Understanding Investments

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Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

Investment Products are not a deposit, not FDIC insured, not insured by any federal government agency, carry no bank guarantee, and may go down in value.

Basic Investment Tools

Individuals with investable funds often have a desire to put those "extra" dollars to work to meet a specific purpose. For some, there may be a desire to accumulate funds for a future purchase, or a need to generate more income to pay current expenses. For others, it may be to put money aside for a "rainy day," or simply to "get rich." Whatever the investment goal, an investor should clearly understand both the role and the potential risks and rewards of each type of investment tool.

Stocks

The terms "stock" and "share" both refer to a fractional ownership interest in a corporation. As "owners," stockholders vote for the company's Board of Directors, and receive information on the firm's activities and business results. Stockholders may share in profits through "dividends" declared by the firm's Board.

When a corporate business is first organized, investors contribute money to fund the enterprise, and in return receive shares of stock representing their ownership in the company. If the business is successful, it will grow and have increasing profits, and the shares generally become more valuable. If the business is not successful, the value of the shares usually declines.

- **Uses:** Investors typically buy and hold stock for its long-term growth potential. Stocks with a history of regular dividends are often held for both income and growth.
- **Risks:** As the long-term growth of a company cannot be predicted, the short-term market value of the company's stock will fluctuate up and down. If the market price of the stock is higher than the purchase price when the stock is sold, a capital gain will result. If the market price of the stock is lower than the purchase price when the stock is sold, the result will be a capital loss.

Bonds

While stocks represent ownership in a business, bonds are debt. Issued by institutions such as the federal government, corporations, and state and local governments, a bond is evidence of money borrowed by the bond issuer. In return, bondholders receive interest and, at "maturity," the principal amount of the bond.

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When first issued, a bond will have a specified rate of return, or "yield." For example, a 6.0% bond will pay $60.00 per year for each $1,000 invested. If a bond is traded on a public exchange, the market price will fluctuate, generally with changes in interest rates. Later investors will receive a yield that may be more, or less, than 6.0%, depending on the price paid for the bond in the open market.

- **Uses:** Bonds are typically bought by investors seeking current income. In some instances, bonds are also used for capital growth.
- **Risks:** Like stocks, the market price of bonds will fluctuate up and down. If an investor sells a bond before it matures, a capital gain or loss may result. Unless the issuer defaults, bonds held to maturity will recover the principal amount. Since a bond pays a fixed return, inflation risk can be a problem; over time, the dollars received will buy less and less. Also, the interest income received may be subject to current income taxation.

Savings Accounts

Most investors are familiar with a savings account at a bank, savings and loan, or credit union. For many, the generic term "savings account" includes both the traditional savings account (allowing for deposits and withdrawals of small amounts), as well as fixed-term certificates of deposit (CDs), for larger sums. Savings accounts are usually prized by investors for two primary characteristics: safety of principal, and liquidity. Such accounts are insured (against a failure of the savings institution) by agencies of the Federal government, such as the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA), for up to $250,000 per account.

- **Uses:** Savings accounts are often used as a reservoir for emergency funds, or as a "warehouse" for dollars ultimately earmarked for some other purpose. Some investors also use such accounts to generate current income.
- **Risks:** Because there is little risk of principal loss, savings accounts typically have a lower yield than other investments. One "risk" to such accounts is the potential additional interest income foregone in exchange for safety of principal. The relatively low yield can also be heavily impacted by inflation and current income taxes.

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Life Insurance

The life insurance industry has developed a number of products that combine the protection of life insurance death benefits, with a significant cash value element. Policies such as universal life, indexed universal life, variable life, and variable universal life allow an individual to purchase a single financial instrument providing for both life insurance and long-term accumulation goals. Such policies may serve as a form of "forced investment" for those who find it difficult to put funds aside on a regular basis, but who routinely pay their bills. Additionally, life insurance company "annuities," either fixed annuities, variable annuities, or indexed annuities, offer a tax-deferred method of accumulating additional retirement funds.

- **Uses:** While life insurance products are primarily used for death benefit protection, they are also used for long-term accumulation goals. Available cash values may also serve as an "emergency reserve," if needed, or a source of loans, since life policies frequently include features permitting borrowing against these cash values.[1]
- **Risks:** Fixed contracts rely on the financial strength of the issuing life insurance company. Inflation may negatively impact a fixed return contract. Variable contracts share the risks of the underlying investments. Loans and withdrawals must be carefully structured to avoid negative income tax results.[1]

Real Estate

Real estate has long been a favored investment for those seeking tax benefits and a hedge against inflation. "Improved" real estate refers to land with apartments, a home, office, store, or other rentable enhancement. Rental income in excess of expenses may provide a "positive" cash flow. Additionally, depreciation may shelter a portion of the cash flow from current income tax. If all goes well, inflation will gradually increase rental income, thus raising the market value of the property.

Real estate investors may also choose to invest in "unimproved" or "raw" land. Typically such land generates no current cash flow, unless rented for agricultural purposes such as animal grazing or farming. Investors in raw land usually try to buy property in the path of expected, long-term growth, with the hope of selling the property at a gain when future demand pushes market prices up.

[1] A policy loan or withdrawal will generally reduce cash values and death benefits. If a policy lapses or is surrendered with a loan outstanding, the loan will be treated as taxable income in the current year, to the extent of gain in the policy. Policies considered to be modified endowment contracts (MECs) are subject to special rules.

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- **Uses:** Investors in improved real estate typically seek tax-sheltered, current income along with long-term capital growth. Investors in unimproved real estate primarily seek long-term capital gains. Real estate serves as a hedge against inflation.
- **Risks:** An investor may find it difficult to keep a property rented, and thus not receive the expected cash flow. Deflation may decrease both rents and property values. Expected long-term growth in a geographical area may not occur. Real estate can be very illiquid; a quick sale may require a substantial reduction in price. Changes in tax law may reduce or eliminate anticipated tax benefits.

Gold

For centuries gold has served as an enduring store of value during periods of political and social turmoil. It has also functioned to preserve purchasing power during times of high inflation. Demand for gold, for jewelry and industrial purposes, also impacts the price of gold.

There are a number of different ways for an individual to invest in gold. For example, an investor can purchase bars of gold bullion (gold refined to a high level of purity). Gold bullion coins, such as the South African Kruggerand or U.S. Eagle offer a more portable way to own the metal. Risk-oriented speculators can participate in gold markets indirectly via gold futures on commodities exchanges. More conservative individuals may choose to invest in mutual funds which specialize in the stocks of companies mining gold.

- **Uses:** Gold serves as a permanent store of value during periods of economic and political anxiety. It also acts as a hedge against inflation.
- **Risks:** The market value of gold can fluctuate widely. Selling gold when the market is down can result in a capital loss. It can be difficult to own and protect. Direct ownership provides no current income.

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Coping With Market Volatility

During periods of economic uncertainty, financial markets are often characterized by wide swings in market value. Such "market volatility," with prices sharply rising and falling, is a reflection of changeable investor sentiment as well as more substantive economic or political events. Even during more stable times, financial markets will fluctuate, although price movements tend to be more moderate. By their very nature, financial markets rise and fall constantly, with an ever-present potential for gain or loss.

So, how does an individual cope with constant market volatility?

Avoid an Emotional Response

When markets fall sharply, some investors will panic, sell all or part of their holdings, and shift assets into what are seen as "safer" investments. Such emotion-based selling after a market decline simply turns paper losses into real ones and limits any possible gains should the markets recover. Some individuals will respond emotionally and buy when the markets are "hot" and values are rising. The end result is often an investor who buys high, sells low, and then wonders, "What happened?"

"Timing" the Market

Some investors attempt to "time" the markets, buying when the market is low and then selling when the market is high. The problem is that it's never clear just when the market has reached a trough or a peak. In the classic Wall Street phrase, "No one rings a bell." Market timing is a concept that, in theory at least, seems logical. In practice, however, no one has yet devised a system for consistently and accurately identifying market tops and bottoms.

Diversify Your Portfolio - Asset Allocation

Asset allocation is an investment strategy that seeks to reduce investment risk by spreading an investor's portfolio over a number of different asset types. This approach takes advantage of the tendency of different asset types to move in different cycles, and thus smooth out the ups and downs of the entire portfolio. Stocks, bonds, and cash (or cash equivalents) are the investments normally used. Tangible assets, such as real estate or gold, may also be included.

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Coping With Market Volatility

The asset allocation process normally begins with an analysis of the historical levels of risk and return for each asset type being considered.[1] These historical values are then used as a guide to structuring a portfolio that matches the investor's individual goals and overall risk tolerance level.

Regularly Review Your Investment Strategy

An investor's portfolio allocation should reflect factors such as the investment goal, timeframe, need for liquidity, risk tolerance, and income tax bracket. As time passes, and as market and economic conditions change, it is likely that an investor's goals, and the optimal portfolio mix to reach those goals, will also change. Adjusting the asset allocation, known as "rebalancing," is a regular part of good investment management, in both up and down markets.

Take a Long-Term View

Historically, the long-term trend in equity markets has been upward, although there have been periods when the markets declined.

An investor can more easily ride out periodic economic storms by clearly understanding his or her long-term investment goals and rebalancing the portfolio accordingly. Additionally, a portion of the portfolio can be placed in safer, more liquid assets, which can then be used to meet immediate cash needs. The balance of the portfolio remains invested for the long term.

Automatic Investing

Rather than making a single, lump-sum investment, some investors feel more comfortable investing an equal dollar amount at regular intervals. Also known as "dollar cost averaging," this strategy does not guarantee a profit, nor does it protect against losses in a declining market. It does have the advantage of buying more shares when the price is low and fewer shares when the price is higher.

Seek Professional Guidance

In both bull and bear markets, the guidance of trained financial professionals is strongly advised.

[1] Historical data is only useful as a general guide. There is no guarantee that past investment performance will accurately predict future investment results..

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Modern Portfolio Theory

Everyone with money to invest faces a primary question: what do I invest the funds in? In answering this question, a number of individual factors are typically considered, such as the dollar amount of investable funds, the investment time horizon, the individual's income tax bracket, and his or her ability to tolerate risk. It goes without saying that all investing involves risk, including the possible loss of principle.

Modern Portfolio Theory

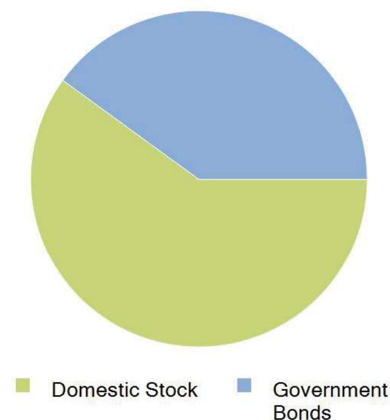
Rather than placing all of their funds in one asset type, many individuals will create an investment "portfolio," a collection of many different types of assets. Modern Portfolio Theory (MPT) is a methodology used to construct a diversified portfolio such that the overall risk of the portfolio is less than the risk of any one investment in the portfolio. There are two key concepts involved in MPT:

- **Correlation:** Rather than adding an investment to a portfolio on its individual merits, investments are selected according to how a particular asset changes in value in relation to the other investments in the portfolio.

- **Risk vs. return:** MPT recognizes that there is a relationship between risk and reward; the higher the risk undertaken, the higher the potential reward; the lower the risk, the lower the potential reward. MPT guides an investor in constructing a portfolio that either maximizes return for a given level of risk, or minimizes risk for an expected rate of return.

Correlation

Consider a hypothetical portfolio consisting of 60% domestic corporate stock and 40% government bonds. As a general rule, these two asset classes will respond differently to the same macroeconomic events.



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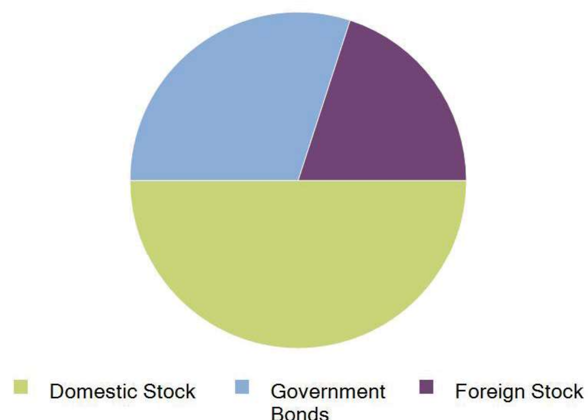
A rising stock market will frequently attract investors and decrease demand for "safe" investment such U.S. government bonds, thus driving down bond prices. On the other hand, a declining stock market frequently causes investors to seek "shelter," generally decreasing the price of stocks and increasing the price of government bonds.

Correlation is the extent to which the investment return of one investment is related to the investment return of a different investment. In the hypothetical example above, U.S. government bonds and domestic corporate stock are considered to be *negatively* correlated. Typically, when one goes up the other goes down and vice versa.

MPT argues that constructing a portfolio from assets that exhibit little correlation to each other is best. Given a long enough time frame, a worthwhile investment will generally appreciate and/or generate income. In the short run, however, the investment will usually experience ups and downs. A portfolio with a wide variety of investments, exhibiting low correlation to each other, can provide consistent portfolio growth, even in the event that a portion of the portfolio declines in value.

Taking the correlation concept one step further, MPT suggests that adding a risky asset to a portfolio can lower total portfolio risk. This risk reduction occurs when this new, "risky" asset has no correlation to the other assets in the portfolio. Continuing with our earlier theoretical example, let's add international stocks:

International stock markets have historically been more volatile (risky) than domestic, US markets. Yet the inclusion of this third class – although by itself risky – lowers the total portfolio risk. This is because each asset in the portfolio shows a low correlation of returns to the other assets in the portfolio.



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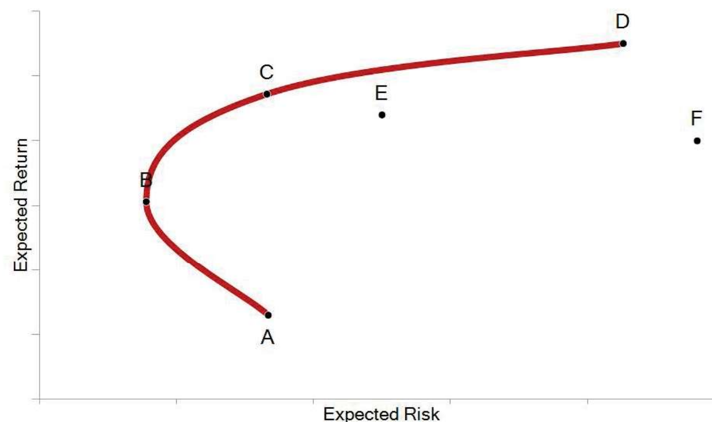
Risk vs. Return – The Efficient Frontier

MPT assumes that investors are rational and that they seek to maximize investment return with the least possible risk. Using the correlation principles of MPT, it is possible to design a portfolio that, for a given level of risk, maximizes the potential return. Such portfolios are deemed “efficient” as no further diversification will lower an individual portfolio’s overall risk. If these risk-return portfolios are plotted on a graph, such as shown below, the line A-B-C-D marks what is termed the “efficient frontier.”



Note the following:

- Portfolio A provides the lowest risk and the lowest possible return. However, Portfolio C carries the same risk, but with a higher potential return.
- Portfolio B carries the lowest risk on this particular risk-reward line, but has a higher potential reward than Portfolio A.
- Portfolio D carries both the highest level of risk and the highest potential return.
- In general, a portfolio that lies below the efficient frontier (Portfolio E) is not optimal as the expected return will be less for a given level of risk. A portfolio that is located to the right of the efficient frontier (Portfolio F) is not a good choice as there is a higher level of risk for an expected rate of return.

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Such an efficient frontier assumes that all investments included in the various portfolios carry some degree of risk. According to some, it is theoretically possible to include a “risk-free” asset, such as U.S. government bonds, that could increase the potential return *beyond* a particular efficient frontier. However, not all observers agree that a truly risk-free asset, even U.S. government bonds, actually exists.

Unsystematic vs. Systematic Risk

The diversification and correlation principles that underlie MPT can offset what is known as *unsystematic* risk, i.e. the risk inherent in holding individual stocks and bonds. An individual company or industry could experience significant problems, leading to a decline in the market value of related securities. Under MPT, diversifying the overall portfolio, with assets that are poorly correlated, should result in portfolio growth, even if a portion of the portfolio declines in value.

Systemic risk, on the other hand, affects an entire market or economy, not just individual companies or industries. War, rampant inflation, and major economic crises are examples of systemic risk. During such traumatic events, all asset classes tend to move together (usually downward) and to be much more highly correlated than they might be during “normal” times. MPT makes no claim to provide any protection against such systemic risk.

Criticism of Modern Portfolio Theory

It should be noted that not all observers agree that MPT is the perfect answer to the question of how to construct an investment portfolio. A number of the key assumptions underlying MPT (for example using historical rates of return as a measure of future risk or that the correlations between assets are unchanging) have been challenged by observers as not matching what happens in the real world. All investors should be aware of these controversies and understand the assumptions underlying any recommendations made by a portfolio manager.

Seek Professional Guidance

In constructing and managing an investment portfolio, of whatever size, the guidance of trained, experienced financial professionals is strongly recommended.

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Passive vs. Active Investing

One primary question that confronts many individuals is whether to follow a "passive" investment strategy or to be a more "active" investor. Each approach has its adherents.

Passive Investing

Passive investing is based on the concept that an individual should invest in a broad selection of stocks or other securities, rather than trying to pick single issues that will be big winners. Underlying this approach is the assumption that no one individual or group will be able to consistently make investment decisions that will provide a return greater than the market as a whole. The primary goal with passive investing is to earn a market return rather than trying to "beat" the market.

Many passive investors implement this strategy using what are known as "index funds." An index fund is a type of mutual fund, exchange-traded fund, or unit investment trust whose primary investment objective is to mimic the performance of a specific market index such as the S&P500 Index or the Russell 5000 Index. To achieve this goal, an index fund will hold all (or a representative sample) of the securities in the chosen index, in the same proportion as those securities exist in the index itself. For many investors, index funds have significant advantages:

- **Lower management costs:** Without the need to pay for expenses such as investment research and the costs of buying and selling, index funds typically have lower management costs.
- **Lower portfolio turnover:** With a passive investment strategy, there is less portfolio turnover (buying and selling) in an index fund than with an actively managed fund.
- **Risk management:** Using an index fund helps manage the risks inherent in investing by spreading the total risk over a broader, more diversified portfolio. This diversity does not, however, protect against the risk of a general market decline.

Active Investing

Active investing, in comparison, is based on the view that an investor can achieve a return greater than that provided by the overall market by actively buying and selling selected stocks or other securities. In effect, active investors are trying to outguess the market and focus on specific stocks or securities that they believe will change in value. Active investing thus offers the potential for greater rewards, at the price of greater investment risk. Other points that should be noted include:

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- **Higher expenses:** Including trading costs, research expenses, and generally higher management fees. Higher costs mean that an actively managed portfolio needs a higher overall rate of return, just to break even.
- **Income tax impact:** Frequent buying and selling can result in short and long term gains and losses, which can complicate tax planning.
- **Concentration increases risk:** By focusing on a limited number of securities or investment sectors, there is less diversification and thus greater investment risk.
- **Luck or skill?** If an active portfolio manager is successful at beating the market, can he or she achieve the same results year after year?

Which is Better?

There are many published studies on whether passive or active investing provides the greatest investment return. Depending on the time frame involved in a particular study, both approaches can be shown to have done well. Ultimately, the question of which approach is "better" often comes down to the facts of an individual's own situation. Personal needs and preferences also play a role in deciding which approach to take. For some investors, a blend of both strategies can be useful.

As a starting point, consider the following key questions:

- **Investment goals:** What do you want your money to do for you? Are you seeking current income, to pay monthly bills? Or, are you accumulating funds to meet a future goal?
- **Risk tolerance:** Investing does involve risk, including the possible loss of principal. In general, risk is related to expected return: the higher the risk, the higher the potential return; the lower the risk, the lower the potential return. Can you afford to lose a portion, or even all, of your investment, without it affecting how you live?
- **Dollar amount of investable assets:** Generally, investors with larger amounts of capital are better equipped to bear a higher level of risk. Also, the investment vehicles open to an investor can vary, depending on the amount of money available.
- **Income taxes:** Income taxes can have a significant impact on your investment results. For high-tax bracket investors, income taxes are a *very* important consideration.

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Seek Professional Guidance

The choice of whether to use a passive or active investment approach is an individual one. For many investors, the guidance of trained financial professionals can help in making this decision.

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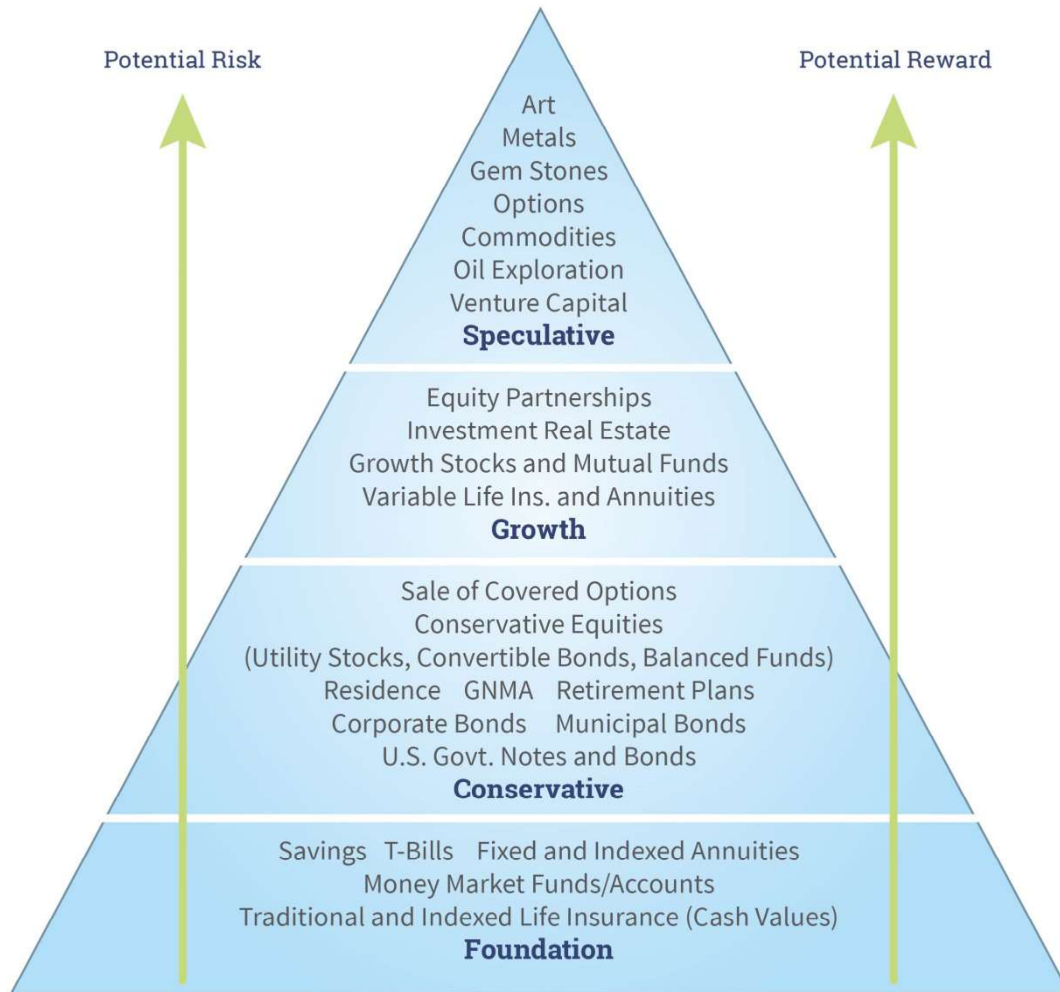
Pyramid of Investments

An investment program should be built like a pyramid - with a strong, broad base. As your potential reward increases so does the potential risk.



Note: This pyramid is intended solely to illustrate a concept; it is not a promise of investment performance. Investors may differ on the risk level to which a particular asset is assigned. Before making any investment in mutual funds, variable life insurance, or variable annuities, you should be sure to read the appropriate prospectus or offering documents for a complete discussion of the fees and risks involved.

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Types of Investment Risk

Whenever an individual takes cash and puts it to work in any form of investment, he or she does so with the anticipation of receiving a return on the money. At some future point in time, the investor expects to get back both the principal amount and something extra as well. The possibility that an investment will return less than expected is known as “investment risk.”

Risk vs. Reward

One of the general truths of the investment world is that risk and reward go hand in hand. The greater the risk an investor is willing to undertake, the greater the potential reward. If an investor is willing to assume only a small amount of risk, the potential reward is also low. In an ideal world, there would be no risk to any investment. Unfortunately, such a risk-free investment does not exist.

There is also more than one type of risk. An investor must understand each type of risk, and use that knowledge to create a portfolio of investments that balances the level of risk assumed, with the desired investment return.

Market Risk

In simple terms, market risk can be defined as the possibility that downward changes in the market price of an investment will result in a loss of principal for an investor. For many, market risk is most closely associated with the ups and downs of the stock market.

Market risk exists for other investments as well. For example, the market price of bonds and other debt investments will move up and down in response to changes in the general level of interest rates. If interest rates rise, bond prices generally fall. If interest rates decline, bond prices generally rise. Tangible assets such as real estate and gold, or collectibles such as art or stamps, also face market risk.

Over time, a number of strategies have been developed to help reduce market risk.

- Invest only dollars that are not required to meet current needs. This helps avoid having to sell an asset when the market may be down.

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- Develop a long-term approach. A longer time horizon allows an investor to ride out market ups and downs.
- Diversify your investments over a number of asset categories, such as stocks, bonds, or cash, and tangible investments such as real estate. Holding assets in different investment categories reduces the possibility that all investments will be down at the same time.

Inflation Risk

For many individuals, safety of principal is the primary goal when deciding where to place investment funds. Such investors frequently put much of their money in bank savings accounts, CDs or T-Bills. While such investments can provide protection from market risk, they do not provide much protection from inflation risk. An investor may hold the same number of dollars; over time, however, those dollars buy less and less.

For example, consider a hypothetical investor who places $10,000 in a 10-year certificate of deposit, earning 2.00% per year. The table below summarizes the effect of a 3.00% annual inflation rate on the purchasing power of these dollars.

End of Year	CD Value at End of Year[1] (2%)	Purchasing Power at 3% Inflation Rate[2]	"Real" Value of CD	"Loss" Due to Inflation
1	$10,200	97.09%	$9,903	$297
2	$10,404	94.26%	$9,807	$597
3	$10,612	91.51%	$9,712	$901
4	$10,824	88.85%	$9,617	$1,207
5	$11,041	86.26%	$9,524	$1,517
6	$11,262	83.75%	$9,431	$1,830
7	$11,487	81.31%	$9,340	$2,147
8	$11,717	78.94%	$9,249	$2,467
9	$11,951	76.64%	$9,159	$2,792
10	$12,190	74.41%	$9,070	$3,119

Values shown in this presentation are hypothetical and not a promise of future performance.

[1] Assumes a 2.0% annual after-tax return, and that interest is reinvested at the same rate of return.

[2] To calculate, divide previous year's percentage by (1+.03). Example: 1.00 / 1.03 = .9709; .9709 / 1.03 = .9426.

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Over the 10-year period, inflation reduces the purchasing power of the investor's dollars by more than 25%. The impact of income taxes, ignored in this example, would further decrease the investor's net return.

While there are ways to potentially shield your portfolio from inflation risk, most involve a higher level of market risk:

- Consider placing a portion of your assets in the stock market.
- Historically, tangible assets such as real estate or gold have tended to do well in periods of high inflation.

Other Common Risk Types

In addition to market and inflation risk, there are a number of other common types of risk that each investor must be aware of:

- **Credit risk:** This is also known as "default risk." The chance that the issuer of a bond or other debt-type instrument will not be able to carry out its contractual obligations. Keeping maturities short, diversifying investments among various companies, and investing in institutions and issues of the highest credit rating are common methods used to help control this type of risk.
- **Liquidity risk:** This risk is the possibility that an investor will not be able to sell or liquidate an asset, without losing a part of the principal, because there is an imbalance between the number of buyers and sellers, or because an asset is not traded very often. Choosing investments traded on an active market, and limiting investments to funds not needed for current expenses are approaches used to help lessen this risk.
- **Interest rate risk:** This is defined as the risk that an increase in the general level of interest rates will cause the market value of existing investments to fall. Generally, this risk applies to bonds and other debt-type instruments, which move opposite to interest rates. As interest rates rise, bond prices tend to fall, and vice versa. One approach to reducing this risk is to stagger or ladder the maturities in the portfolio so that a portion of the portfolio matures periodically, rather than all at the same time. Holding a security until maturity, at which time it is redeemable at full value, is also useful.

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- **Tax risk:** This refers to the possibility that a change in tax law, at either the federal, state or local level, will change the tax characteristics of an investment. After such a legislative change, an investment may no longer meet an individual's needs. In some cases, new legislation has included a grandfather clause allowing current investors to continue under the old rules. Making an investment because it's a good investment, rather than focusing on the tax benefits, is an excellent way to help reduce this risk.

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Mutual Funds

Individuals with excess dollars to put to work in some form of investment have an often-bewildering range of choices. An investor may decide to tackle the financial markets alone, and buy and sell investments directly, in his or her own name. A second option is to invest indirectly, using an investment medium known as a mutual fund.

What Is a Mutual Fund?

A mutual fund is an organization designed to pool the assets of many investors, to achieve a common purpose. The money raised is then invested in accordance with pre-defined goals. This mutual effort of a number of investors provides benefits that an individual, working alone, might not be able to receive.

- **Professional management:** Trained, experienced investment professionals provide the research, selection and monitoring skills needed to manage an investment portfolio.
- **Diversification:** Owning shares in a mutual fund allows an investor to participate in a diversified portfolio. Instead of placing all the eggs in one basket, diversification spreads the risk over many different securities.
- **Convenience:** Mutual funds offer many conveniences. Investment programs can be started with relatively small amounts of money. Dividends and other gains can be automatically reinvested. Many funds offer features to automate both contributions and withdrawals. Regular fund statements ease bookkeeping by tracking an investor's purchases, withdrawals and reinvestments, as well as providing tax information.

Types of Mutual Funds

Mutual funds are classified according to their structure and investment objectives:

- **Open-end mutual funds:** Mutual funds that issue as many shares as the public wishes to buy are called open-end mutual funds. When a shareholder wants to sell, open-end funds redeem all shares tendered.

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- **Closed-end mutual funds:** Closed-end mutual funds are funds that have a fixed number of shares. Unlike shares in an open-end fund, where the fund itself sells and redeems all shares, the shares in a closed-end fund are traded on public exchanges.

- **Investment objective:** Mutual funds are also classified according to the investment objective of the fund. Examples of mutual fund investment goals include:

  - **Money market funds:** These funds invest in a variety of short-term, money market debt, such as Treasury bills or commercial paper.

  - **Growth funds:** Have an emphasis on long-term capital growth, usually through investment in common stock.

  - **Income funds:** Focus on providing high, current income, using bonds and other income producing securities.

  - **Balanced funds:** Strive to provide income and long-term capital gain. Both stocks and bonds are used.

Key Mutual Fund Concepts

- **Prospectus:** The Securities and Exchange Commission (SEC) requires that every prospective investor in an open-end mutual fund be provided a document called a prospectus. The prospectus contains valuable information concerning how the fund works, the fund's goals and risks, its history, and any expenses or charges involved. The prospectus is intended to provide the facts necessary for an investor to make an informed investment decision and should be reviewed carefully. For closed-end mutual funds, a prospectus is issued only when shares are first offered to the public.

- **Net asset value:** At the end of each business day, the managers of a fund will add up the market value of all securities held by the fund. The total market value is then divided by the number of outstanding shares in the fund. The result is the Net Asset Value (NAV) per share. For open-end funds, NAV is used to calculate the price per share for both purchases and sales. For closed-end funds, NAV measures only the value of the securities in the fund; the market price of shares in the fund can be higher or lower than NAV.

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- **Load vs. no-load:** The term "load" traditionally refers to a commission paid to purchase shares in an open-end mutual fund. Funds which are no load do not charge a commission to purchase their shares. Even though a fund is no load, other fees or expenses may apply. Investors are encouraged to consult a fund's prospectus for a discussion of the fees and expenses charged by a fund.
- **Offering price:** This is the price charged to purchase shares in an open-end fund. For a load fund, it is the net asset value (NAV) plus the commission charged. For a no-load fund, offering price and NAV are the same.

Possible Risks

The risks involved in owning shares in a mutual fund are the same as those involved in directly owning the underlying securities. However, these risks are generally "spread" by the fund manager over a range of securities, to help minimize the impact of any one risk on the fund's performance as a whole.

- **Mutual funds holding stock investments.**
  - **Market risk:** The value of stock can fluctuate up and down. If stock purchased at a higher price is sold when the market is down, a loss will result.
- **Mutual funds holding bonds or other debt instruments.**
  - **Market risk:** The value of a bond will fluctuate, usually in response to changes in interest rates. If a bond is sold before it matures, the investor may receive more or less than originally paid.
  - **Default risk:** The possibility that the issuer of a bond or other debt will not pay either principal or interest.
  - **Inflation risk:** As fixed-return investments, bonds are subject to inflation risk; over time, the dollars received have less purchasing power.

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Mutual Fund Families

Mutual funds offer the investor immediate diversification into carefully selected and managed securities. An investment program can be started for a small amount of money (typically $500-$1,000), and subsequent purchases can be as small as $50. Automatic reinvestment of capital gains and dividends[1] is a convenient way to purchase additional shares.

Family of Funds

Many mutual fund families have a broad spectrum of funds to meet the needs and temperaments of various investors. A typical family of funds might include:

MONEY MARKET FUNDS[2]

- Invest in short-term money market (debt) instruments.
- Yields fluctuate daily.
- Taxation of dividends received depends on underlying investments.
- Often used as a liquid, short-term storehouse for funds.

SECTOR FUNDS

- Generally invest in stocks and bonds of companies focusing on a particular sector of the economy.
- Typical areas might include technology, health, energy, utilities, precious metals, etc.
- Income and capital gains generally taxable.
- Usually appeal to investors with a concern or interest in a particular area of the economy.

[1] Federal income tax law taxes qualifying stock dividends at marginal rates, which can be lower than those generally applicable to ordinary income. State and local income tax treatment of such dividends may differ.

[2] Money market mutual funds (MMMFs) are neither insured nor guaranteed by any government agency. There is no assurance that a MMMF will be able to maintain a fixed, net-asset value of $1.00 per share. Such funds should be clearly distinguished from money market deposit accounts (MMDAs) in banks and savings and loans. Most financial institutions offering MMDAs are protected by government deposit insurance.

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MUNICIPAL BOND FUNDS

- Invest primarily in municipal bonds, or other short-term municipal debt.
- Federally tax-free dividends.
- Dividends may also be state tax exempt.
- Dividend income may be subject to alternative minimum tax.
- Typically used by high tax-bracket investors seeking current income.

AGGRESSIVE GROWTH FUNDS

- Typically invest in stocks of companies with high potential earnings growth.
- Generally seek capital appreciation.
- Relatively high risk/reward potential; market value can be volatile.

BOND FUNDS

- Invest in bonds and debt-type instruments.
- Taxability of dividends received depends on underlying investments.
- Commonly used as source of current income.

GROWTH FUNDS

- Commonly invest in stocks of companies with relatively stable potential earnings growth.
- Generally seek capital appreciation.
- Typically follow a more conservative investment strategy than aggressive growth funds.

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INCOME FUNDS	GROWTH AND INCOME FUNDS
• Invest in bonds and other debt-type instruments such as preferred or high-yield stocks. • Usually seek maximum current income. • Taxation of dividends received depends on underlying investments. • Appeals to investors seeking a relatively high level of current income.	• Often invest in both stocks and bonds or other debt-type instruments. • Commonly seek both capital appreciation and current income. • Taxation of dividends received depends on underlying investments. • Also called balanced funds.

Possible Risks

The risks involved in owning shares in a mutual fund are the same as those involved in directly owning the underlying securities. However, these risks are generally spread by the fund manager over a range of securities, to help minimize the impact of any one risk on a fund's performance as a whole.

- **Mutual funds holding stock investments**
    - **Market risk:** The value of a stock can fluctuate up and down.
- **Mutual funds holding bonds or other debt instruments**
    - **Market risk:** The value of a bond will fluctuate, up and down, usually in response to changes in interest rates.
    - **Default risk:** The possibility that the issuer of a bond or other debt will not pay either interest or principal.
    - **Inflation risk:** As fixed-return investments, bonds are subject to inflation risk; over time, the dollars received may have less purchasing power.

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Exchange Privilege

Exchange from one fund to another may be allowed at any time for a nominal fee and no commission charge. There will be tax consequences at the time of exchange if there is a profit or a loss. Purchasing mutual funds from different mutual fund companies may result in paying additional sales loads.

Timing Services

For a fee, these organizations manage funds, typically shifting in and out of the market by switching from growth funds to money market funds through the exchange privilege.

Seek Professional Guidance

All investment decisions should be made only after consultation with a professional advisor and a complete review of the appropriate prospectuses. Investors in mutual funds are subject to a variety of risks; both investment return and market value can fluctuate. When redeemed, an investor's shares may be worth more or less than their original cost.

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Mutual Fund Share Classes – A, B, and C

Mutual funds can be divided into two broad groups, based upon the method by which they are marketed. When you pay a commission to a financial adviser or stock broker to buy mutual fund shares, that charge is called a "load" and the type of fund involved is called a "load fund." With a "no-load" fund, however, there is no commission charged to purchase fund shares. Shares in a no-load fund are purchased directly from the fund itself.

Load or No-Load?

Both load and no-load funds have their role in the marketplace and you must decide which is best for your needs:

- **No-load funds:** The advantage of a no-load fund is that you have all of your money working for you the moment you make your investment. The disadvantage is the lack of professional guidance with regard to your investment; you take direct responsibility for what to buy, when to buy or sell, or when to make changes to your portfolio.
- **Load funds:** The advantage of a load fund is that the broker or adviser can provide professional investment guidance. Your adviser monitors market conditions and can help you select the appropriate fund as well as recommend when to make other portfolio changes. The disadvantage of a load fund is that the commission or fees paid reduce your investment return.

Load Fund Share Classes

Over time the brokerage industry has developed various share "classes," to allow investors a choice as to how to pay the sales charges and service fees associated with load funds. Although the specifics vary from mutual fund to mutual fund, there are three common share classes that generally can be described as follows:

- **Class A Shares:** With the exception of very large purchases, these shares impose a "front-end" sales charge. This means that a sales charge is deducted from your

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investment each time you purchase shares. For example, if you invest $1,000 with a 4% sales charge, your commission will be $40 and you will receive shares valued at $960. These shares typically have a lower "expense ratio" (total annual operating expenses as a percentage of the fund's assets) compared with other share classes. Most companies will offer discounts for large purchases of Class A shares, termed "breakpoints."

- **Class B shares:** Instead of imposing a sales charge up-front, as with Class A shares, Class B shares levy a "back-end" or "contingent deferred sales charge" (CDSC), which is a sales charge you pay when you redeem your shares. For example, if your mutual fund has a CDSC of 3% and you redeem $1,000 worth of shares, you will receive $970 in cash. $30 is deducted for the CDSC. The percentage amount of the CDSC normally declines over time until it eventually reaches zero. The period of time over which the CDSC is phased out varies, but can range from five to eight years. Once the CDSC is eliminated, Class B shares usually convert to Class A, with the conversion occurring some time (generally one year) after the CDSC reaches zero. Class B shares typically have a higher operating expense ratio than Class A shares.
- **Class C shares:** Class C shares are similar to Class B shares in that they share the same higher operating expenses and both have a CDSC. The CDSC for Class C shares; however, is often lower than that for Class B share and frequently disappears after a relatively short period of time, generally two years or less. Unlike Class B shares, Class C shares generally do not convert to Class A shares once the CDSC is eliminated.

Factors To Consider

There are a number of factors to consider when deciding which share class to use:

- **How much you plan to invest:** If you plan to invest a large amount of money, Class A shares, with their breakpoint discounts and lower operating expenses, may be preferable to Class B or Class C shares.
- **How long you plan to hold your funds:** The length of time you plan to hold your funds is an important factor in deciding whether an up-front sales charge or a back-end sales charge would be more advantageous.
- **Class annual operating expenses:** Annual operating expenses have a direct impact on your investment return. Funds with lower operating expenses are highly desirable.

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Mutual Fund Share Classes – A, B, and C

Do Your Homework

Each fund makes available a "prospectus" which explains the investment objectives of the fund and details the expenses and fees the fund charges, as well as the potential risks involved. Investing involves risk, including the possible loss of principal. Read the prospectus carefully before investing.

Crunch The Numbers

The Financial Industry Regulatory Authority (FINRA) makes available on its website a Fund Analyzer which allows you to compare the costs of different mutual funds or share classes and estimate the impact that the various expenses and fees can have over time. This calculator automatically provides the fee and expense data for you. The calculator can be found on the internet at:

https://tools.finra.org/fund_analyzer/

Seek Professional Guidance

Your broker or other financial professional is a key source of information and guidance in selecting and managing your investment portfolio.

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Exchange-Traded Funds

For many investors, open-end mutual funds serve as a vital component of their investment tool kit. But these funds have a limitation in that they can only be bought from or sold to the issuing mutual fund at the net asset value (NAV) calculated at the end of the trading day. In comparison, shares in exchange-traded funds (ETFs), may be bought and sold through brokerage firms at the current market price, any time the exchange is open.

How Are Exchange-Traded Funds Structured?

In a traditional, open-end mutual fund, individual investors buy shares in the fund directly from the mutual fund itself. The money is then put to work according to the fund's investment goals. When an investor sells his or her shares, the mutual fund itself redeems those shares. If many shareholders redeem their shares at the same time, the fund may need to sell a portion of its portfolio to raise the cash needed to repay departing investors.

An ETF, however, does not deal directly with individual investors. Rather, "creation units", typically representing 50,000 shares, are "sold" to institutional investors like brokerage firms, in exchange for a portfolio of securities that match the ETF's investment goals. The institutional investor, in turn, can then sell the ETF shares to individual investors on the open market. If an individual wishes to sell shares, he or she can do so by selling to other individual investors on the open market. An institutional investor can "sell" a creation unit's worth of ETF shares back to the fund. To complete the redemption, the fund does not have to sell anything; it simply distributes the underlying securities to the institutional investor and then "destroys" the creation unit.

Types of Exchange-Traded Funds

There are several broad types of ETFs:

- **Index ETFs:** Index ETFs are structured to track an underlying index, to achieve investment returns that mirror, as much as possible, the return (up or down) of the chosen index. An Index ETF may seek to follow broad market averages (for example, the S&P 500), industry sectors, (such as healthcare or technology), or follow the

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securities of specific foreign countries or parts of the world economy. Index ETFs may also follow commodities such as oil and gas, precious metals such as gold or silver, currencies, or track debt instrument such as U.S. Treasury or corporate bonds.

- **Actively-Managed ETFs:** While Index ETFs use a passive strategy, Actively-Managed ETFs use an active, hands-on investment strategy to achieve a specific investment objective. Actively-managed ETFs generally strive to “beat the market” by frequently buying and selling parts of the portfolio as market conditions change. Like Index ETFs, Actively-Managed ETFs may follow stock indices, industry sectors, commodities, or debt instruments.

- **Leveraged and Inverse ETFs:** These types of ETFs typically seek to deliver a return that is a “multiple” (2x or 3x) of an index or benchmark. For example, a Leveraged ETF (a “Bull” fund) looks for a particular index or benchmark to rise and seeks to achieve a return that is a multiple of the change in the underlying index. Leveraged ETFs gain when the index rises and lose when the index falls. An Inverse ETF (a “Bear” fund) looks for a particular index to fall and seeks to deliver the opposite, -2x or -3x, of the change in the underlying index. An Inverse ETF gains when the index falls and loses when the index rises.

  Such ETFs typically hold large amounts of cash (leverage) and are characterized by their use of esoteric financial instruments. Leveraged and Inverse ETFs measure their results on a daily basis; their performance over time may vary significantly from that of the underlying index.

Advantages of Exchange-Traded Funds

- **Generally lower operating costs:** Because they do not have to deal with a large number of individual investors, many ETFs have very low annual expense ratios. In a mutual fund, the need to provide shareholder services is an additional expense.

- **Tax efficiency:** The underlying structure of an ETF, using “creation units,” is regarded as being very tax efficient. The low turnover, buy-and-hold approach of many Index ETFs adds to this tax efficiency. Individual investors will generally realize a gain or loss only when they sell their own ETF shares.

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- **Trading flexibility:** Because ETF shares are bought and sold on the open market, an investor can use trading tools such as limit or stop-loss orders, “sell short” the ETF shares, or even trade the shares on margin, using borrowed money.
- **No required minimum purchases:** No minimum purchase requirements are needed to buy shares in an ETF. Many mutual funds have minimum purchase requirements.

Disadvantages of Exchange-Traded Funds

- **Commission charges:** To buy or sell shares in many ETFs, the individual investor must pay a commission. Some financial services firms make available commission-free ETFs and allow commission-free ETF trades; certain restrictions or limitations may apply.
- **Client services:** Most mutual funds provide client services such as automatic dividend reinvestment or keeping track of average cost basis for tax purposes. For investors in ETFs, these services may be available from the broker, sometimes for an extra fee.

Exchange-Traded Funds vs. Mutual Funds

ETFs are frequently seen as a competing alternative to mutual funds. ETFs can provide trading flexibility, but often at the cost of paying commission charges. ETFs also typically have lower operating expense ratios and are usually more tax efficient than mutual funds. Mutual funds provide many investor services but have a more limited ability to be bought or sold.

One way to approach this question is to compare the total cost of owning an ETF with the total cost of owning a mutual fund. The Financial Industry Regulatory Authority (FINRA) makes available on its website a mutual fund and ETF analyzer which allows you to compare the different funds or share classes and estimate the impact that the various expense and fees can have over time. This calculator automatically provides the fee and expense data for you. The calculator can be found on the internet at:

https://tools.finra.org/fund_analyzer/

Seek Professional Guidance

The guidance of trained professionals can be helpful both in selecting the right investment and in monitoring the investment for any needed changes.

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