Investment Planning

Chapter 11

Learning Goals

- **LG1** Discuss the role that investing plays in the personal financial planning process and identify several different investment objectives.
- **LG2** Distinguish between primary and secondary markets, as well as between broker and dealer markets.
- **LG3** Explain the process of buying and selling securities and recognize the different types of orders.
- **LG4** Develop an appreciation of how various forms of investment information can lead to better investing skills and returns.
- **LG5** Gain a basic understanding of the growing impact of the computer and the Internet on the field of investments.
- **LG6** Describe an investment portfolio and how you’d go about developing, monitoring, and managing a portfolio of securities.

How Will This Affect Me?

- Investing is the means by which many important financial goals in life are achieved. This chapter discusses how to determine the amount of investment capital is needed to reach common financial goals and explains how to invest for retirement, to fund major expenditures, to earn needed income, and to establish tax shelters. The market context in which investing occurs is described, and how to buy and sell investments is explained. A framework for evaluating investments is also presented, which includes how to describe, monitor, and manage a portfolio. Sources of investment information are discussed, as well as some of the useful investing tools available online. After reading this chapter you should be able to plan your investments to better meet your financial goals.

Financial Facts or Fantasies?

- Stocks listed on the New York Stock Exchange are traded in the over-the-counter market.
- If you lose a lot of money because a broker gave you a poor investment recommendation, you can recover most or all of your loss by filing a claim with the Securities Investor Protection Corporation.
- An aggressive investor would short sell a stock if he or she expects its price to go down.
- You should pay little attention to annual stockholders' reports because they are so biased.
- Coming up with a sound asset allocation plan will likely have more of an impact on long-term investment return than the specific securities you hold in your portfolio.

The Objectives and Rewards of Investing

- **Investing:** The process of placing money in some medium such as stocks or bonds in the expectation of receiving some future benefit.
- **Speculating**: A form of investing in which future value and expected returns are highly uncertain.
- The average investor is **risk averse** and requires higher expected returns as compensation for taking on greater risk.
- Before investing, you should have **sufficient savings** for emergencies and adequate **insurance coverage**.

How Do I Get Started?

- Regularly allocate a portion of earnings for Investing – Build a pool of invested capital
- Take advantage of automatic investment and dividend reinvestment programs
- Learn about investments and “play” trading
- Determine financial objectives
- Read the business press to learn about investments

Building Capital for Investment

- How much money will it take to get started?
- Do you have lump-sum to invest now, or will you systematically build an investment pool?
- You design an investment plan to guide you toward your goal
- The amount of capital you can build depends upon the rate of return you can earned on the investment
- Future Value of $10,000, 10 years, 9 % =
- $10,000 * 2.367 (from appendix A) - $23,670
- See Worksheet 11.1

Rates of Return

- A reasonable estimate of future rates of return is to look at the past years
- For Example:

Holding Period	Stocks-S&P 500	US Bonds	US Notes
5 years 2010-14	15.69%	5.82%	0.07%
10 yrs 2005-14	9.37%	5.31%	1.44%
15 yrs 2000-14	6.0%	6.36%	6.18%
87 yrs 1928-2014	11.53%	5.28%	8.40%

Building Capital

- To determine the annual savings needed to raise a determined amount of capital
- Factors in appendix A, B, C, and D

$$\text{Yearly Savings} = \frac{\text{Future Amount of Money Desired}}{\text{Future Value Annuity Factor}}$$

Investment Objectives

- Current Income: Common for retired people
- Retirement: Invest so you can live comfortably in retirement
- Major Expenditures: build a college education fund, down payment on a home, or start a new business
- Shelter from Tax: Use tax strategies to preserve more of your pre-tax earnings
- Investment Plan: A statement—preferably written—that specifies how investment capital will be invested to achieve a specified goal.

Different Ways to Invest

- There are multiple types of investments, referred to as vehicles for investment
- Common Stock
- Bonds
- Preferred Stock and Convertible Bonds
- Mutual Funds, Exchange Traded Funds, and Notes
- Real Estate

Common Stocks

- A form of equity, that is they represent an ownership interest in a corporation.
- Return on stock in two forms:
- Dividends paid, varies from 0 to 6%
- Appreciation in share price

Bonds

- Obligations of corporation to pay principal and interest to the bond holder—IOU's of the issuer
- Interest paid is the stated rate on the bond times the face value of the bond, typically paid twice a year
- A stated rate of 5% on a $1,000 bond would pay interest of $25 twice a year
- Value of bond varies as interest rate varies, but inversely
- Rates go up, value goes down; Rates down, Value up

Preferred Stocks and Convertible Bonds

- Preferred stocks have stated (fixed) dividend rate that must be paid before any common stock dividend is paid
- Preferred stock could be callable or convertible to common stock
- Convertible Bonds are like other bonds, pay interest twice a year and return principal at maturity date, BUT along the way if the bondholder desires, the bonds may be convertible to common stock - referred to as Hybrid Securities.

Mutual Funds and Exchange Traded Funds and Notes

- Mutual Funds: Professionally managed portfolio of stocks, bonds, and other investments. Return varies based upon the market and the type of investments selected by manager
- Exchange Traded Funds (ETFs): Designed to track a basket or index of equity securities. They may be traded throughout the day.
- Exchange Traded Notes (ETNs): Senior, unsecured, unsubordinated debt securities
- ETNs face market risk and risk of default by issuing bank

Real Estate

- Investments in real estate ranges from raw land speculation to limited-partnerships in commercial property to common stocks in real estate corporations
- Returns come from rents, capital gains, and favorable tax benefits
- Investor must be aware of the risk of falling prices such as during business cycles 2007-2009

Securities Markets

- “Arenas” where financial instruments trades
- Capital Market – long-term securities with maturities of more than one year
- Money Market – low risk, short-term securities with maturities of less than one year

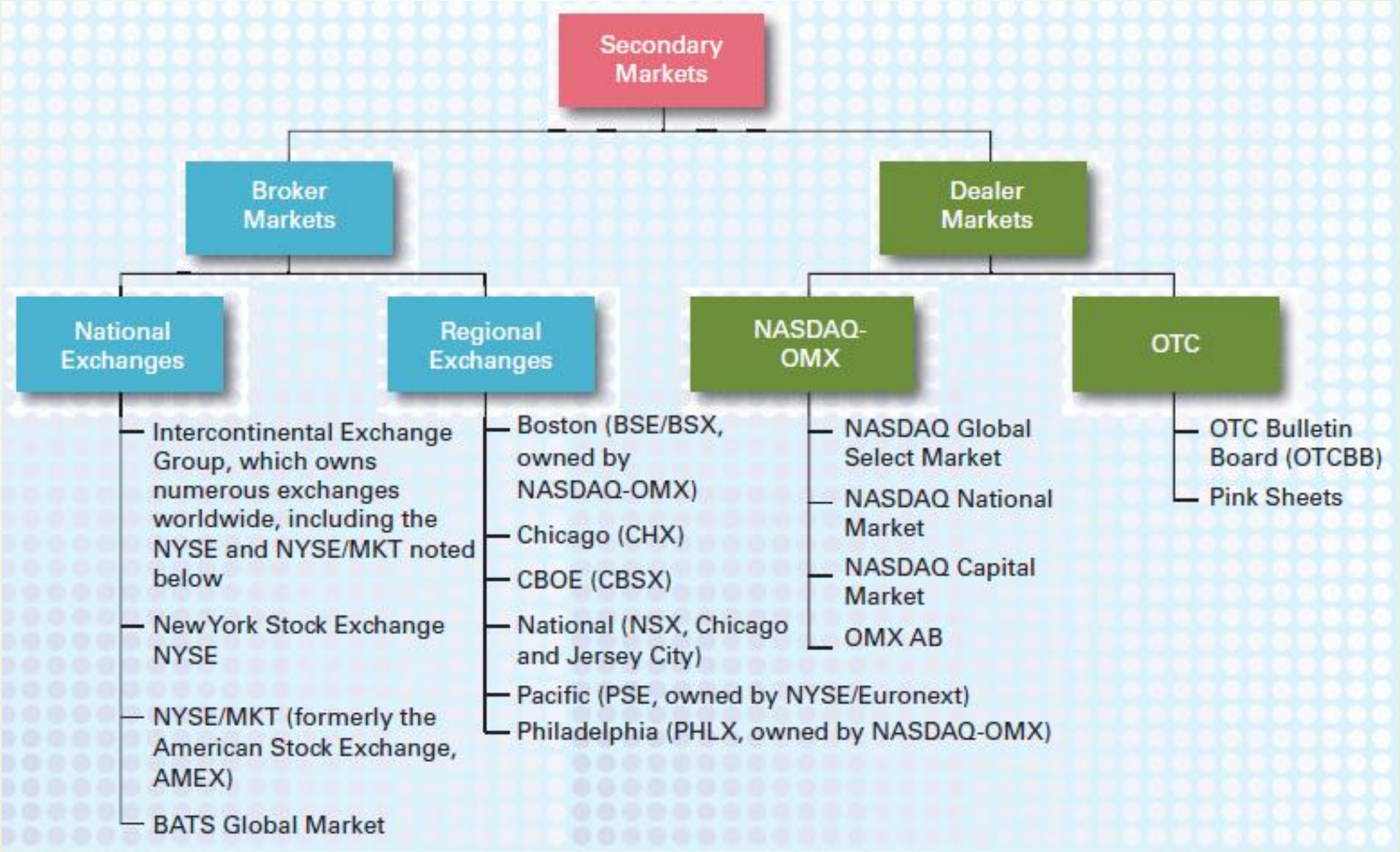
Securities Markets

- Primary Market: New issues available for the first time
  - Investment bank underwrites
  - Issuing company get net proceeds and issues a prospectus
- Secondary Market: Trades previously issued securities
  - Stock Exchanges
  - NASDAQ
  - OTC market

Broker and Dealer Markets

- Broker Market: Buyer and seller come together, direct trade takes place between the two
- Dealer Market: Buyer and seller never meet
  - Buy/sell orders are executed separately through securities dealers acting as market makers
  - Most common transactions

Broker and Dealer Markets-Exhibit 11.1



Broker Markets

- National/International Exchanges:
- New York Stock Exchanges and major exchanges in ten other cities in Europe owned by Intercontinental Exchange Group
- Stocks listed on these exchanges include 90% of those in the Dow Jones Industrial Average and 80% of those in S&P 500 Index.
- Regional Exchanges: Operates similar to New York Stock Exchange but tends to specialize in local companies but offer securities that are listed on New York Stock Exchange

Dealer Markets

- Made up of many market makers who are connected via a mass telecommunications network
- Each market maker is a securities dealer who makes a market in one or more securities by setting the BID/ASK price
- Investors pay the ASK price when buying
- Investor receive the BID price when selling
- Dealer Market accounts for 40% of all shares traded

NASDAQ/OTC

- National Association of Securities Dealers Automated Quotation System – in 2006 recognized by SEC as a “listed exchange” thereby giving it the same status as the NYSE
- Over-the-Counter Bulletin Board is regulated by the SEC which requires audited financial statements. The OTC Pink Sheets represent the unregulated segment of the market where companies are not required to file with the SEC
- Together these two comprise the dealer market

Regulating the Securities Market

- Primary agency is the Securities and Exchange commission (SEC) established by Congress in 1933 and amended in 1934
- The various laws enacted designed to protect the investor by requiring disclosure of company data to protect consumers from exploitative financial services practices

Bull Market or Bear?

- When stock prices are rising, said to be a Bull Market
- When pricing are falling, a Bear Market
- Past 50 years market has been generally bullish with significant exceptions in 2000, 2001, 2002, 2008, and 2011. 2008 second-worst stock market performance since 1825.

Making Transactions in the Securities Markets

- Brokers or account executive and financial consultants ***buy and sell securities for their customers***
- Brokers must be licensed by the exchanges and abide by ethical guidelines of the exchanges and the SEC regulations

Brokers

- Important that broker understands your investment objectives and will help you effectively pursue them
- Full Service broker offered wide array of broker services including investment advice and information , trade execution, holding securities for safekeeping, online brokerage services and margin loans. Examples include Merrill Lynch, Edward Jones, and Morgan Stanley.
- Discount broker offers fewer service, primarily executes trades, and have low fees. Examples include Bank of America, Charles Schwab, and J.D. Seibert.
- Online broker executes trades via internet and charges low fees. Examples include TD Ameritrade, E*Trade, and Scotttrade.

Investor Protection

- Securities Investor Protection Corporation (SIPC) provides protection against loss of securities or cash held by your broker. While it is regulated by the SEC it is not an agency of the federal government.
- Provide insurance for each account up to $500,000, $100,000 if cash.
- Ensures only that the securities themselves will be returned
- If you have a dispute with your broker, discuss with manager of branch, then firm's compliance officer, state securities office, and then appeal case to an arbitration panel.

Executing Trades

- Investor establishes an account with broker
- Trades can be executed by phone, at brokerage firm or online
- Market orders can take less than two minutes
- Day traders: An investor who buys and sells stock rapidly throughout the trading day in hopes of making quick profits. Change in price must cover trading costs.

Types of Orders

- Market order – trade now at best available price
- Limit order – trade when a specified price or better is reached
- Stop-loss order – sell if stock drops to certain price, used to limit losses

Calculating Investment Returns

- Rate of Return depends on the increase or decrease in the price of an investment as well as any income during period

$$\text{Rate of Return} = \frac{\text{Ending Value} - \text{Beginning Value} + \text{Income}}{\text{Beginning Value}}$$

Calculating Investment Returns -- Example

You bought 100 shares of The Walt Disney Company (DIS) one year ago at \$81.22 a share. The stock is currently selling at \$111.40. Over the year Disney paid dividends of \$1.15 per share. What rate of return did you earn?

$$\text{Rate of Return} = \frac{\text{Ending Value} - \text{Beginning Value} + \text{Income}}{\text{Beginning Value}}$$

$$= \frac{(100 \times \$111.40) - (100 \times \$81.22) + (100 \times \$1.15)}{(100 \times \$81.22)}$$

$$= 38.57 \text{ percent}$$

Margin Trades and Short Sales

- Margin Accounts: Allows investors to use borrowed money to make security transactions. Strict margin requirements
- Allows higher returns on your money if prices go up; if down, subject to a margin call where the brokerage firms will sell you securities to pay off your margin account.
- Short sale: A transaction that involves selling borrowed securities with the expectation that they can be replaced at a lower price at some future date; made in anticipation of a decline in the security’s price
- Both Margin trades and short sales are risky and for knowledgeable investors only.

Source of Information for Investor

- Annual Stockholders' Reports – available on company's website
- The Financial Press – subscription service or local library will have some
- Market, Industry, and Company data – various sites, See S&P Report on Apple in text
- Dow Jones Industrial Average – every news program
- Stock Quotes, Brokerage Reports, other indexes – available on various web pages
- Advisory Services – subscriptions or through press

Annual Report

- CEO’s letter – mostly good news about the company
- Highlights or selected financial data – short version of financial statements
- Management’s discussion and analysis section – more detail than CEO letter
- Financial statement and NOTES – issues will be in notes
- Auditor’s report – look for language that is not standard

Managing your Investment Holdings

- Build a diversified portfolio based on goals and personal situation – typically include stocks, bonds, and short-term cash investments
- Allocate assets according to objectives – mix of portfolio will change as you get older. In the long term, total return on portfolio is influenced far more by its asset allocation than by specific security selections.
- See Exhibit 11.7 for example asset allocations in portfolios classified by age and family

Tracking Your Investments

- Track investments, rebalance portfolio as needed
- See Worksheet 11.2
- Holding an investment is a decision to be made, the fact that you purchased a share of stock does not mean that you never sell it. Monitor your portfolio and make changes when you think it is appropriate.

Worksheet 11.2

AN INVENTORY OF INVESTMENT HOLDINGS					
Name(s): Drew and Renee Porter				Date: May 1, 2015	
Type of Investment	**Description of Investment**	**Date Purchased**	**Amount of Original Investment**	**Latest Market Value**	**Cumulative Return**
Common stock	250 shares–McDonalds	12/7/2005	$8,815.00	$24,450.00	+177.37%
Common stock	300 shares–Disney	10/19/2007	$10,143.00	$33,156.00	+226.89%
Common stock	150 shares–Intel	8/11/2010	$2,914.50	$5,013.00	+72.00%
Exchange-traded fund	400 shares–Vanguard Total International Bond ETF	8/12/2014	$20,444.00	$221,368.00	+ 4.52%
Mutual fund	200 shares–Vanguard Health Care	6/16/2004	$25,142.00	$45,426.00	+80.68%
Mutual fund	725 shares–Fidelity Contrafund	6/16/2004	$37,149.00	$73,384.50	+97.54%
	Portfolio Totals		**$104,607.50**	**$231,683.36**	**+93.87%**