Wealth Accumulation

Investment (Part 1)

Wealth Accumulation: Investment

1. Life is good with investment
2. Investment
3. Individual Investment life cycle
4. Types of investors
5. Analyzing Risk Tolerance

1. Life is good with investment

1.1 Why do u invest?
1.2 Saving VS Investment
1.3 Return and Risk
1.4 What is Asset Allocation?

1.1) Why do u invest?

Table 2-3 Performance of Various Assets as Store of Value (Average Annual Real or Inflation-Adjusted Rates of Return)

Period	Money*	Gold	Treasury Bills	U.S. Government Bonds	AAA Corporate Bonds	Common Stocks
1926–1976	−2.4%	1.5%	0.0%	0.8%	1.5%	6.6%
1976–2003	−4.5	−0.7	2.1	3.8	4.6	7.8
1926–2003	−3.0	0.9	0.7	1.7	2.5	7.0

-To get the return to cover inflation rate to maintain or increase purchasing power over time.

Time Value of Money

- A dollar now is worth more than a dollar in the future, even after adjusting for inflation, because a dollar now can earn interest or other appreciation until the time the dollar in the future would be received.

Time Value of Money Example

Age	Smart Sam	Amount Deposited	Wild Willie	Amount Deposited	Dedicated Dave	Amount Deposited
19	$2,000.00	$2,000.00			$2,000.00	$2,000.00
20	$4,200.00	$2,000.00			$4,200.00	$2,000.00
21	$6,620.00	$2,000.00			$6,620.00	$2,000.00
22	$9,282.00	$2,000.00			$9,282.00	$2,000.00
23	$12,210.20	$2,000.00			$12,210.20	$2,000.00
24	$15,431.22	$2,000.00			$15,431.22	$2,000.00
25	$18,974.34	$2,000.00			$18,974.34	$2,000.00
26	$22,871.78	$2,000.00			$22,871.78	$2,000.00
27	$27,158.95	$2,000.00			$27,158.95	$2,000.00
28	$31,874.85	$2,000.00			$31,874.85	$2,000.00
29	$35,062.33		$2,000.00	$2,000.00	$37,062.33	$2,000.00
30	$38,568.57		$4,200.00	$2,000.00	$42,768.57	$2,000.00
31	$42,425.42		$6,620.00	$2,000.00	$49,045.42	$2,000.00

Time Value of Money Example (continued)

Age	Smart Sam	Amount Deposited	Wild Willie	Amount Deposited	Dedicated Dave	Amount Deposited
60	$672,998.45		$402,275.53	$2,000.00	$1,075,273.98	$2,000.00
61	$740,298.29		$444,503.09	$2,000.00	$1,184,801.38	$2,000.00
62	$814,328.12		$490,953.40	$2,000.00	$1,305,281.52	$2,000.00
63	$895,760.94		$542,048.74	$2,000.00	$1,437,809.67	$2,000.00
64	$985,337.03		$598,253.61	$2,000.00	$1,583,590.64	$2,000.00
65	$1,083,870.73		$660,078.97	$2,000.00	$1,743,949.71	$2,000.00
66	$1,192,257.81		$728,086.87	$2,000.00	$1,920,344.68	$2,000.00
67	$1,311,483.59		$802,895.56	$2,000.00	$2,114,379.14	$2,000.00
68	$1,442,631.95		$885,185.11	$2,000.00	$2,327,817.06	$2,000.00
69	$1,586,895.14		$975,703.62	$2,000.00	$2,562,598.76	$2,000.00
70	**$1,745,584.65**		**$1,075,273.98**	$2,000.00	**$2,820,858.64**	$2,000.00
Amount Invested at 10%		**$20,000.00**		**$84,000.00**		**$104,000.00**

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1.2) Savings vs. Investments

Who is rich? He that is content. Who is that? Nobody."
~ Benjamin Franklin

- How much money should you have in savings vs. investments?
- What is the difference?

"Savings is not to make you rich, but it is to keep you from being poor." ~ J.B. Quinn

- Savings – No or low-risk investments with low returns.

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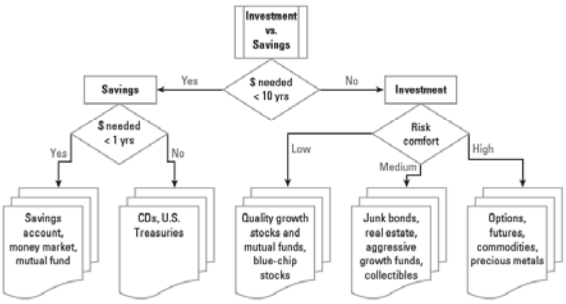
Should You Save or Invest?
Figure 11.1



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Impact of Inflation on Savings

- Inflation is the overall increase in the price of goods and services over time
- Savings – retain your purchasing power by having your interest rate remain the same or higher than the inflation rate
- Investing – beat the inflation rate and grow your value in real terms
- Bureau of Labor Statistics Consumer Price Index page
- Consumer Price Index from 1913 – present

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1.3) Risk and Return

- Investing has risk – the chance of losing some or all of your investment
- To compensate for risk and entice an investor, investments with risk must pay a premium
- Risk premium – compensation for taking on the risk
- "Zero" risk – FDIC, NCUA, U.S. Treasury bills, notes, and bonds – risk-free rate

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Types of Risk

- **Liquidity Risk** – The risk that you will not be able to cash out your investment quickly enough to either meet cash flow needs or to prevent a loss.

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Types of Risk

- **Default Risk or Credit Risk** – Risk that the company invested in may declare bankruptcy
  - 2009 Chrysler bankruptcy: bondholders received $0.26 for every dollar they invested
  - Bondholders could lose their entire investment
  - FDIC and NCUA will insure deposits up to $250,000 until December 31, 2013, when the cap will revert back to $100,000

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Types of Risk

- **Interest Rate Risk** – Risk taken on when you lock into a fixed-rate investment for a specific length of time
  - Negative relationship between interest rate and bond price.

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Types of Risk

- **Market Risk** – The risk that the value of your investment will decrease due to changes in the market
  - Gold prices
  - Housing market
  - Oil prices

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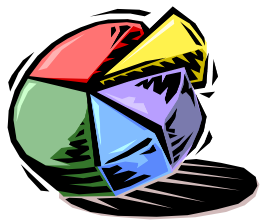
1.4) What is Asset allocation?

- The process of deciding how to distribute wealth among *asset classes, sectors, and countries for investment* purposes.
- Not an isolated choice, but rather a component of the portfolio management process.



Managing Risk

Since risk drives expected return, *investing involves managing risk* rather than managing return.

Diversification of Assets

- **Diversification** – Spreading out the risk across multiple investments
  - ➢Why is diversifying your investments important?
    - **Reduce risk without sacrificing the returns**
- **Portfolio** – Holding more than one investment
- **Asset Allocation** – Percentage of funds investing in different types of assets
- Diversified Balanced Funds – Both equities and bonds

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2. Investment

2.1 Types of Investment

1. Consumer investing e.g. Property, jewelry, collectible antiques, coins.

2. Financial investing e.g. money market instruments, debt instruments, equity instruments and derivative instruments.

→ Example from chapter 3: Money market and capital market instrument instruments

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3. Individual Investor Life Cycle

The individual investors life cycle can often be described using four separate phases or stages:

- Accumulation Phase
- Consolidation Phase
- Spending Phase
- Gifting Phase

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1) Accumulation Phase

- Early to middle years of careers
- Attempting to satisfy intermediate and long-term goals
- Net worth is usually small, debt may be heavy
- Long-term investment horizon means usually willing to take *moderately high risks* in order to make above-average returns

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2) Consolidation Phase

- Past career midpoint
- Have paid off much of their accumulated debt
- Earnings now exceed living expenses, so the balance can be invested
- Time horizon is still long-term, so *moderately high risk investments are still attractive*

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3) Spending Phase

- Usually begins at retirement
- Saving before, prudent spending now
- Living expenses covered by Social Security and retirement plans
- Changing emphasis toward *preservation of capital*, but still want investment values to keep pace with inflation

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4) Gifting Phase

- Can be concurrent with spending phase
- If resources allow, individuals can now *use excess assets to provide gifts* to other individuals or organizations
- Estate planning becomes important, especially tax considerations

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4. Types of investors

- Passive investor : investors will invest with the intention of long term appreciation, they belief that in long term the investment will be profitable, they will follow the benchmark return thus the transaction cost will be lower.
- Active investor : investors invest and continuously monitor their activity in order to exploit profit by looking at the price movements many times a day and they will try to beat the benchmark return. Typically, they are seeking short term profits, thus the transaction cost will be higher

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5. Analyzing Risk Tolerance

- How much can you afford to lose?
- Rule of thumb: The higher the risk, the higher the potential return and the less likely you are to achieve the higher return
- Risk tolerance quizzes
  - Rutgers University's Investment Risk Tolerance Quiz
  - money.msn.com

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