Types of Investments

Almost anything can be an "investment" – a home, a piece of art, or even a coin collection. But most people choose investments that are highly "liquid," meaning they can easily be converted to cash and vice versa.

Stocks

A stock is an investment that represents a certain percent of ownership in a company. For example, a company may have one million shares of stock outstanding, so owning 100 shares means that you own 0.01% of the entire company. If the company is growing, the stock is worth more money. If the company is shrinking, it is worth less. Some companies even pay a dividend, or cash payment, to stockowners each year.

As long as a company is publicly traded, you can buy shares. But owning just one stock can be risky – what happens if the company is mismanaged and the value drops to zero? You could lose your investment.

To reduce the risk of putting all their money in one company, many people purchase a group of stocks known as a mutual fund. A mutual fund could be made of the stocks in a certain type of business (like transportation) or it could be a group of companies that are a certain size (like the 500 largest companies). Some stock funds are managed, meaning there is someone making decisions about which stocks to buy and sell. Others are passive index funds, meaning they simply track an established group of stocks. Examples of stock indexes would be the S&P 500 (500 largest stocks in the USA) and the Dow Jones Industrial Average (30 large companies). Index funds have lower fees, and many experts consider them to be the best choice for most investors over the long-term.

Bonds

A bond is an investment that comes from interest paid on a loan. When you purchase a bond, you are loaning money to a company, government, municipality or other large organization that issues the bond. The rate of return on bond investments is tied to the rate of interest the bond issuer agrees to pay in exchange for the loan. The greater the risk that the issuer will not repay the loan, the higher the return on investment will be. On the other hand, the lower the risk, the lower the return.

Like stocks, bonds can be bought individually or as part of a fund. Since the purchase requirement of bonds can be in the thousands or hundreds of thousands of dollars, most individual investors buy bond funds. These funds allow investors to spread risk among many different bond issuers and to purchase a bond investment for a low dollar amount.

Cash Investments

Bank certificates of deposit, money market funds, savings accounts, and even interest-bearing checking accounts are all considered cash investments. These investments are chosen primarily as a way of preserving money without risk. The interest offered by these accounts tends to be similar to the overall inflation rate, so they are also a way of minimizing losses to inflation.

Some cash investments, such as bank CDs, offer a guaranteed return. Others offer a variable rate of return that is linked to an interest rate set by the government. Bank CDs offer guaranteed returns, but require a certain length of investment that can range from a few months to a few years. If you withdraw the money before the end of the agreed to period (known as the maturity date), you must pay a penalty.

A Note on Asset Allocation

Each of the investments covered here involves different levels of risk and reward. One term you will often hear with regard to investment planning is "asset allocation." Asset allocation simply means the percentage of your entire investment portfolio that is invested in each of the three main asset categories.

Younger investors, who have years before retirement, typically choose a higher percentage of stock ownership – this offers greater opportunity for growth, but also more risk. As investors get older and preserving savings becomes more important than rapid growth, they may gradually transition to a majority of bonds and cash as they approach retirement.