An Introduction to Stocks and Bonds

Stocks and bonds are two of the most common types of investments. Like other investment or savings tools, they have different levels of risk and potential rates of return.

Stocks

Stocks basically represent ownership in a corporation. As you buy more stocks, you are buying more shares (units of ownership) in that company. It also gives you equity (ownership) in that specific company. The value of your investment depends on the value of the company. It can increase, or it can decrease. Stocks appreciate (increase in value) as the company earns more profits and has expectations for future growth. Stocks depreciate (decrease in value) when the opposite happens—the company starts losing money and has less potential for future growth. In the most extreme cases, the company could go bankrupt and, depending upon the situation, your stock may be worthless. However, you cannot be held responsible for the debt the corporation owes. With stocks, you have limited liability which means you only lose the money you invested.

Your rate of return on stocks varies considerably. If you pay a low price for stocks and sell them at higher prices, you earn the difference. In addition, some stocks pay dividends (a share of the profits), which are quarterly payments made to the stockholders. Fluctuations or changes in the value of a stock depend on many different factors, including the overall economy, the management of the company, expectations about the future, and even how people feel about the company.

One way to reduce risk with stocks is buying "blue chip" stocks, which are stocks in large, financially secure corporations. They tend to be less volatile (rapid, wide swings in stock values and prices) and weather financial storms better than other stocks, giving them the potential for long, stable years of growth. Examples of "blue chip" stocks include Coca-Cola, Disney, PepsiCo, Walmart, General Electric, IBM, and McDonald's.

At the same time, penny stocks (stocks valued at less than one dollar a share and therefore highly speculative) or stocks in new, emerging companies can be more volatile or unpredictable. Their cheap prices, however, can provide greater returns if the value increases significantly, or greater potential of losing everything you invested. Thus, low prices can lead to higher rates of return if you are willing to tolerate the risk of losing your investment.

Even considering the risk, stocks can still be an excellent investment strategy. The annual return on stocks has historically averaged around ten percent. While you may not earn that rate of return every year, the low years will be offset by the higher years when you invest for the long-term.

Bonds

Bonds are different. They are similar to making a loan. When you purchase a bond, you are lending money to the corporation, government, agency, or other institution that issued the bond. In return you receive interest payments on the bond. These payments are based on the original value (called the face value) of the bond and the interest rate (called the coupon rate) that existed when the bond was issued. Because bonds can be traded in secondary markets after they are issued, the price of bonds (and the yield they earn) can differ from the face value (and the coupon rate).

Most bonds have a maturity date, which is the date the money you loaned the company must be paid back to you. While shares of stock may last indefinitely, bonds generally mature in one to 40 years. The type of bond can impact the length of maturity. For example, government bonds tend to mature in 10, 20, and 30-year increments—but corporate bonds may mature in 1 to 40 years.

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Bond prices, like stock prices, are generally determined by the supply of and the demand for them. In addition, bonds have ratings that influence the price people are willing to pay for them. These rating provide information about the financial well-being of the organization issuing the bonds. Ratings go from AAA (highest) to C or D (lowest.) Because AAA bonds are considered the most "safe" bond investment, their prices tend to be higher than bonds rated C or D, which have the greatest risk. However, their rate of return tends to be lower than the potential rate of return for C or D bonds. Therefore, the prices for those C and D bonds must be lower to provide an incentive (a benefit/reward that influences choices or motivates you to take an action) for people to buy them.

One other factor also influences bond prices: date of maturity. Bonds with shorter maturity dates tend to have higher prices than bonds with longer maturity dates. Why? Because it is more difficult to predict what will happen in 30 years than in one year. As a result, people are often more willing to invest for short periods of time than for longer periods of time. That means, the rate of return must be higher and the bond prices lower to provide the incentive for people to invest for the long-term.

Bonds have some of the same risks as stocks. What looks good today can change if the overall economy changes. Companies can still go bankrupt and you can lose the money you invested. However, stocks and bonds provide a good balance for long-term investing. They also tend to have a much greater rate of return over many years than a traditional savings account.

Selling Stocks and Bonds

Selling stocks and bonds is accomplished through specialized markets. However, those markets are rather different. Stocks are bought and sold in centralized stock exchanges such as the NASDAQ or the New York Stock Exchange (NYSE) while bonds tend to be bought and sold "over the counter" (OTC), meaning you can buy or sell them from various dealers or even directly from the issuer.

Stocks and bonds are part of a broad category of investments called securities. In the United States, the buying and selling of securities is regulated by the Securities and Exchange Commission (SEC). The overall mission of the SEC is to protect investors and maintain a fair, efficient, orderly market for buying and selling securities.

Summary Questions

Investing stocks and bonds is much like anything else. You can minimize the risk if you understand the basic principles, ask lots of questions before investing, do your research before investing, and appreciate the concept that taking some risk can increase your potential rewards.

a. List two differences between stocks and bonds.

b. Give one reason that you might want to buy a stock.

c. Give one reason that you might want to buy a bond.

d. What determines the prices for stocks and bonds?

e. What is a "blue chip" stock?

f. What is the purpose of the SEC?

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