Personal Finance:

Understanding the Investment Instruments

Updated by:

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# Personal Finance

## Introduction

Will you have enough money to retire when you are ready to quit your job, kick back, and enjoy your life? What is considered enough? Unfortunately, many people will not be able to do so. Therefore, you need to learn how budget your income and expenses; to manage your money wisely; to invest your savings prudently; and to ensure that you have enough money for your retirement. It is never too early to plan for your retirement. Because of the compounding effect, the earlier you plan, the better off you are.

The best time to prepare for your retirement is NOW. Money do not grow on trees – you need to save your money FIRST before they can grow and multiply for you. You can get started by putting aside a few dollars a week into a piggy bank, and then deposit the accumulation into an individual retirement account (IRA) account at your local bank or any online investment companies such as TD Ameritrade or Scottrade.

This research paper describes the various types of investment options that you can pick to invest in your IRA account. You need to determine what kind of risk level you are willing to take in return for the rate of return on your investment. Generally speaking, the higher the rate of return, the higher is the risk. Do your homework – there are many valuable financial resources available on the Internet. You may visit Web sites such as CNN Money, Kiplinger, The Motley Fool, and Suzy Orman. Depending on the services offered by these Web sites, you can opt to receive weekly e-mail savings or investment tips, or listen to weekly/monthly podcast series. Some of the investment instruments that you can consider are:

* Equity stocks
* Corporate bonds
* Long-term government bonds
* U.S. Treasury bills
* Mutual funds
* Fixed deposits

In the following subsection, you will learn more about each of these instruments. Read and understand how each of these investment works, and then evaluate their pros and cons,

## Equity Stocks

The major stock market in the country is the New York Stock Exchange (NYSE), the American Stock Exchange (ASE), and the National Association of Securities Dealers Automate Quotation System (NASDAQ). The overall performance of the stock market is evaluated in various ways. For instance, the Dow Jones Industrial Average (DJIA) is a composite of 30 stocks with a daily average. If the market trends move up, it is called a bull market. On the other hand, if the market trends move down, it is called a bull market. Individual stocks and real estate are considered high-risk investments. However, traditionally, stocks had in fact offered an average rate of return between 7 to 10% annually. But that is never a guarantee. Warren Buffet has several quotes about investing in the stock market.

“Risk comes from not knowing what you’re doing.”

“I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years.”

“Only buy something that you’d be perfectly happy to hold if the market shut down for 10 years.”

Source: Quotes by Warren Buffet

## Bonds

If you want something a little less risky than stocks, you can consider buying bonds. When you buy a bond, you are lending money to the buyer. There are several types of bonds and they are listed below:

1. Corporate bonds – these bonds are sold by business corporations, and they traditionally pay a little more interest than the government bonds.
2. Long-term government bonds – these bonds are backed by the government; therefore, they are considered relatively safe.
3. Municipal bonds – these bonds are issued by the state, local, county, local hospitals, or colleges, instead of the federal government. One of the advantages of municipal bonds is that the interest payments is not subjected to federal income taxes.

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## Mutual Funds

A mutual fund is a financial investment that is managed by a team of professionals, and the investors have to pay a varying managing fee/expense. Generally speaking, a mutual fund can be described as a collection of various investment vehicles that are regulated and sold to the general public Mutual funds typically offer mid-level risks to investors, and examples of mutual funds include money mutual funds and stock mutual funds.

## U.S. Treasury Bills

U.S. Treasury bills and government securities are low-risk investments. They usually mature in a year or less. They function as a zero-coupon bonds; that means they do not pay interest prior to their maturity, but they are sold at a discount of the par value so that they can create a positive yield to maturity. Because they are guaranteed by the U.S. government, this financial instrument has very low risk.

## Fixed Deposits

A fixed deposit is a financial instrument provided by a bank and guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to $250,000 per account. Because of this guarantee, the rate of return from a FD is relatively low. Be aware that FDIC does not provide guarantee to credit unions.

What does Warren Buffet have to say about people who put their money in the bank?

“Today people who hold cash equivalents feel comfortable. They shouldn’t. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value.”

Source: Quotes by Warren Buffet

## Conclusion

How should you invest your money? There is no right or wrong answer. How you invest depends on the risk level that you are willing to accept. The choices range from the higher rate or return but more risky equity stocks to the low, but guaranteed rate of return offered by the US government. If you want to able to sleep at night, perhaps you should stick with the very conservative fixed deposits. Besides making smart investments, don’t forget to put money aside for any unexpected emergencies and establish a healthy credit rating.

## Sources

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