funds

Mutual funds can be an attractive choice for both new and experienced investors for a number of reasons:



Affordability. You can open a mutual fund

account for as little as \$1,000, and add to it in even smaller amounts. In some cases, you can invest as little as \$50 a month if you arrange for an automatic transfer from your checking or savings account into your fund account.



Diversification. By buying shares in a mutual fund, you're investing in all the different stocks or bonds the fund owns. Owning many investments instead of just a few can help protect you against losses you might have if the ones you'd selected happened to fall in value.



Liquidity. You can convert your shares into cash at any time by selling them back to the fund. The selling price is determined by the fund's net asset value (NAV) and may be higher or lower than the amount you originally paid.



Professional expertise. A professional manager runs each fund, making all buy and sell decisions.

Some words of caution

As with all investments, there are risks you encounter when you purchase mutual funds. For example, results are not guaranteed. That

means you can lose money as well as make money, even though your funds are managed by experts.

Exchange traded funds (ETFs) and mutual funds are both pooled investments that work in similar ways. They have some important differences though.

| ETFs | Mutual funds |
|--|---|
| Traded all day, with a fluctuating price | Traded only at the end of the day, at one price for the day |
| Don't have to buy and sell fund assets to accommodate investors entering or leaving the fund, which may offer tax advantages | May have to buy and sell fund assets to accommodate investors entering or leaving the fund, which may trigger capital gains taxes |
| Often have lower expense ratios than mutual funds | Often have higher expense ratios than ETFs |
| You have to pay commission when you buy or sell shares | Sales charges vary depending on the mutual fund, and not all impose sales charges |

Mutual fund fees

As with all products and services, different companies charge different prices for what they offer. Mutual funds are no exception, and you should evaluate the fees that various funds charge before choosing among them. The more you pay in fees, the more the fund must earn for you to realize a strong return. Fees can range from a low of 0.10% to a high of 8.5% of the assets you have in the fund. You

can find most of the information on what the fees are and how they are paid in the fund's prospectus, on the fund company's website, or from your investment adviser.



Expense ratio. You pay a percentage of your account's value for management and operating expenses. Since this is a recurring rather than a one-time fee, it's especially important in evaluating a fund's cost.



Transaction fees.

You pay your share of the commissions and other expenses the fund has in buying and selling investments. Some funds trade frequently while others, such as index funds, trade only when the securities in the index change.

Sales charges. You may pay a percentage of the amount you invest when you buy shares in a fund or you may pay sales charges if you sell within a certain time period after you purchase your shares. Other funds, called no-load funds, do not have sales charges.



If you pay sales charges when you buy, those shares are usually known as Class A shares. If you pay when you sell, those shares are



usually known as Class B shares. There are often other classes of shares as well, indicated by different letters.



Redemption charges.

You may have to pay a fee if you sell shares within a specific period of time after purchase to prevent a practice known as market timing.



Marketing fees, called 12b-1 fees.

You may be charged fees to cover marketing and advertising expenses and sometimes to pay bonuses to professionals managing the fund if results exceed certain performance targets.



Exchange fees,

You may pay a fee to move money from one fund to another within a group of funds offered by the same investment company.

Pay it again, Sam

Almost all mutual funds offer reinvestment plans so you can use your earnings to buy additional shares in the fund. It's an easy way to build the value of your account. Remember, though, that you will still owe income tax on those earnings, unless you own the fund in a tax-deferred or tax-free account.

Dollar cost averaging

If you're interested in building your investment portfolio gradually, you may want to consider a popular investment strategy called **dollar cost averaging**. When you use this approach, you invest the same dollar amount every month or every quarter in the same fund or company.

Because you invest regularly—perhaps by arranging for direct deposit as a payroll deduction or from a bank account—you're providing a regular cash infusion to build your account value. And by investing through the markets ups and downs, you can avoid paying only the highest prices.

Here's how it works: The price per share will tend to move up and down over time. When the price is up, you buy fewer shares with your investment dollars. And when the price is down, you buy more shares.

Making the strategy work

Dollar cost averaging is attractive, especially when the markets are strong and you can see that your

account is increasing in value. But to allow this strategy to work, it's important that you continue to invest even in periods when the market is down and the value of your investment may be dropping. If you stop buying when the price drops, you will have paid only the higher prices and won't reduce your average cost.

That doesn't mean you should continue to throw good money after bad if a fund or a company seems unlikely to recover. There may be a point when the wisest decision is to cut your losses. But understanding how the regular buying strategy can work in your favor may give you the incentive to ride out a market downturn.

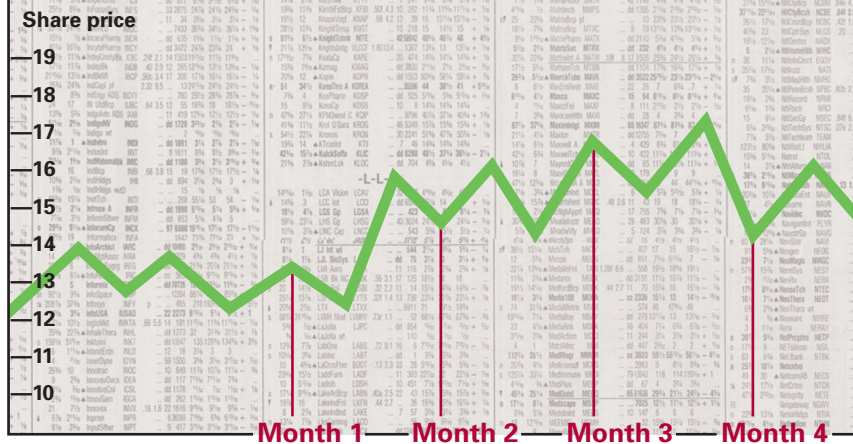
The bottom line

Dollar cost averaging can be effective, and it does make investing easy, but you do have to remember that it doesn't ensure that you'll make a profit. And it can't protect you from losses in a falling market.

For example, suppose you invest \$100 a month in mutual fund A. Turn the page for a four-month snapshot of what you'd buy:

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How Dollar Cost Averaging Works



| | | | | |
|----------------------------------|---------|-------|-------|---------|
| Amount invested | \$100 | \$100 | \$100 | \$100 |
| Price per share on purchase date | \$13.50 | \$15 | \$17 | \$14.50 |
| Number of shares purchased | 7.4 | 6.67 | 5.88 | 6.9 |

The Average Share Price

$$\frac{\text{Average share price per month}}{\text{Number of months}} = \text{Average share price}$$

$$\frac{(\$13.50 + \$15 + \$17 + \$14.00)}{4} = \$15 \text{ Average share price}$$

Your Average Share Cost

$$\frac{\text{Total amount invested}}{\text{Total shares purchased}} = \text{Average share cost}$$

$$\frac{\$400}{26.85} = \$14.90 \text{ Average share cost}$$

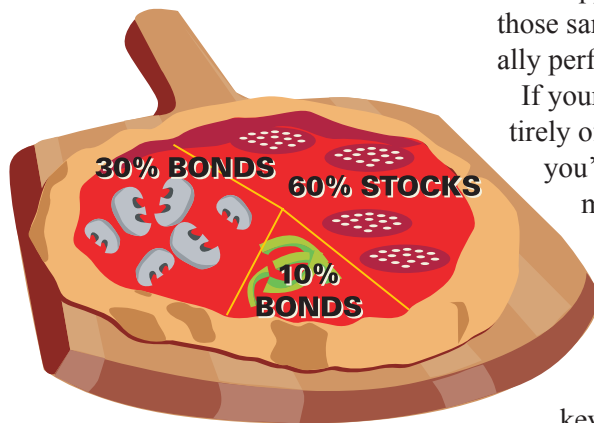
In this case, you would have purchased 26.85 shares for an average share cost of \$14.90 when the average share price was \$15.

have purchased just 23.53 shares—again a small difference but one that could have a big impact over time if you always bought shares at their highest prices.

The 10-cent difference doesn't seem like much, but over an extended period could allow you to afford a number of additional shares. In contrast, if you'd saved up your money and invested \$400 in Month 3, when the price was highest, you would

Asset allocation

Asset allocation is the strategy you use to divide your portfolio among **stocks**, **bonds** and **cash equivalents** or the mutual funds that invest in those asset classes. Since each asset class carries different levels of risk and reacts differently to changes in the economy, the way you allocate your assets has a major impact on reaching your financial goals.



Why allocation works

- Historically, stocks have provided the strongest return of these three asset classes by doing extremely well in some years, although doing poorly in others

- Bonds have produced strong returns in some years and weaker returns in others, though the highs and lows tend to be less extreme than with stocks
- Cash equivalents usually provide the smallest, but most consistent, returns

In most years, though, one of these asset classes has a stronger return than the others.

For example, if interest rates are high and corporate earnings are weak, stock returns are likely to be disappointing. However, under those same conditions, bonds usually perform well.

If your portfolio consisted entirely of stocks in this situation, you'd face losses—potentially major ones. But if your portfolio included bonds, their earnings would have the potential to make up for, or offset, what your stocks lost. The key is finding a balance between asset classes that meets your particular needs.

The complication is that you never know, from year to year, which asset class will be the strongest performer and which will be the weakest. So the solution may be to always have some assets in each class.

Allocation models

You typically allocate a portfolio by assigning a percentage of the total to each of the asset classes you're including. For example, you might assign 60% of your holdings to stocks, 30% to bonds and 10% to cash—or almost any other combination.

Since each person has his or her own set of financial goals and risk tolerance, there's not one asset allocation model that fits everybody. The most important factors in determining your allocation are most likely to be the time you have until you want to pay for your goal and your comfort level with risk.

The impact of age

If you're young and you're investing for retirement, you may want

to invest up to 80% of your principal into a diversified portfolio of stocks and stock funds for the potentially stronger return they offer. If they decrease in value in the short term, you have enough time to wait for a rebound. As you grow older, and closer to retirement, you'll probably want to reduce the assets you have in stocks to a smaller percentage of your total holdings.

These questions can help you find the right balance between risk and reward:

1. What are your financial goals? Are you trying to earn enough for a new car, or are you more concerned with retirement?
2. What is the time frame you're working with?
3. What level of risk do you feel comfortable with?

Diversification

Each asset class is made up of **subclasses**, or subcategories, which expose investors to different levels of risk and provide their strongest returns at different times in an **economic cycle**. For example, some stocks, such as blue chips—issued by large, well-regarded companies—are considered less risky than aggressive growth stocks—issued by new companies

in new fields. Sometimes blue chips provide the best return, and other times aggressive growth stocks do.

The point is that no single subclass consistently produces the best **return** year after year. And there's no way to predict the pattern of performance. But you can be confident that subclasses will have their ups and downs just as asset classes do.

Create a mix

While risk can't be completely eliminated, it can be controlled. One way to manage some of the risks you face by not knowing which subclasses will be strong or weak at any specific time is to **diversify** your **portfolio**, or your list of investment holdings. To diversify means to choose investments in several different sectors, issued by companies of different sizes, and in the cases of bonds with different terms and issuers, within an asset class, rather than concentrating your money in just one or two areas.

Diversification is the investment equivalent of the old saying: "Don't put all your eggs in one basket." It enables you to:

1. Take maximum advantage of market conditions and changes in the economy.
2. Protect yourself against economic and industry downturns.

How do you do it?

When diversifying your portfolio, it's just as important to understand the investments you already have as well as those you're considering adding. Using a simplified example, say your portfolio consisted entirely of stock in Company A—perhaps the company you work for. If this were the case, your portfolio

wouldn't be diversified, and if Company A were to fail, your losses could be major.

But if you were to buy shares in companies B, M and Z, in addition to A, your portfolio would be more diversified—provided that B, M and Z were all in

different sectors of the economy and had different market capitalizations. While that may mean you limit your gains, it also means you position yourself to limit your losses, since different types of stocks are not as likely to lose value at the same rate or at the same time.



Mutual funds

One popular way to diversify portfolios is to invest in **mutual funds**. When you buy shares in a mutual fund, you're investing in the different stocks or bonds the fund owns. So, as long as the mutual fund is diversified, so is your investment.

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