Investment Alternatives

Investment in Cash

Cash investments are short-term debt instruments that you can convert into cash easily, with little or no cost or penalty. They are sometimes called short-term reserves, cash reserves or cash. Examples include money market mutual funds, bank checking accounts, certificates of deposit (CD's) and Treasury bills (T-bills). The advantages of cash investments are their stability of principal and liquidity. Disadvantages include inflation risk and income risk.

Investment in Bonds

Bonds are debt securities issued by corporations or governments in exchange for money you lend them. In most instances, bond issuers agree to repay their loans by a specific date and to make regular interest payments to you until that date. That's why bonds are often referred to as fixed-income investments.

Bonds vary according to different criteria. One is the issuer. Bonds are issued by the U.S. Treasury, U.S. government agencies, corporations, and state or local governments. Another criteria is the bond maturity. The maturity date is the date when the bond issuer agrees to repay you the principal or face value of the loan. Bonds can be short-term (less than 5 years), intermediate-term (5–10 years) or long-term (more than 10 years). Yet another criteria of bonds is their credit quality. A bond's quality is measured by the issuer's ability to pay interest and repay principal in a timely manner. Treasury bonds have the highest credit quality because they are backed by the full faith and credit of the U.S. government. Corporate high-yield "junk" bonds have the lowest credit quality.

Advantages of investing in bonds include both current income and broad diversification possibilities. Disadvantages include interest rate risk, credit risk and call risk.

Interest rate risk means that the market value of your bonds could decline due to rising interest rates. (In general, bond prices fall when interest rates rise—and rise when interest rates fall.)

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Credit risk can also affect the value of your bond investment. You could lose money if a bond issuer defaults, fails to make timely payments of principal and interest, or if a bond's credit rating is reduced.

Another possible disadvantage of investing in bonds is what is termed call risk. During periods of falling interest rates, corporate and municipal bond issuers may prepay or call their loans before maturity in order to reissue the loans at a lower rate. You as lender, then, must reinvest this prepaid principal sooner than you had anticipated—and possibly at a lower interest rate.

The last two possible disadvantages to investing in bonds are inflation risk and event risk. The danger of inflation risk is that the interest income you earn from a bond investment remains the same over the life of the bond. The value of that income could be eroded by inflation. With event risk, the credit quality or market value of your bonds could suffer in response to an event such as a merger, leveraged buyout or other corporate restructuring.

The list below explains some ratings for various levels of bonds and a description of their risks. As noted these come from both Standard & Poor's and Moody's. When purchasing any kind of bond, always check the risk and rating. The actual return should be your last consideration.

Standard & Poor's	Moody's	Description
AAA	Aaa	Best quality, smallest degree of risk
AA	Aa	High quality, slightly more risk
A	A	Upper medium grade, possible risk
BBB	Baa	Medium grade, but not well-secured
BB	Ba	Speculative issues, moderate protection
B	B	Very Speculative, little protection
CCC	Caa	Issues in poor standing, may default
CC	Ca	Highly speculative, marked shortcomings
D	C	Lowest quality, in default

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Investment in Treasury Securities

Treasury securities are negotiable debt obligations issued by the U.S. government for a specific amount and maturity. The government issues three types of Treasuries:

- Treasury bills (T-bills), with a maturity of 1 year or less.
- Treasury notes (T-notes), with a maturity of 1 to 10 years.
- Treasury bonds (T-bonds), with a maturity of 10 to 30 years.

There is safety in the purchase of U.S. Treasury Securities. They are backed by the full faith and credit of the U.S. Government and are considered ideal for safeguarding and preserving capital.

If held to maturity, Treasuries are guaranteed to repay your original investment. No matter how volatile the market may be, you never risk your principal if you hold the security until the date of maturity.

Since Treasuries are a fixed-rate security, you'll know exactly what your income will be and when you will receive interest payments. When purchasing Treasury Notes or Bonds, you will receive a steady stream of income from the semiannual interest payments. Although Treasuries are federally taxable, the interest is exempt from both state and local taxes. Therefore, your after-tax return may be higher than the same yields on fully taxable investments, especially if you live in a high-tax state.

There is an active secondary market for Treasuries which trades billions of dollars every day. This enables you to trade your Treasury securities before maturity should you need to raise some quick cash. Of course, should you sell before maturity, you may realize either a gain or a loss on your investment, depending on market value when you sell. If interest rates have fallen, the value of the securities goes up and you'll most likely get back more than you anticipated. However, if the reverse is true, your return will probably fall short.

When buying Treasuries you have a lot of flexibility as to when you want the principal back. Whether you are saving for the children's education or your own retirement, you can target the exact date that you want the security to mature to meet your individual

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investment goals. T-Bills are short-term instruments and have maturities of three and six months and one year. T-Notes mature in two, three, five, seven and ten years. T-Bonds have maturities of 11 to 30 years. STRIPS have maturities of six months to 30 years.

So what are Treasury Bills? Short-term Treasury Bills are sold at a discount and return their full face value at maturity. The interest you earn is the difference between the face value and the price you actually pay. The discount rate simply indicates the trading price and does not refer to the actual yield, which is always higher. For example, if a one-year T-Bill is quoted at 7.72, the security is selling at a discount of 7.72 percent of $10,000, or $9,228. At maturity, you'd receive your original investment plus $772 in interest earned, for a yield of 8.37 percent. Treasury Bills can be an excellent investment alternative to savings accounts or CDs. Exempt from both state and local taxes, T-Bills not only protect your capital, but may also provide a better return than fully taxable alternatives.

Treasury Notes and Bonds

These securities pay interest semiannually and can provide the investor with a steady source of income. If held to maturity, intermediate T-Notes and T-Bonds both lock in a fixed rate of return that is guaranteed regardless of changes in market conditions.

Zero Coupon Bonds

Zero-Coupon Treasuries, or STRIPS, is another outstanding investment vehicle. The prospect of having to have a specific sum of money at a set point in time can be a worrisome dilemma. Whether it's your children's college tuition, your retirement, a wedding, dream vacation or a second home you are looking forward to, U.S. Treasury Zero Coupon Bonds can help to offer you an assured way to take what you have today and turn it into what you need for tomorrow.

They are sold at deep discounts and cost substantially less than their face value. Your return is the difference between what you pay for your STRIPS and what you receive at maturity. Zero Coupon Bonds make no regular interest payments. The interest on the STRIPS accrues over the life of the bond and is automatically reinvested so that you earn interest on both the interest and the principal. This compounding locks in a rate of return and enables a small initial investment to achieve dramatic growth if held to maturity.

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You buy Zero Coupon Bonds at a small fraction of their $1,000 face amount — then redeem them at full value at maturity. For example, if you buy approximately $8,500 worth of 10 year Zero Coupon Bonds that pay 8.75 percent compounded semiannually, your $8,500 will grow to $20,000 at maturity. This investment vehicle is thought to be just about the best way of knowing exactly how much a certain sum of money will grow to in a given number of years. And because there are so many maturity dates to pick from, you can select the maturity that matches the time you'll need the money and know precisely how much you'll have on that date.

Since STRIPS do offer a wide choice of maturities they are popular for investors who need a large lump sum at a specific future time, such as for college or retirement. Although interest isn't paid until the STRIPS mature, it is taxable the year it's credited to you. It is because of this that STRIPS are favored for tax-deferred accounts such as IRA's.

The predictability of zeros depends on your holding them until maturity. That's why they may be ideal for your IRA. All interest (if in an IRA account) accumulates tax-deferred until withdrawn at retirement, when your tax bracket is usually much lower.

Many individuals use zeros as a long-term savings tool. With some planning, you can purchase zeros that will mature during your retirement years. At that time, the return on your zeros will supplement other sources of retirement income (pensions, profit sharing plans and Social Security benefits).

Here is a quick look at different types of zeros. You can choose from a variety of zero coupon bonds. Many IRA investors opt for Treasury zeros or STRIPS. They offer the highest degree of safety because they are backed by the full faith and credit of the United States government and your return is guaranteed if held to maturity. They are also exempt from state and local taxes.

Corporate zeros tend to offer higher yields than Treasury zeros, but safety may be compromised. They are backed only by the issuing corporation. Corporates are rated by independent agencies, such as Moody's or Standard & Poor's, to indicate their level of credit risk at the time of purchase. In addition, corporate zeros may be called or bought

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back by the issuing company prior to the bond's stated maturity date, putting your principal at risk.

There are some tax issues to consider. In non-retirement accounts, zero-coupon bonds are subject to tax on so-called phantom income. This means the annual buildup of interest from most zeros is taxed even though you do not actually receive any payment until maturity. The amount taxed each year starts low and increases as the bond moves closer to maturity. In the case of an Individual Retirement Account, however, you avoid having the phantom interest included with your taxable income. You bypass paying yearly taxes on the accumulating interest and you only pay taxes when you withdraw your retirement funds.

As with all other types of investment opportunities and possibilities, there are both advantages and disadvantages to investing in treasury securities, but the overall benefits are substantial. First is the stability of principal. Next is the liquidity factor. Treasuries are considered to have the highest credit quality of all debt instruments and are therefore easily sold and converted to cash. Not to be lost in the discussion of benefits is the call protection factor. Treasuries generally are not callable, which means the issuer cannot redeem the security before its scheduled maturity date. This feature locks in your interest rate until maturity. And one final benefit is the tax advantage. Income from treasury securities is exempt from state and local taxes (but not from federal income tax).

Every investment alternative has its particular downside. With treasuries, it is the interest rate risk. You are guaranteed only to receive timely payment of interest and repayment of principal upon maturity. Before maturity, however, the market value of your securities could decline due to rising interest rates. There is also the possibility of less current income. Because they have high credit quality, treasuries provide less interest income than bonds with comparable maturities and lower credit quality. One final reminder is that bonds of all types are subject to inflation risk. The interest income you earn from a bond investment remains the same over the life of the bond, so the value of that money could be eroded by inflation.

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Investment in Agency Securities

Agency securities are issued by agencies that are owned, backed or sponsored by the U.S. government. The most common agency securities are as follows:

GNMA – known as Ginnie Maes. GNMA securities are issued by the Government National Mortgage Association.

FNMA – known as Fannie Maes. FNMA securities are issued by the Federal National Mortgage Association.

FHLMC – known as Freddie Macs. FHLMC securities are issued by the Federal Home Loan Mortgage Corporation.

FHLB - These securities are issued by the Federal Home Loan Bank.

These sponsored agencies, as in the case of all investments, have both benefits and risks. The benefits include the stability of principal. Some agency securities are backed by the full faith and credit of the U.S. government while others carry less formal guarantees, but all are considered to have high credit qualities. Disadvantages include the risk of prepayment. Prepayment risk is the possibility that, as interest rates fall, homeowners will refinance their mortgages. You, then, must reinvest this prepaid principal sooner than you had anticipated and possibly at a lower interest rate.

Additional risks include interest rate risk. The market value of your securities could decline due to rising interest rates. Then there's the risk of less current income. Because they have high credit quality, agency securities provide less interest income than bonds with comparable maturities and lower credit ratings. Finally comes inflation risk. The interest income you earn from a bond investment remains the same over the life of the bond. The value of that money could be eroded by inflation.

Investment in Corporate Bonds

Corporate bonds are debt instruments of varying credit quality issued in a range of maturities by corporations. Corporate bonds vary according to both credit quality and maturity or length of the term. Consider first the maturity variances. Corporate bonds

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range from short-term (less than 5 years) to intermediate-term (5–10 years) to long-term (more than 10 years).

Now let's take a look at the credit quality factor. Most corporate bonds are assigned a letter-coded rating by independent bond-rating agencies such as Moody's Investors Service, Inc. and Standard & Poor's Corporation. The rating indicates the likelihood that the issuer will pay interest and repay the principal in full and on time.

Bonds rated BAA or higher by Moody's or BBB or higher by Standard & Poor's are called investment-grade bonds. Bonds rated BA or lower by Moody's or BB or lower by Standard & Poor's are known as high-yield bonds (because of the higher interest rates they must pay to attract investors) or junk bonds (because of the possibility that the issuer will default).

When deciding whether or not to invest in corporate bonds, also consider the benefits of having current income. Corporate bonds generally provide higher interest income than Treasuries and agency bonds because they are considered to be less safe than government securities and the market rewards investors for assuming even a small amount of additional risk.

When considering whether or not to invest in corporate bonds, also consider the potential disadvantages. First, consider the possibility of a call risk. Again, during periods of falling interest rates, corporate bond issuers may prepay or call their loans before maturity in order to reissue the loans at a lower rate so that you as the lender must reinvest this prepaid principal sooner than you had anticipated and possibly at a lower interest rate.

There is always a great possibility of credit risk. You could lose money if a bond issuer (corporation) defaults, that is, fails to make timely payments of principal and interest or a bond's credit rating is reduced. There is event risk as there would also be in buying equities. The credit quality or market value of your bonds could suffer in response to an event such as a merger, leveraged buyout, or other corporate restructuring. There can be tax consequences. The interest income on your corporate bonds (unlike the interest

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income on treasuries and some agency securities) is taxable at the federal, state and local levels.

You also have to consider the interest rate risk. The market value of your bonds could decline due to rising interest rates. And finally there is the risk of inflation. The interest income you earn from a bond investment remains the same over the life of the bond. The value of that money could be eroded by inflation.

Investment in Municipal Bonds

Municipal bonds (often referred to as "munis") are issued by state and local governments to finance public projects or support other financial needs. These bonds are attractive to investors in higher tax brackets because their interest income generally is exempt from federal and state taxes. Municipal bonds also known as tax-exempt or tax-free bonds are available in two main types. Revenue bonds are used to finance municipal projects that generate revenue (a toll road, for example). This revenue is used to make interest and principal payments to the bond holders.

Another municipal bond is classified as a general obligation bond. These are issued for municipal projects that do not generate revenue (such as a government office building). These bonds are backed by the full faith and credit of the issuer and are repaid with taxes assessed by the issuer. Municipal bonds, like other bonds, can vary widely in credit quality and maturity. There are certain tax advantages when purchasing municipal bonds. You should consult your CPA for information about them. Disadvantages include less than current income, interest rate risk, call risk, credit risk and inflation risk.

Investment in Common Stocks

Common stocks represent part ownership or equity in a public corporation. Companies issue stock as a way to raise money to expand or build their business.

When you buy stock, you hope that the value of your investment will grow. Market value is determined by such factors as a company's current earnings and long-term growth prospects, overall trends in the securities markets, and economic conditions. Many companies also distribute a portion of their profits to stock owners in the form of regular dividends. If a company encounters difficulties, however, the value of your investment

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could decline. The company could stop paying dividends or the market value of the stock could decrease. Because stock prices tend to fluctuate suddenly and sometimes sharply, stocks are considered riskier than bonds or cash investments.

The strong stock market of the 1990's lulled many investors into a false sense of security. If there's one thing you should know about stocks, it's that the stock market is unpredictable. The value of your stock could rise one day and decline the next. So, while stocks offer the potential for regular dividends and significant capital growth, they also present substantial risks.

Of course, there are many potential benefits to owning stocks. One is the possibility of long-term growth. Over the long haul, stocks tend to offer you the greatest potential return on your investment. Since 1926, according to experts, common stocks have returned an average of 11.2 percent annually — more than bonds or cash investments and well ahead of inflation. There is also the potential for current income through stocks that pay regular dividends, which you can receive as cash or reinvest in more shares. Companies differ, however, in how much of their profits they distribute to shareholders and how much they put back into the company.

The long list of disadvantages begins with a huge one—market risk. The price of your stock could decline over short or even extended periods. Stock markets tend to move in cycles, with periods when prices rise and other periods when prices fall. (Price declines can be dramatic: On October 19, 1987, the Standard & Poor's® 500 Composite Stock Price Index fell 20 percent. And, in the worst bear market since World War II, the S&P 500 Index declined by 48 percent from January 1973 to October 1974.) In the years 2000, 2001 and 2002, the market had consecutive declining years.

Another very real consideration is the risk of losing your principal. You could lose money by investing in stocks. There is also industry risk. The price of your stock could decline due to developments affecting its company's industry. And of course, as in many investment alternatives, there is event risk. The price of your stock could decline in response to an event such as a merger, leveraged buyout or other corporate restructuring. Because of their short-term volatility, stocks should be considered a long-term investment.

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Investment in Money Market Funds

Money market funds seek income, liquidity and a stable share price by investing in high-quality, short-term cash investments (that mature in 13 months or less), including certificates of deposit (CD's), Treasury bills, banker's acceptances and commercial paper.

Because cash investments are considered to be the safest of the three primary asset classes, these funds are ideal for stashing emergency money or cash that you plan to use in two years or less. Money market funds are low-risk investments that offer low returns in exchange for providing peace of mind.

The benefits of investing in money market funds include stability of principal. Cash investments are viewed as safe because your money generally is invested with reliable borrowers for only a brief period. In addition, the Securities and Exchange Commission requires that all taxable money market funds invest at least 95 percent of their assets in securities of the highest grade, as rated by Moody's Investors Service, Inc. or Standard & Poor's Corporation.

Of course there is the benefit of current income streams. Dividends, distributed monthly by the funds, typically are higher than the dividends paid by a bank savings account or CD. Another very good benefit is liquidity. Most of the funds offer free check-writing privileges and you can redeem your money at any time.

Disadvantages include inflation risk and income risk. Let's begin with inflation risk. Because cash investments are considered safe, the interest rates they pay are low and, over time, their returns have only slightly exceeded the rate of inflation. From 1926 through most of the nineties, cash investments returned an average of 3.9 percent per year while inflation averaged 3.1 percent, leaving a return after inflation of only 0.8 percent per year.

Therefore, if you have a long-term time horizon, money market funds should not be your primary choice, although they can play a smaller role in a diversified investment portfolio. Last is income risk. Money market funds hold short-term investments that must be reinvested by the fund manager when they mature and possibly at a lower rate of return.

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Investment in Bond Mutual Funds

Bond mutual funds emphasize current income by investing in corporate, municipal, U.S. government debt obligations, or some combination. Bond funds can have average maturities that are short-term (less than 5 years), intermediate-term (5–10 years), or long-term (more than 10 years).

The primary types of bond funds are as follows:

U.S. Government Bond Funds | Invest in securities issued by the U.S. Treasury or agencies of the U.S. government.

Mortgage-Backed Securities Funds | Invest in securities representing pools of residential mortgages.

Corporate Bond Funds | Invest in the debt obligations of U.S. corporations.

Municipal Bond Funds | Invest in tax-exempt bonds issued by state and local governments.

There are many benefits in choosing bond mutual funds as a part of your overall investment portfolio:

Current Income | While most individual bonds pay interest twice a year, most bond funds distribute interest monthly. You may choose to receive those distributions as cash or reinvest them in additional fund shares.

Diversification | A bond fund may hold bonds from hundreds of different issuers, so a default by one bond issuer would have only a slight effect on your investment.

Stability | In addition, because bond returns tend to fluctuate less sharply than stock returns, a bond fund could help reduce your portfolio's overall volatility.

Professional Management | Few investors have the time or expertise to compare the thousands of bonds available. With a bond or stock fund, an experienced manager makes sure the fund's investments remain consistent with its investment objective—whether that's to track a market index or use research and market forecasts to actively select securities.

Liquidity | You can buy or sell shares of a bond fund whenever you want. It's easy and there is no penalty for early withdrawal (although there may be a redemption fee, depending on the fund).

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Convenience | With most bond funds, you can buy and sell shares, change distribution options and obtain information by telephone, by mail or online.

There are, however, some specific disadvantages to be aware of with bond funds, compared with individual bonds.

Tax Consequences | Unlike an individual bond, a bond fund has no fixed maturity date but maintains a rolling maturity by selling off older bonds and buying newer ones. These trades could create taxable capital gains (or losses) for you if you hold your shares in a taxable account. You could also realize a capital gain (or loss) if you sell your shares at a higher or lower price than you paid for them.

Income Fluctuation | While your interest payments from an individual bond are fixed, income from a bond fund could fluctuate moderately as the fund buys and sells individual bonds. In addition, bond funds face the same risks as individual bonds, including interest rate risk, call risk, credit risk, income risk, inflation risk and event risk.

Investment in Stock Mutual Funds

The primary objective of nearly all common stock funds is to provide long-term capital growth. Some conservative stock funds may include dividend income as a secondary consideration. Stock funds (also known as equity funds) vary based on whether they invest in companies emphasizing capital growth or consistent dividends and on the market value of those companies (known as market capitalization).

There are three primary types of stock funds, which vary in investment style:

Growth Funds | invest in stocks of companies that have above-average growth potential.

Value Funds | invest in stocks of companies that are attractively priced; these companies frequently produce above-average dividend income.

Blend Funds | invest in both growth and value stocks.

There are also three categories of market capitalization (though a fund may hold stocks in multiple categories).

Small-Cap | invest in stocks of small, emerging companies (defined by Vanguard as having a total market value of less than $1 billion).

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Mid-Cap | invest in stocks of medium-sized companies (market value of $1 billion to $12 billion).

Large-Cap | invest in stocks of large, established companies (market value of more than $12 billion).

Choosing to invest in stock mutual funds brings great potential to the table. The first is that of long-term growth. Over the long haul, stocks tend to offer you the greatest potential return on your investment. Remember, since 1926, common stocks have returned an average of 11.2 percent annually, more than bonds or cash investments and well ahead of inflation.

There is the very real benefit of diversification. A stock fund may invest in the stocks of hundreds of different companies. This helps to reduce your overall investment risk, because losses from some stocks are offset by gains from others. Mutual funds offer professional management. Few investors have the time or expertise to compare the thousands of stocks available.

Other benefits include convenience and dividend reinvestment. With most stock funds, you can buy and sell shares, change distribution options, and obtain information by telephone, by mail or online. Most stock funds allow you to reinvest dividends automatically in more fund shares.

And, of course, there are always a number of disadvantages to every investment alternative. Let's begin again with what is called market risk. Stock prices could decline over short or even extended periods. Stock markets tend to move in cycles with periods when prices rise and other periods when prices fall.

Then there is the disadvantage of investment style risk. If your fund's investment style is out of favor, its returns could trail the overall stock market or the returns of stock funds with different investment styles. For example, growth funds may do poorly when value funds do well and vice versa. You can add to this management risk and principal risk. In an actively managed fund, poor stock selection by the investment adviser could cause your fund to lag comparable funds. You could lose money by investing in stock funds.

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Investment in Balanced Mutual Funds

Balanced funds invest in a mix of stocks, bonds and cash investments. These funds provide a convenient way to achieve your desired asset allocation with a single investment. There are two basic types: Traditional balanced funds invest in a stable mix of assets (such as 60 percent common stocks and 40 percent corporate bonds) or maintain asset allocations that fall within a predetermined range (such as 60-70 percent stocks, 30-40 percent bonds). The funds periodically rebalance their portfolios to maintain the desired asset mix. Asset allocation funds periodically shift their desired mix of assets in pursuit of maximum return when the market is strong and minimum risk when the market is down.

Traditional balanced funds are middle-of-the-road investments that seek growth, income and preservation of capital. Though they vary in asset allocation, a typical mix is 60 percent stocks and 40 percent bonds. Balanced funds offer the benefits of diversification in a single investment—with the accompanying risks of each asset class the funds hold.

> "The greatest benefit for the investor is that of diversification."

The fund enables you to create a diversified portfolio through a single investment. There is also less volatility. Because stock and bond prices don't move in lockstep, the price of a balanced fund is likely to fluctuate less widely than a fund holding stocks alone.

Balanced funds also enjoy potential tax advantages. The fund may be able to achieve periodic rebalancing by purchasing assets with money from new shareholders, instead of by selling assets, which could trigger a taxable capital gain. In contrast, if you hold stocks and bonds in separate funds, you might have to rebalance by selling shares of the fund in the better-performing asset class to buy more shares of the other fund.

Now it is time to consider the disadvantages. First comes market risk. The price of your fund's stock investments could decline over short or even extended periods. Stock markets tend to move in cycles, with periods when prices either rise or fall. With interest risk, the market value of your fund's bond investments could decline due to rising interest rates. And management risk occurs with poor stock or bond selection by the investment adviser.

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