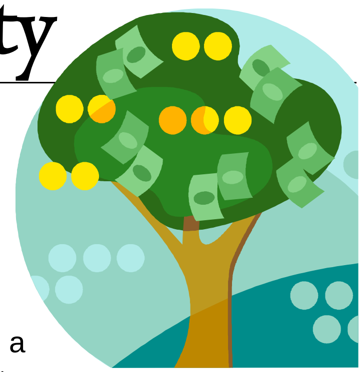
Risk, Return and Liquidity



You just inherited $100,000 from a distant relative. However, there is one condition on the use of the money. You may not spend the money immediately. It must be set aside today for spending some time in the future. Your task is to decide what to do with the $100,000. Your group will be assigned a couple of investment alternatives. After you have studied the alternatives, do the following:

1. Summarize the investment alternatives you were assigned on a Post-It Pad. Make sure to explain the advantages and disadvantages of each choice, considering risk, return, and liquidity.
2. Present your investment alternatives to the class in a complete, professional manner.
3. Tell which one of your alternatives your group wishes to invest the inheritance in.

Criteria Used In Evaluating Investments

Most investors develop criteria to guide their choices as they make investments. Here are three important criteria:

RISK: The chance of losing some or all of the money invested.

RETURN: Earnings from an investment.

LIQUIDITY: The ease with which savings or investments can be turned into cash.

Scale	
Low	♦
Moderate	♦♦
High	♦♦♦
Very High	♦♦♦♦

Forms Of Saving And Investing

Below are a few of the more popular assets you can choose when you're thinking about where to put your money. There are benefits to each asset class, but also drawbacks to each. We'll start with the safest kinds and then proceed down the list to some riskier ones.

BANK SAVINGS ACCOUNTS

Bank savings accounts are focused primarily on safety of principal (the amount you start out with). The returns on your money are pretty small, but you can sleep easy knowing that your money will still be there when you wake up. If you are willing to give up a little liquidity (like with a CD) you can earn a little more return, but not a lot. Risk is very low on all of these accounts since funds are federally insured.

Regular Savings Accounts

These accounts are insured by the federal government, and no one has ever lost even a penny of federally-insured individual savings deposits. The Federal Deposit Insurance Corporation (FDIC) insures savings accounts for up to $250,000. Your money will be safe in a savings account. There are two other things to know about savings accounts, however. The first is that the money won't be as easy to spend as cash or money in a checking account. You'll have to make a separate transaction to withdraw the money from a savings account before you can spend it. The second is that the money will not earn a high return. The interest paid on savings is small but steady.

RISK	RETURN	LIQUIDITY
♦	♦	♦♦♦♦

Current income from interest: interest rates 0.50%-2.00% (some high yield savings accounts are paying more though)

Money Market Accounts

The FDIC also insures these special bank accounts for up to $250,000. Your interest rates go up and down, but they are higher than those on regular savings accounts. Banks often require that you deposit $1,000 or more, and you can quickly get your money by writing checks or by withdrawing cash. Think of this as a cross between savings and checking accounts.

RISK	RETURN	LIQUIDITY
♦	♦	♦♦♦♦

Current income from interest: interest rates 0.50%-2.00% (but you can get higher rates)

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Certificates of Deposit (CDs)	
Just like savings and money market accounts, certificates of deposit (often called CDs) are made available by banks and are federally insured. When you buy a certificate of deposit, you're tying your money up for a specified period - from one month to a number of years. That means it's harder to spend than money from a checking or savings account. Before spending it, you have to wait until the term is up - or be assessed interest penalties for an early withdrawal. In return for giving the bank greater use of your money, you earn interest at rates somewhat higher than the rates paid on a savings account. Banks usually require that you deposit at least $500.	**RISK** ♦ **RETURN** ♦♦ **LIQUIDITY** ♦♦ Current income from interest: interest rates 1.50%-5.00%

GOVERNMENT SECURITIES

Government securities are IOUs that the government issues when it borrows money. They are very low risk because the government guarantees them. Below are four varieties.

Savings Bonds	
You can buy savings bonds from the federal government for as little as $25. You can't sell them to other people, but you can sell them back to the government after a certain period of time by going into a bank branch. Many students have received these over time as gifts from relatives. For instance, you can buy a $50 EE Savings Bond for $25 (half of the "face value" on the bond). The difference between what you pay for the bond and what you sell it for is interest. You must hold these for at least 1 year and will get a penalty fee if you sell them before 5 years.	**RISK** ♦ **RETURN** ♦ **LIQUIDITY** ♦ Current income from interest: interest rates ~ 2.50%

Treasury Bills (T-Bills)	
Treasury bills, or T-Bills, are short-term IOUs that the government repays in less than one year. You can easily sell Treasury bills if you want cash. The government requires that you buy at least $1000 worth of bills at one time. T-bills, are sold in terms ranging from a few days to 26 weeks. Bills are sold at a discount from their face value. For instance, you might pay $970 for a $1,000 bill. When the bill matures, you would be paid $1,000. The difference between the purchase price and face value is interest.	**RISK** ♦ **RETURN** ♦♦ **LIQUIDITY** ♦♦♦ Current income from interest: interest rates 5.25%.

Treasury Notes (T-Notes)	
Treasury notes, sometimes called T-Notes, are medium-term IOUs from the government. Treasury notes earn a fixed rate of interest every six months until maturity. Notes are issued in terms of 2, 3, 5, and 10 years. You can easily sell Treasury notes if you want cash. The government requires that you buy at least $1,000 worth each time that you make a purchase.	**RISK** ♦ **RETURN** ♦♦ **LIQUIDITY** ♦♦♦ Current income from interest: interest rates 4.5%.

Treasury Bonds	
Treasury bonds are long-term IOUs that the government repays after 10 or more years. Currently, only 30-year bonds are being sold by the government. You can easily sell Treasury bonds if you want cash, but the government also requires that you buy at least $1,000 worth.	**RISK** ♦ **RETURN** ♦♦ **LIQUIDITY** ♦♦♦ Current income from interest: interest rates 4.75%.

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CAPITAL MARKETS
The term "Capital Markets" refers to the various markets (like stock and bond markets) where businesses can go to raise capital and where you can invest your money in financial instruments. There are literally thousands of different types of financial instruments in the capital markets to choose from. The three main ones are: Bonds, Preferred Stock, and Common Stock.

Corporate Bonds

Corporate bonds are IOUs that corporations issue when they borrow money. Your risk of losing your money is higher than it is with government IOUs because companies can go bankrupt. You must have at least $1,000 to buy a corporate bond, but you can easily sell corporate bonds if you want cash. The bonds pay a fixed interest rate which is typically much higher than on government securities or bank savings accounts. The bond will specify under what terms you get your money repaid and what the interest will be. The safety of the bonds depends upon who issues them. Some bonds are fairly safe, such as those issued by major corporations. Almost certainly, you'll get your money back with interest, but there's a chance that even a major corporation could fail. Some bonds are known as "junk bonds." Junk bonds are high-risk investments. There is a real probability that the companies issuing them may not be able to pay investors back.

RISK	**RETURN**	**LIQUIDITY**
♦♦	♦♦♦	♦♦♦

Current income from interest. (depends on the credit rating).

You may also receive a small capital gain from selling bonds for more than you paid for them.

Preferred Stock

A type of stock ownership in a company which pays a "preferred" dividend before any dividends are paid on common stock. Preferred stock can be thought of as a cross between corporate bonds (fixed income payments) and common stock (ownership in the company). Preferred stock usually pays a higher dividend than the common stock, however, preferred stock is less liquid and usually doesn't have voting rights. People usually buy preferred stocks to take advantage of their dividends. Many preferred stocks pay dividends of 6% or more. These stocks also move in relation to the stock price, but often less noticeably. The amount of money you must have to buy preferred stock depends on the price of the preferred stock you buy and the number of shares you want.

RISK	**RETURN**	**LIQUIDITY**
♦♦♦	♦♦♦	♦♦

Current income from dividends. (depends on the credit rating).

You may also receive a small capital gain from selling preferred stock for more than you paid for it.

Common Stock

When you buy a stock, you're actually becoming a part-owner of a corporation. Ownership is easy to see when four people contribute equally to a new corporation and each owns a fourth of the venture. All four would share in the profits of the business and all four would have a fourth of the decision-making authority. Ownership is harder to see in today's corporations. But while modern corporations issue millions of shares, the principle is the same. More importantly for investors, some corporations make payments to shareholders called dividends. You can earn money with stocks by getting dividends, and also by the increase in the value of the stock over time, if the company does well. Of all the assets mentioned so far, stocks carry the highest risk. A company could have great success, making its shareholders rich. Or it could go down the tubes, making its shareholders lose whatever they invested. The amount of money you must have to buy stock depends on the price of the stock you buy and the number of shares you want.

RISK	**RETURN**	**LIQUIDITY**
♦♦♦♦	♦♦♦♦	♦♦

Current income from dividends.

Capital gains from selling stock for more than you paid for it.

Risk, Return and Liquidity

REAL ESTATE
Real estate is a very popular way to invest and can be extremely rewarding. That being said, real estate as an investment can be risky, expensive, illiquid, and time consuming to purchase/sell.

Real Estate	
Most people's homes are indeed their largest investments. We all have to live somewhere, and a happy side effect is that real estate tends to appreciate in value over time. When you own your own home, it's a relatively safe investment. You pay on the home and you get a place to live. Over time, its value will likely go up and you'll pay down the amount of the loan. But you should know that there are risks that come with investing in real estate (other than your own home). If you are going to use real estate as a true investment vehicle by buying a second home, a piece of land, or a rental property, it's important to keep the following in mind. • First, despite the exceptionally strong appreciation real estate values have had the past several years, real estate can and does occasionally decline in value. • Second, real estate taxes will constantly eat into returns. • Third, real estate owners must worry about physically maintaining their properties or must pay someone else to do it. Likewise, they often must deal with tenants and collect rents. If a renter is late with a monthly payment, that doesn't excuse you from making payments to the bank on any loans you used to buy the property. • Finally, real estate is rather illiquid and takes time to sell—a potential problem if you need your money back quickly. Out of all the asset classes we have discussed, real estate investing requires the most money to get started. The potential for returns is significant, but again, the risk is also high. Real estate is the least liquid of all investments we have discussed.	<u>**RISK**</u> <u>**RETURN**</u> <u>**LIQUIDITY**</u> ♦♦♦♦ ♦♦♦♦ ♦ **VARIES BASED ON LOCAL MARKETS** Current income from rent payments received. Capital gains from selling property for more than you paid for it.