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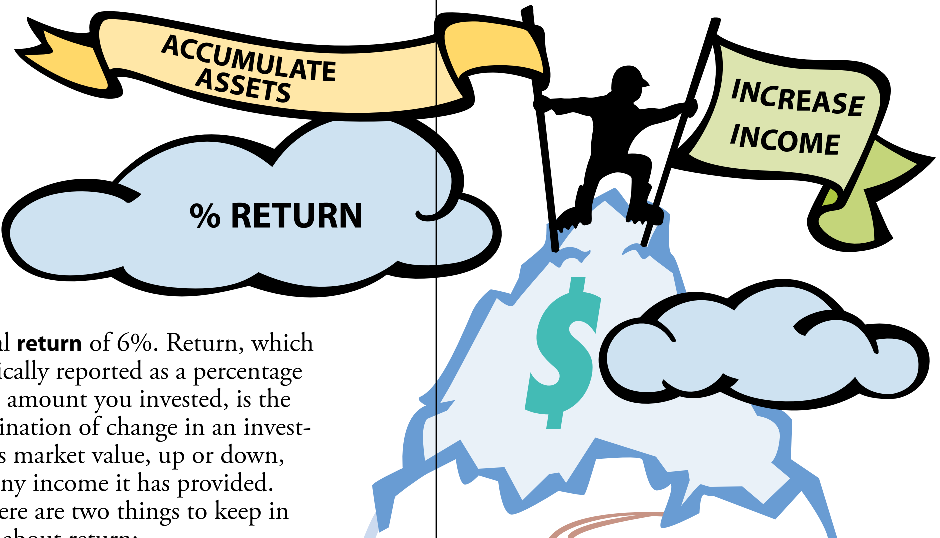
GUIDE TO UNDERSTANDING INVESTING

Investing Basics

When you invest, your dual goals are accumulating valuable assets and increasing your income.

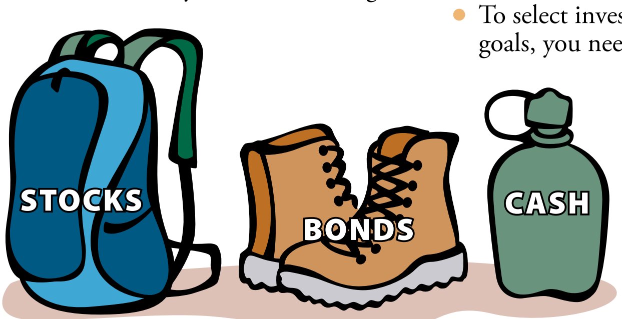


Investing means using the money you have to build a portfolio of assets that you expect to grow in value over time, provide current income, or, in some cases, provide both growth and income. Done wisely, investing can help you meet your financial goals—paying for a college education, enjoying a comfortable retirement, buying a home, or whatever is important to you.

Investing even a small amount on a regular basis has the potential to produce positive results over the long term. For example, investing just $96 a week for 30 years can add up to more than $400,000 if you have an average annual **return** of 6%. Return, which is typically reported as a percentage of the amount you invested, is the combination of change in an investment's market value, up or down, plus any income it has provided.

There are two things to keep in mind about return:

- It isn't guaranteed. While it could be 6% or higher, it could also be less, or even negative, in some years, reducing the annual average.
- To select investments to meet your goals, you need to understand what the choices are, the return that's possible with different choices, and the risks you'll take.



INVESTMENT OVERVIEW

There are three core investment categories, called **asset classes**: stocks, bonds, and cash.

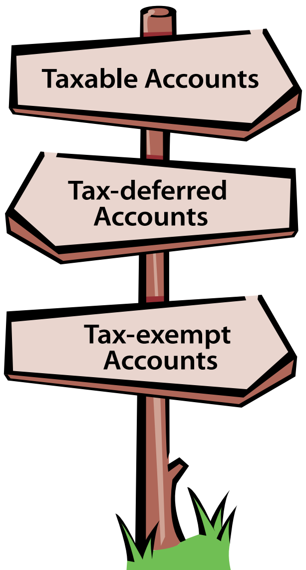
- **Stocks** are ownership shares in a corporation.
- **Bonds** are loans to a corporation or government.
- **Cash investments** include certificates of deposit (CDs) and US Treasury bills.

To invest, you typically buy and sell through a brokerage firm account. In some cases, you can buy directly from the issuer. In others, you invest through an account in a plan offered by your employer or the state where you live.

You can purchase individual investments or invest indirectly by choosing mutual funds or exchange traded funds (ETFs) that own stocks, bonds, or cash—or sometimes a combination of asset classes. The combination of assets you own makes up your **investment portfolio**.

WHAT'S THE ISSUE?

The corporations and governments that offer investments for sale are issuers. The act of offering is called issuing, and each investment is an issue.



INVESTMENT ACCOUNTS

Just as there are different types of investments, there are different types of investment accounts.

You can invest as much as you can afford in a **taxable account** each year, purchase any investments you choose, and withdraw as you wish. You pay tax on investment earnings and on capital gains from selling investments for more than you paid to buy them. Most dividends and all capital gains on investments you've owned for more than a year are taxed at a lower federal rate than your ordinary income.

You may have **tax-deferred accounts** for your retirement savings. You pay no tax on earnings in these accounts as they accumulate and, in many cases, no tax on the money that's invested. The amount you can invest is subject to an annual cap, which is adjusted from time to time to reflect inflation. When you take money out, usually after you retire, it's taxed at the same rate you pay on your ordinary income. Annual withdrawals are mandatory after you turn 70½, and there's a penalty if you withdraw before 59½.

You may choose **tax-exempt accounts** to invest for retirement, education, or healthcare expenses. You invest after-tax income in all except a healthcare account. If you follow the rules, no tax is due on the earnings as they accumulate or when you withdraw. But, there may be restrictions on how much you can invest each year and how you use the withdrawals.

WHAT'S A SECURITY?

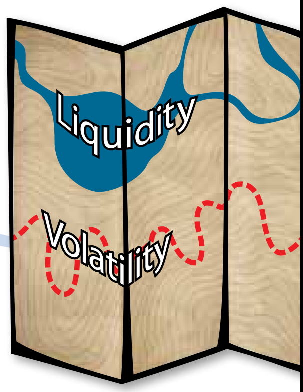
Securities, by definition, are written proofs of ownership, such as stock or bond certificates. But as electronic records have replaced certificates, the term survives as a synonym for investments.

CHOOSING INVESTMENTS

As you evaluate an investment for your portfolio, you consider it on its own merits and how it complements the investments you already own. For example, if you hold a number of stocks issued by large, well-known companies, you may decide to choose the stock of a smaller or newer company to add variety.

You'll also want to consider a number of personal factors, including your financial goals, your time frame, and your risk tolerance, as you make your selections. For example, a stock mutual fund that's appropriate for a retirement account may not be a good choice when you're trying to accumulate a down payment for a home.

The issues in this case are **liquidity** and **volatility**. The term liquidity refers to how quickly you could convert an investment to cash with little or no loss of value. Volatility is a measure of how quickly and how often an investment's price changes. You don't need liquidity in a retirement account, but you probably do in an account you're planning to withdraw from in the near future. Since volatility tends to flatten out over time, it's not a concern in retirement accounts but is if you have a short time frame.



You'll also want to look at an investment's risk/return profile. In brief, that is the level of return can you expect for the degree of risk you are taking. For example, insured bank investments pose very limited risk, but they tend to provide a smaller return than investments, such as stocks, that expose you to more risk. Conversely, taking more risk means greater potential return.

Investment Risk

There's no such thing as a totally safe investment, but you can choose the level of risk you're comfortable with.

When you invest, you always take a certain amount of risk. The most dramatic consequence is the possibility you could lose some or all of your principal. But you also have to consider the more probable risk that you won't accumulate as much as you need to reach your financial goals.

The two are interrelated. If you focus on reducing the risk of loss, you usually reduce your potential return and long-term financial security. If you can tolerate some fluctuation in your accounts' values, the most productive approach is often a middle ground. This means you include some investments with little risk to principal, a few with considerable risk, and the majority in assets that pose some risk but may also provide a strong return.

The bottom line is that you have to find a comfortable balance between too much risk and too little or adjust your goals to align with the risk you're willing to take.

ESTIMATING RISK

There's no way to predict how investments will perform in the future or the factors that may limit their return. But by looking at the way that an investment or type of investment has performed in the past, you can get a sense of the level of return it's reasonable to expect.

For example, if the annual return on large-company stocks has averaged about 10% since 1926, it's unrealistic to assume that future returns will average 15% or more, despite the fact that they have been that high or higher in some years. In other years, returns have been significantly lower and in about one-third of the years they've been negative.

KEEPING YOUR EYES CLOSED

One of the worst mistakes you can make as an investor is to ignore or minimize the risks you're taking, or to assume that nothing bad is going to happen. The only thing that's more risky is failing to invest because you're afraid you could lose money. Although you're likely to suffer some loss of portfolio value in a market downturn, in the next upturn you're positioned not only to regain lost ground but to accumulate additional savings provided you stay invested.

The Investment Pyramid

Risk is the result of **volatility**—how much and how quickly the value of an investment changes—and **uncertainty**.

HIGHER RISK

Derivative products, such as futures contracts or some options, speculative equity investments, low-rated bonds, and certain commodities generally expose you to higher than average risk most of the time. In some cases, you could lose more than your initial investment.

HIGHEST GAINS OR LOSSES
You can win big, but lose bigger, with risky investments.

MODERATE RISK

Some investments pose greater risk at some times than at others. Stocks, equity mutual funds, and ETFs, as a group, may provide strong returns in some but not all periods. Individual stocks can expose you to major gains or losses. The same is true of bonds and real estate.

LIMITED RISK

Investing in the stocks and bonds of the largest and most stable issuers and the funds that invest in them poses more limited risk of major losses, but losses can and do occur in some periods. Even some investments considered essentially free of default risk, such as Treasury issues, can expose you to market risk.

LOWER RISK

The investments that pose the least risk of loss are insured bank products and short-term government issues. However, they typically expose you over the long term to inflation risk, which can be especially severe when interest rates are low.

LOWEST GAINS OR LOSSES
$10,000 in a savings account at rates below inflation will be safe but will lose value over time.

INTRODUCTION TO INVESTING

THE SECURITY OF INSURANCE

One of the reasons people feel comfortable about putting money into bank products—like CDs, money market accounts, and regular savings—is that their investments are insured through the **Federal Deposit Insurance Corporation (FDIC)**. Even if the bank folds, the money is safe.

But, it's not that simple. If a bank is bought out by another bank—a common phenomenon as large regional banks expand—the money will be safe, but the rates you had been earning might not be. Banks that acquire others are under no obligation to pay the same CD rates, for example, that the banks they bought paid.

It's also important to understand how FDIC insurance works. Basically, it insures you per **account category** in each bank. The five categories that most people use are individual, joint, trust, retirement, and business accounts. For example, if you had an individual account and an IRA, both of them would be covered up to the limit, currently up to $250,000 per account. Accounts in separate branches of the same bank are considered the same account, but if you have an individual account in two different banks, each account is covered up to the limit.

THE RISK OF HIGH YIELDS

When the economy is down, and investment earnings decline, you might be tempted to seek an investment that produces the higher returns to which you've grown accustomed. The risk is buying lower-quality investments (which pay more to attract buyers), or investments you don't know anything about. It's a good idea to be skeptical of any investment described as risk free, except perhaps US Treasury bills, or that promises a dramatically higher yield than better-known products. Even if it's legitimate, it's likely to have strings attached.

EMPLOYER STOCK

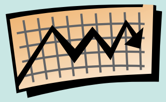
If you work for a publicly traded company, one of your retirement plan choices may be buying its stock. Or your employer may make its matching contributions in stock. There may be good reasons to choose the stock, including the fact that it gives you an opportunity to share in the success of your company.

But there are risks in tying your financial security too tightly to a single source. At worst, you could lose your job and your 401(k) could take a big hit. A useful guideline is to keep company stock to less than 10% to 20% of your account value.

OTHER KINDS OF RISK

Beyond the risks of the investments themselves—for example, a new company that fails or an established company that suffers severe losses—there are other risks you can't predict or control but must be prepared for:

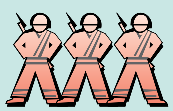
MARKET RISK depends on the state of the economy as a whole. If the stock market tumbles, your stock investment will probably decline in value even if the companies whose stock you own are making money.



CURRENCY FLUCTUATION is increasingly a factor in investment risk, as more people put money into international markets. If the dollar rises in value, for example, the value of overseas investments declines—and vice versa.

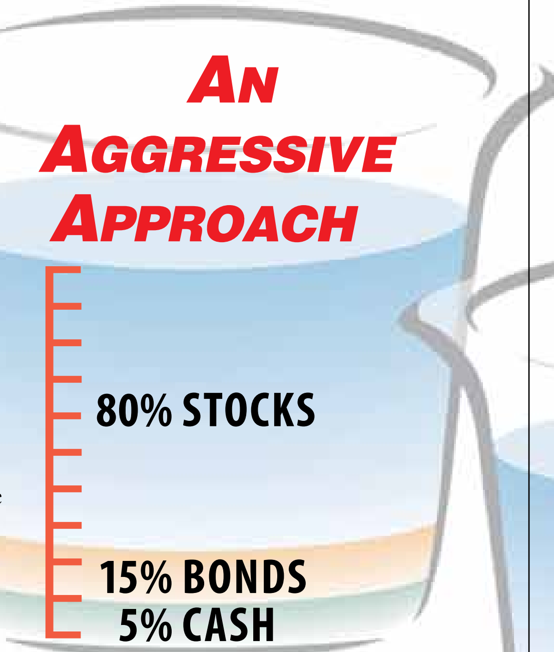
INFLATION RISK affects the value of fixed-rate investments like bonds and CDs. If you buy when interest rates are low, the value of your investments declines as inflation and interest rates rise because the old interest rate isn't adjusted to keep pace.

POLITICAL TURMOIL is a risk because the economies of different nations are closely intertwined. Threats to the oil supply, for example, have disrupted the economy before and could again.



Allocating Your Assets

Divide and conquer is often the best way to win your investment battle.



Asset allocation is a strategy for increasing investment return while helping to manage investment risk. You allocate by assigning percentages of your overall portfolio to different categories of investments known as **asset classes**. Each asset class differs from the others in some critical ways, including how the value of the underlying investments is determined and how they put your money to work.

There are several reasons why asset allocation is a crucial principle of sound investing:

- No single asset class produces the strongest return year in and year out.
- Different asset classes tend to produce their strongest returns at different times and under different conditions.
- An asset class with a strong return in one year may have a weak return in the next, or the reverse.

As a result, if you're invested in several asset classes at the same time, you can benefit from each class's strong years without being as vulnerable in their weak ones—provided, of course, that you don't move all your money into the current strong performer and sell off the weak one.

FOLLOWING A FORMULA

To make your allocation decisions easier, financial professionals have devised some standard formulas for dividing up your portfolio based on factors including your age, your investment goals, your liquidity needs, and the amount of risk you're willing to take. These models are flexible, though, and you can adapt them to your own needs.

For example, you may decide on a classic allocation model—say 60% in stocks, 30% in bonds, and 10% in cash—and stick with it. Or you may decide to be more aggressive, increasing your stock holdings to 80% early in your financial life, and then become more conservative by reducing them to 40% after you retire.

MAKING IT WORK

Thinking in percentage terms as you add money to your accounts may seem complicated, but it's really not.

A MATTER OF TASTE

Deciding on the percentages of your investment assets to allocate to stocks and stock ETFs and mutual funds, bonds and bond ETFs and mutual funds, and cash and cash equivalents isn't an easy task. There's no single asset allocation that's right for everyone. And the one that's appropriate when you're 25 probably won't be suitable when you're 50 or 75.

That's because the element of unpredictability in investing, especially investing in stocks and stock funds, isn't such a threat when you've got a long time to reach your goals. But if you're counting on your investment assets to meet an important near-term goal, you'll probably want to reduce the risk of losing your principal.

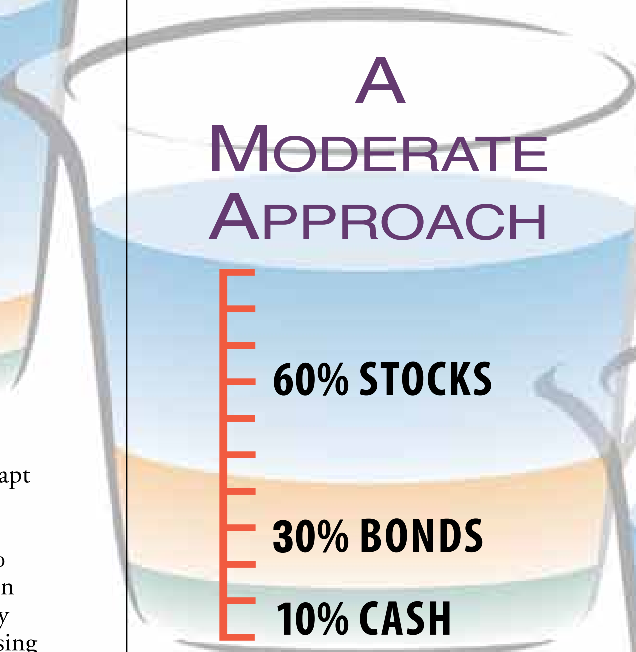
In addition to your age, you also have to consider what your goals are, what they are likely to cost, the size of your investment portfolio, and your risk tolerance in selecting an allocation. Investment experience also plays a role.

While many investors stick to stock, bonds, and cash, others investigate adding small percentages of real estate, equity options, commodity funds, and direct investments to the mix. One reason is to include non-correlated investments, or those whose prices are not influenced by the same factors that drive changes in stock and bond prices.

INTRODUCTION TO INVESTING

If you're using the moderate 60%-30%-10% approach, for example, each time you have money to invest—say $1,000—you could put $600 into a stock mutual fund, $300 into a bond fund, and $100 into a money market fund toward the purchase of your next CD or T-bill.

While your overall portfolio may never be allocated as precisely as a hypothetical model, perfection isn't what you're after. But by adding money to all three investment categories, in the approximate proportions you've decided on, you've made it easier to maintain the allocation you want.



A CYCLICAL PATTERN

Investment markets and the economy as a whole tend to move in recurring cycles that affect how different asset classes perform. For example, the prices of existing bonds tend to drop when market interest rates rise and increase when rates fall. Stocks, on the other hand, tend to gain value when rates fall and may retreat when rates rise.

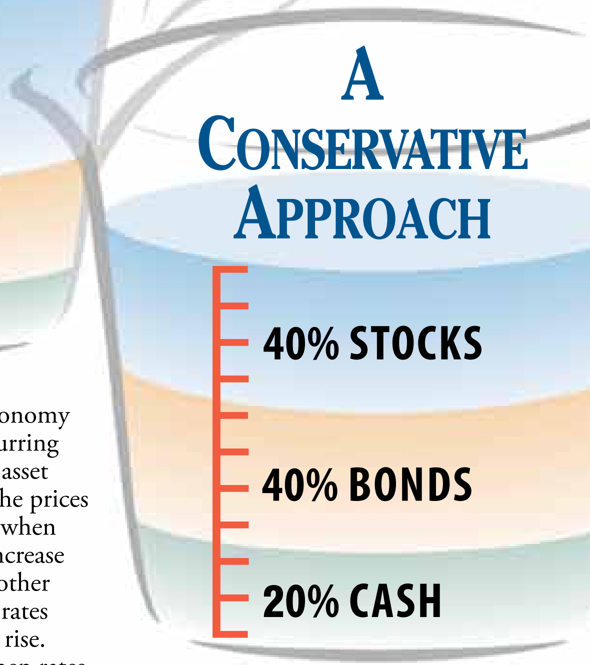
While you can't pinpoint when rates will change or the timing and intensity of any of the other factors—such as corporate earnings, unemployment rates, or political uncertainty—that affect investment performance, you can count on asset allocation to smooth, though not eliminate, the impact on your portfolio value. In contrast, if you owned only stocks when stock markets were falling, there would be nothing to cushion the blow. One word of caution, though: Asset allocation doesn't guarantee a profit or insulate you from losses in a broad market downturn.

INTO THE FUTURE

It's just as important to allocate the investments in your retirement funds as it is to direct the money you're investing on your own. That may mean putting a substantial part of your 401(k) or IRA account, for example, into stocks and some into fixed-income investments, though probably little or nothing in cash.

It also means looking at the bigger picture of your retirement and nonretirement investments together. For example, if you're putting most of your 401(k) money in stock mutual funds, you may want to balance that by putting a larger share of your nonretirement money into fixed-income investments.

Or, if you know you're eligible for a specific, fixed-income pension when you retire, you may want to invest more heavily in stocks on your own. Sorting out all the details and figuring out the best overall allocation is one of the ways working with your financial adviser may make a real difference to your bottom line.



ANTICIPATING RESULTS

It's impossible to predict investment return for any asset class in a single year, but you can calculate historical average annual return, which lets you anticipate probable long-term future return. That is essential to choosing the appropriate asset allocation. For example, large-company stocks tend to have a higher return than long-term bonds over time, despite having deeply negative returns in some years. That's why these stocks tend to command the largest allocation in many portfolios.