Frequently Asked Questions

Table of Contents

What are the steps in the investment process?

The investment process is comprised of several steps that enable you to select a portfolio appropriate to your risk tolerance and desired return. The primary steps in this process are:

- Determine your desired return and risk tolerance
- Develop an asset allocation plan
- Select diversified investments within each asset class
- Monitor your investments

Q: How are risk and return related?

A: Risk and return are positively correlated. The higher the risk of an investment, the higher a return it must offer in order to compensate for the risk. Risks comes in many forms such as the volatility of the market, inflation risk, interest rate risk, and business risk. You must determine the degree of risk that you are willing to tolerate. Your investment professional can assist you in this process.

Select the level of risk that permits you to sleep at night. If you have a long investment horizon, then focus on your desired return. Year to year fluctuations should not be a concern. Over the long term, stocks have generated annual returns of about 10 to 11 percent and have had the highest level of risk while long term government bonds have had long term returns of 5 to 6 percent and have had the lowest level of risk. The more risk you can tolerate or the higher your desired rate of return, the higher the portion of your portfolio invested in stocks should be.

Q: What is an asset allocation plan?

A: Asset allocation is the distribution of investments among asset classes. Asset classes include different types of stocks, bonds, and mutual funds. It is a significant factor in determining your investment return relative to risk. Proper asset allocation maximizes returns and minimizes risk. This is because different classes of assets react differently to economic upswings or downswings. Allocation differs from diversification in that it balances a portfolio among different classes of assets, for example, growth stocks, long bonds, and large-company stocks, while diversification focuses on variety within an asset class. Generally, allocation among six or seven asset classes is recommended.

Q: What is diversification?

A: Diversification is the selection of multiple investments within a portfolio. For example, investing in a portfolio of 30 stocks rather than in just a few. By maintaining a diversified, varied portfolio, you are minimizing risk. You're less likely to make that "big killing", but when individual investments take a nose-dive, you won't take a big hit.

Q: How can I best monitor my investments?

A: Examine carefully and promptly any written confirmations of trades that you receive from your broker, as well as all periodic account statements. Make sure that each trade was completed in accordance with your instructions. Check to see how much commission you were charged, to make sure it is in line with what you were led to believe you would pay. If commission rates have increased or will increase in the immediate future, or if charges such as custodial fees are to be imposed, then you should be informed in advance.

If securities are held for you in street name (where the customer's securities and assets are held under the name of the brokerage firm instead of the name of the individual who purchased the security or asset), you may request that dividends or interest payments be forwarded to you or put into an interest-bearing account, if available, as soon as they are received, rather than at the end of the month or after some other lengthy period of time.

Tip: Set up a file where you can store information relating to your investment activities, such as confirmation slips and monthly statements sent by your broker. Keep notes of any specific instructions given to your account executive or brokerage firm. Good records regarding your investments are important for tax purposes, and also in the event of a dispute about a specific transaction.

Periodically, ask yourself the following questions about your investment:

- Is this investment performing as I was told it would?
- How much money will I get if I sell it today?
- How much am I paying in commissions or fees?
- Have my investment goals changed? If so, is the investment still suitable?

- Have I decided what contingencies need to happen for me to sell the investment (i.e., a certain percentage decrease in value)?

go to top

What types of risks are involved in investing?

Nobody invests to lose money. However, investments always entail some degree of risk. Be aware that:

1. The higher the expected rate of return, the greater the risk. Depending on market developments, you could lose some or all of your initial investment, or a greater amount.
2. Some investments cannot easily be sold or converted to cash. Check to see if there is any penalty or charge if you must sell an investment quickly or before its maturity date.
3. Investments in securities issued by a company with little or no operating history or published information may involve greater risk.
4. Securities investments, including mutual funds, are not federally insured against a loss in market value.
5. Securities you own may be subject to tender offers, mergers, reorganizations, or third party actions that can affect the value of your ownership interest. Pay careful attention to public announcements and information sent to you about such transactions. They involve complex investment decisions. Be sure you fully understand the terms of any offer to exchange or sell your shares before you act. In some cases, such as partial or two-tier tender offers, failure to act can have detrimental effects on your investment.
6. The past success of a particular investment is no guarantee of future performance.

go to top

What steps can I take to avoid unnecessary risks?

1. Never give in to high pressure. A high pressure sales pitch can mean trouble. Be suspicious of anyone who tells you, "Invest quickly or you will miss out on a once in a lifetime opportunity."

2. Never send money to purchase an investment based simply on a telephone sales pitch.

3.Never make a check out to a sales representative.

4.Never send checks to an address different from the business address of the brokerage firm or a designated address listed in the prospectus.

Tip: If your broker asks you to do any of these things, contact the branch manager or compliance officer of the brokerage firm.

5. Never allow your transaction confirmations and account statements to be delivered or mailed to your sales representative as a substitute for receiving them yourself. These documents are your official record of the date, time, amount, and price of each security purchased or sold. Verify that the information in these statements is correct.

go to top

What questions should I ask before making any investment?

Have this list of questions with you the next time you talk to your broker. Write down the answers you get and the action you decide to take. Your notes may come in handy later if there is a dispute or a problem. A good broker will be happy to answer your questions and will be impressed with your seriousness and professionalism.

- Is this investment registered with the SEC and a state securities agency?
- Does the investment match my investment goals?
- How will the investment make money for me (dividends, interest, capital gains)?
- What set of circumstances have to occur for the value of the investment to go up? To go down? (e.g., must interest rates rise?)
- What fees do I have to pay to buy, maintain, and sell the investment? After fees, how much does the value have to increase by before I make a profit?
- How easy is it for me to unload this investment in a hurry, should I need the money?
- What are the specific risks associated with this investment, for example what is the risk that rising interest rates will devalue your investment or the risk that an economic recession could decrease its value?
- Is the company experienced at what it is doing? How long has it been in business? What is their track record? Who are their competitors?
- Can I get more information: a prospectus, the latest SEC filings, or the latest annual report?

go to top

What questions should I ask before making a mutual fund investment?

Here is a list of potential questions to ask before making a mutual fund investment:

- How has the fund performed over the long run? Where can I get an independent evaluation of it?
- What specific risks are associated with it?
- What type of securities does the fund hold?
- How often does the portfolio change?
- Does this fund invest in derivatives, or in any other type of investment that could cause rapid changes in the NAV (Net Asset Value)?
- How does the fund's performance compare to other funds of its type, or to an index of similar investments?
- How much of a fee will I have to pay to buy shares? To maintain shares?
- How often will I get statements? Can you explain what the statement tells me about the investment?

go to top

What investment hazards should I look out for?

There are no magic formulas for successful investing. It takes a disciplined, reasoned approach, a commitment to follow some basic, solid rules that have proved effective over time, and to stay in it for the long haul.

Here are some specific tips.

Don't Let Greed Cloud Your Better Judgment. A disciplined approach, taking into account your investment objectives, will pay dividends in more ways than one. Investors who are constantly chasing the jackpot usually lose in the long run.

Don't Rely on Tips. The "hot tip" is the bane of investors. There may be short-term gain in some cases, but in this regard, it's generally wise to follow the maxim, "What goes up must come down."

Be Resolute. Develop a comprehensive, reasoned plan with your adviser, and stick to it, despite the temptation to "take a flyer." When you have developed your plan, and in the absence of other factors, follow it.

Consider All Your Needs and Get a Plan That Fits. For financial planning to be truly effective, all your needs must be considered: money management, tax planning, retirement planning, estate planning, insurance, etc.

Evaluate Investments Periodically. An investment program is not static and unchanging. Your financial situation and objectives may change, as does the economic situation. Review your plan with your adviser and, if necessary, update it to reflect your current and long-term needs.

Monitor your investments. Stay informed. Don't rely on others to "take care of" your portfolio. Keep up with your reading, whether in newsletters, magazines, or the internet.

Read Broker-Account Forms With Care. Many investors pay scant attention to the forms involved in opening and maintaining a brokerage account. As pointed out earlier, many investors are not aware that much of the paperwork is intended, at least in part, to protect the broker and the form against any complaints they might bring.

go to top

What should I invest my IRA in?

Like any other investment, you should match the portfolio with your desired return, risk tolerance and investment time horizon. The higher your desired return and risk tolerance and the longer your time horizon, the greater the portion of your portfolio should be in equity investments such as common stocks. Since IRAs are generally long term investments, equity investments are generally appropriate for a portion of the account.

For those with a lower risk tolerance, short-term fixed income investment would be appropriate. Many people have their IRAs invested in CDs. This is appropriate only for those with a very short time horizon or very low risk tolerance. IRA money, like any other investment, should be invested in something that will provide a decent return.

Municipal bonds should never be used within an IRA. In doing so, you sacrifice return and may convert otherwise tax-free income to taxable income when you withdraw the funds.

go to top

What are derivatives and options?

A derivative is an investment instrument whose value is based on underlying assets such as stocks, bonds, commodities, currencies, interest rates and market indexes. Options are one of the most common types of derivatives and are a useful tool for enhancing a portfolio's income and in many cases, reducing risk. Other types of derivatives include futures contracts, forward contracts, and swaps, but these are more appropriate for sophisticated investors.

Stock options are contracts that give the purchaser the right to buy or sell at a specific price and within a certain period of time, for instance, 100 shares of corporate stock (known as the underlying security). These options are traded on a number of stock exchanges and on the Chicago Board Options Exchange.

When investors buy an option contract, they pay a premium, typically the price of the option as well as a commission on the trade. If they buy a "call" option, they are speculating that the price of the underlying security will rise before the option period expires. If they buy a "put" option, they are speculating that the price will fall.

Tip: While options trading can be very useful as part of an overall investment strategy, it can also be very complicated and sometimes extremely risky. If you plan to trade in options, make sure that you understand basic options strategy and that your registered representative is qualified in this area.

go to top

How can I avoid the most frequent money-losing mistakes?

Here are the top mistakes that cause investors to lose money unnecessarily.

- Using a cookie-cutter approach
- Taking unnecessary risks
- Allowing fees and commissions to eat up profits
- Not starting early enough
- Ignoring the costs of taxes
- Letting emotion govern your investing

Q: Should I use a standard asset allocation formula such as those seen in many popular finance magazines?

A: Most investors are satisfied with a one-size-fits-all investment plan. However, your individual needs as an investor must govern any plans you make. For instance, how much of your investment can you risk losing? What is your investment timetable? (i.e., are you retired or a young professional?) The allocation of your portfolio's assets among various types of investments should match your particular needs.

Q: Can I make a decent return without taking unnecessary risks?

A: You do not have to risk your capital to make a decent return on your money. While all investments have some degree or risk, many investments that offer a return that beats inflation without unduly jeopardizing your hard-earned money. For instance, Treasuries are one of the safest possible investments and offer a decent return with very little risk.

Q: What is the downside of high fees and commissions?

A: Many investors allow brokers' commissions, fees, and other costs to cut into their returns. Be aware of the fees you are paying and make sure they are appropriate for the services you are receiving. The more you pay in fees the lower your net return will be.

Q: When should I start investing?

A: Today. Many investors are not cognizant of the power of interest compounding. By starting out early enough with your investment plan, you can invest less, and in the long run still come out ahead of where you would be if you start later in life.

Q: What is the impact of taxes on my investment returns?

A: Net profits on your share of your mutual funds' stock sales are taxable to you as capital gains. Unless you are in a tax-deferred retirement account, the taxes will eat into your profits. The solution? Invest in funds where shares are bought and sold less frequently and have a low turnover rate (10 percent or less per year).

Q: Should I let my emotions affect my investments?

A: Never give in to pressure from a broker to invest in a "hot" security or to sell a fund and get into another one. The key to a successful portfolio lies in planning, discipline, and reason. Emotion and impulse have no role to play. Try to stay in a security or fund for the long haul. (On the other hand, when it's time to unload a loser, then let go of it.) Finally, do not fall prey to the myth of "market timing." This is the belief that by getting into or out of a security at exactly the right moment, we can retire rich. Market timing does not work.

Instead, use investment strategies that do work: a balanced allocation of your portfolio's assets among securities that suit your individual needs, the use of dollar-cost averaging and dividend-reinvestment programs, and a well-disciplined, long-haul approach to saving and investment.

go to top

What is the difference between my cumulative return and annualized return?

Suppose Mr. N. Vestor invests $100 in an investment that earns 10 percent this year and 10 percent the next year. What is his cumulative return? The answer is 21 percent.

Here's why. N. Vestor's 10 percent gain makes his $100 grow to $110. Next year, he earns another 10 percent, leaving him with $121. His investment has earned a cumulative 21 percent return over two years. His annualized return, however, is 10 percent.

The fact that the cumulative return of 21 percent is greater than twice the 10 percent annual return is due to the effect of compounding, which means that your yearly earnings are added to your original investment before the current year's earnings are applied.

go to top

What is the rule of 72?

The rule of 72 is a way of finding out long it will take for your investment to double. Divide an investment's annual return into 72, and you will have the number of years necessary to double your investment.

Example: An investment's annual return is 10 percent. Ten percent divided into 72 is 7.2, so your investment will double in 7.2 year.

go to top

What is "Total Return" and why is it important?

If you reinvest all of your gains, including dividends and interest, you will be getting the most from compounding. The percentage you achieve is termed "total return." It includes appreciation, interest and dividends. It is particularly important in examining the past and current performance of mutual funds.

Mutual funds must, by law, distribute almost all of their capital gain and dividend income each year. Many investors reinvest these distributions, using them to buy more fund shares. Because the fund's share price is reduced after a fund makes a distribution, the long-term price trend of a fund's shares may not accurately reflect the fund's performance. However, the fund's total return, which takes into account reinvested dividends, is often a more accurate reflector of the fund's performance.

go to top

How does "yield" differ from "total return?"

Yield is the amount of dividends or interest paid annually by an investment. The yield is usually expressed as a percentage of the investment's current price. It does not consider appreciation.

Because certificates of deposit and money-market funds maintain the same value, their total return does not differ much from their yield. But because stocks and bonds fluctuate in price, there can be a large difference between yield and total return.

go to top

Can I measure my return as the increase in the value of my portfolio over a given period?

Investors often take the following shortcut, which often yields misleading results. Instead of looking at total return, they simply compare their year-end portfolio value with the value at the beginning of the year, and attribute the entire growth to investment gains.

The reason this shortcut may be misleading is that any additional investments or withdrawals made during the year are not taken into account.