WHAT IS AN ASSET?
An asset is something of economic value that can be turned into cash.

HOW ARE ASSETS CLASSIFIED?
Financial professionals classify assets in five groups.
1. Cash
2. Stocks – also called Equities
3. Bonds – also called Fixed Income Securities
4. Real Estate Investment Trusts (REITs)
5. Commodities

#1 CASH
Cash is essential to keep on hand for day-to-day needs and to cover emergencies.

Individuals should have
- one to two months of monthly expenditures in cash in a checking account.
- three to nine months of monthly expenditures in cash in a savings account as an emergency fund. Those with less stable employment, who are retired, or are entrepreneurs with fluctuating income, need to veer towards nine months of emergency funds; than those with steady, reliable employment can have less.

To determine the proper amount of cash to keep on hand, an individual needs a Cash Flow Statement (aka budget) – see handout 3.00 and 3.01**.**

CAN A PERSON HAVE TOO MUCH CASH?
Yes. if a person has excess cash, it means that the funds are probably not earning as much as they could be if they were invested in stocks and bonds. While cash can earn interest, it is rarely enough to keep up with inflation.

WHAT ARE THE DIFFERENT WAYS THAT CASH IS HELD?
Cash can be kept in a variety of forms. Typical are:

- Checking Account
- Savings Account
- Money Market Accounts
- Certificate of Deposits.

All cash accounts are not the same. A checking, savings or money market account allows immediate access to a depositor's money. Whereas a Certificates of Deposit, require a depositor to tie up their money for some time (3 months, 6 months, 1 year 5 years etc.). In most cases, the Certificate of Deposit can be broken, but there is a penalty if it is prematurely cancelled.

SHOULD CASH BE KEPT IN AN FDIC INSURED BANK?

Yes, cash which is used for routine expenses and for an emergency fund should be kept in an institution that offers FDIC insurance. FDIC insurance stands for the Federal Deposit Insurance Corporation. If a bank is FDIC insured it means that if the bank fails, the federal government will be responsible for reimbursing the depositor up to the FDIC limit.

As of 2020, the FDIC insurance is limited to to $250,000 per depositor but only if the institution is an FDIC insured entity. Deposits held in different ownership categories are separately insured, up to at least **$250,000**, even if held at the same bank. Thus, if a couple had a joint account, the account would be covered up to $500,000.

#2 – STOCKS = EQUITIES

WHAT IS A STOCK (aka Equities)?

A **stock** (also known as equity) represents fractional ownership of a corporation.
Units of **stock** are called "shares." By owning shares in a company, the Investor owns a portion of the corporation's net worth (assets less liabilities).

WHAT RIGHTS DOES A STOCKHOLDER HAVE?

A Stockholder (also called a Shareholder) of Public Companies has the right to:

1. Vote to elect the company's Board of Directors. The Board of Directors is responsible for hiring company management and setting the direction of the company.
2. Receive a share of the profits provided that the profits are distributed to the Shareholders. Payments to stockholders are called "dividends." However, not all companies pay dividends. In some companies, the management decides to reinvest the profits in the business, and no dividend is paid.
3. Sell their shares and participate in any change in the company value. (Gain or loss). It is easy to sell shares of a public company, but often harder or impossible to sell a minority interest in a private company.

HOW ARE STOCKS CLASSIFIED?

Stocks are typically classified by four characteristics – domicile, size, outlook and industry.

Domicile: classified as US (Domestic) vs. Ex-US (International) There are:

- 4,000 US public companies
- 43,000 Ex-US public companies

  Of the EX-US companies – approximately 7,000 are in “Emerging Market” countries. An Emerging market country is one undergoing rapid industrialization. The ten largest Emerging Markets (BEM) economies are (alphabetically ordered): **Argentina, Brazil, China, India, Indonesia, Mexico, Poland, South Africa, South Korea, and Turkey**. Egypt, Iran, Nigeria, Pakistan, Russia, Saudi Arabia, Taiwan, and Thailand would also be considered an Emerging Market country.

Size: Public Companies are classified as micro, small, mid, large, or mega

Another word for the size of a company is "capitalization." Capitalization is calculated by taking the current share price and multiplying it by the number of outstanding shares. Often the financial world talks about “small cap” or “large cap” stocks, they are referring to smaller or larger firms.

- Mega Cap - when the share price times outstanding shares = $200 billion.
- Large Cap- when the share price times outstanding shares = $10-200 billion.
- Mid Cap - when the share price times outstanding shares = $ 2-10 billion.
- Small- when the share price times outstanding shares = $ 30 million – $2 billion.
- Micro - when the share price times outstanding shares = $50-300 million

Outlook: Growth vs. Value

The financial industry distinguishes between companies based on their growth pattern, calling them either Growth or Value – if they have blended characteristics they are called Blend.

- Growth Companies generate positive cash flows or earnings faster than the overall economy. Growth companies typically reinvest their earnings into the company instead of paying out dividends to continue spurring growth. Examples of Growth companies are also those rapidly investing and changing – such as Amazon, Netflix, Apple, Google, Tesla, Meta,
- Value stocks are publicly traded companies trading for relatively low valuations relative to their earnings and long-term growth potential. They are more likely to pay dividends. Examples of Value stocks are companies called "the old guard," such as General Motors, Berkshire Hathaway, Johnson & Johnson, and Exxon Mobile. Value stocks tend to pay consistent dividends.

A fun way to look at it is as the Tortoise and the Hare. The Hare is the Growth Company, and the Tortoise is the Value Company.

Sector: Segregated by the Industry that they serve. There are 11 industry categories. Examples are Healthcare, Utilities, Energy, Technology, Basic Materials, and Financial Services.

WHAT ARE THE BENEFITS TO OWNING STOCKS?

Stockholders can benefit in two ways

- Dividend Distributions – which is a return of profits, provided the company makes a profit and elects to give its shareholders a distribution
- Increase in Market Value – in the event the public believes the company is worth more than its original issuance value, they will buy the shares at a higher value. Thus, if an individual owns shares, they call sell their stock for more than they paid for it. This is called “Capital Appreciation”

When the financial industry talks about increase in value, they count both the dividend distributions made and the increase in market value.

#3 REAL ESTATE INVESTMENT TRUST (REIT)

WHAT IS A REAL ESTATE INVESTMENT TRUST? (REIT)

A **REIT** is a corporation, trust, or association that invests directly in income-producing real estate and is traded like a stock.

REITs can own a variety of different types of properties – including shopping centers, strip malls, and restaurants leased to chains. They can even own single-family houses, which they rent out to tenants.

HOW ARE REIT'S CLASSIFIED?

REITs are commonly subdivided by DOMICILE – thus, there are US-based REITS and International based REITs.

WHAT ARE THE BENEFITS TO OWNING A REIT?

Owning a REIT is an excellent way to get involved in the real estate market without the hassle of becoming a landlord and dealing directly with tenants. It also allows an invetor to diversify their risk by owning many properties which have different economic exposures. For example, properties might be in different geographic areas, or have different types of clienteles.

REITs hire professional managers to handle all aspects of taking care of the property, finding tenants, collecting rent, and making capital improvements. Shareholders receive their share of the net rent.

If you own shares in a REIT, it is almost always easier to sell them and turn them into cash compared to owning property directly.

#4 BONDS (Fixed Income Security)

WHAT IS A BOND?

A **bond** is like an IOU. An investor lends an entity money, and the entity issues a Bond indicating that it will pay back the money on a specific date.

WHAT IS THE BENEFIT OF BEING A BOND HOLDER?

The Investor receives interest from the time they lend the money until they get it back.

Additionally, the investor had the ability to sell the bond to a third party. In that case the price of the bond may be more or less than what the investor paid for it, and the change in price is directly related to how interest rates have changed?

WHO ISSUES BONDS?

Most bonds are issued by the government (federal or municipal and sometimes local governments), but a bond can also be issued by a corporation.

WHAT ARE THE KEY CHARACTERISTICS OF A BOND?

When a bond is "issued," the issuing entity sets the term (length) and the interest rate they will pay during the loan period. Interest can be paid quarterly, semi-annually or annually, but quarterly is the most common.

Interest is generally taxable income, but some bonds are tax-exempt from federal, state or municipal taxes or a combination.

The "face value" of the bond refers to the total amount borrowed. At the end of the term, the "face value" must be repaid to the borrower.

Bonds are commonly subdivided based on

- Issuing Entity: Treasury, Municipal, Corporate
- Length: Short (under 3 years), Mid (3-7 years), Long Term (over 7years)
- Tax Status: Taxable. Vs. Tax-Exempt
- Interest Rate: Market Rate vs. Linked to Inflation

When a bond is sold to an investor, it can be held for its duration, at which point the issuing entity will repay the original amount borrowed. Alternatively, investors can re-sell the bond to a new investor. However, when a bond is resold, the rate that someone will pay for it is often adjusted up or down, based on the then current interest rate.

The slogan “When interest rates rise Bond prices fall, and when interest rates fall Bond prices rise.” Is worth bearing in mind and understanding.

#5 COMMODITIES

WHAT IS A COMMODITY?

A C**ommodity** is a tangible good that can be bought and sold or exchanged for products of similar value.

C**ommodities** have value and can be traded on open markets. **Commodities** can fluctuate in price according to supply and demand. Examples of Commodities would be:

- Precious Metals: Gold, Silver,
- Grains: Wheat, Corn.
- Currencies, including foreign currencies or Virtual currencies (and crypto)

Some investors believe in owning commodities, especially gold. They believe that gold will "hold its value" in turbulent times.

While it is true that gold rises in value whenever there is a worldwide economic crisis, if you look at charts showing the return on gold over the long haul, it is not as profitable as stocks or bonds.

WHAT IS A BENEFIT TO OWNING A COMMODITY?

Commodities do not pay dividends, such as equities, nor do they pay interest such as bonds, but they do change in value based on economic conditions. Individuals who own commodities are hoping that they can sell them for more than they paid for them and thus have “capital appreciation”

WHY DO MOST PEOPLE TALK ABOUT STOCKS AND BONDS AND IGNORE THE OTHER ASSETS?

While the above identifies five categories of the financial community, most investors simplify and talk only about two classes: Stocks and Bonds, because

- Cash is not considered an investment.
- REITs being companies with a specific focus, are counted as a stock/equity.
- Commodities are rarely a significant part of an Investor’s holdings (less than 2% if at all)

HOW DOES AN INVESTOR CHOSE AMONG THESE ASSET CLASSES?

An investor must first make sure that they have enough cash on hand to cover their day-to-day needs and have an emergency fund. Once adequate cash has been set aside, they can consider the other asset classes.

In general, investing in stocks will produce the highest return over the long term, but it will be very volatile, meaning values go up and down steeply.

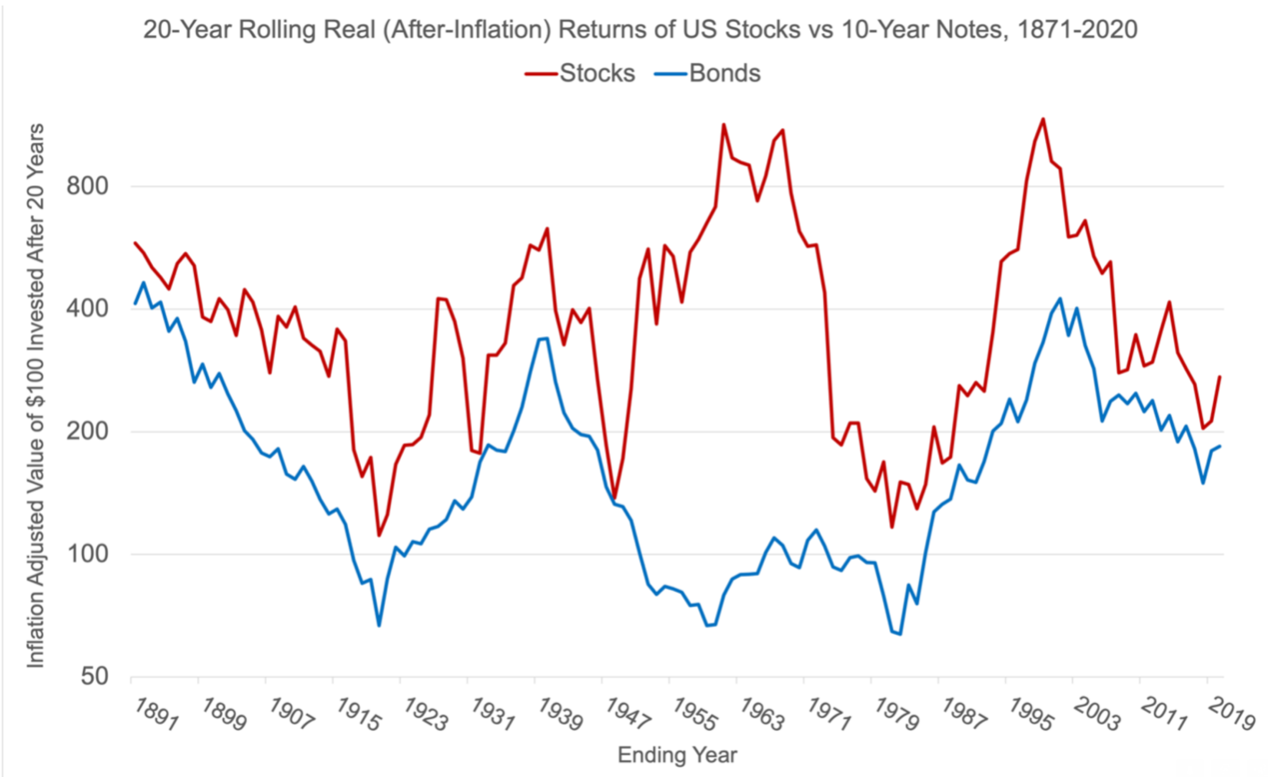
Investing in bonds, produces a smaller return, but is less volatile. So, the biggest decision an investor needs to make is their ratio between stocks and bonds.

The decision of how much to put in stocks and how much to put in bonds should be based on when the investor will need to withdraw their money. If an investor has a long horizon, they can invest more heavily in stocks, if they have a shorter horizon, they should reduce their stock holdings and have more in bonds. See handout 12.04

WHAT ARE THE TRADITIONAL RETURNS AND VOLATILITY OF STOCKS AND BONDS?

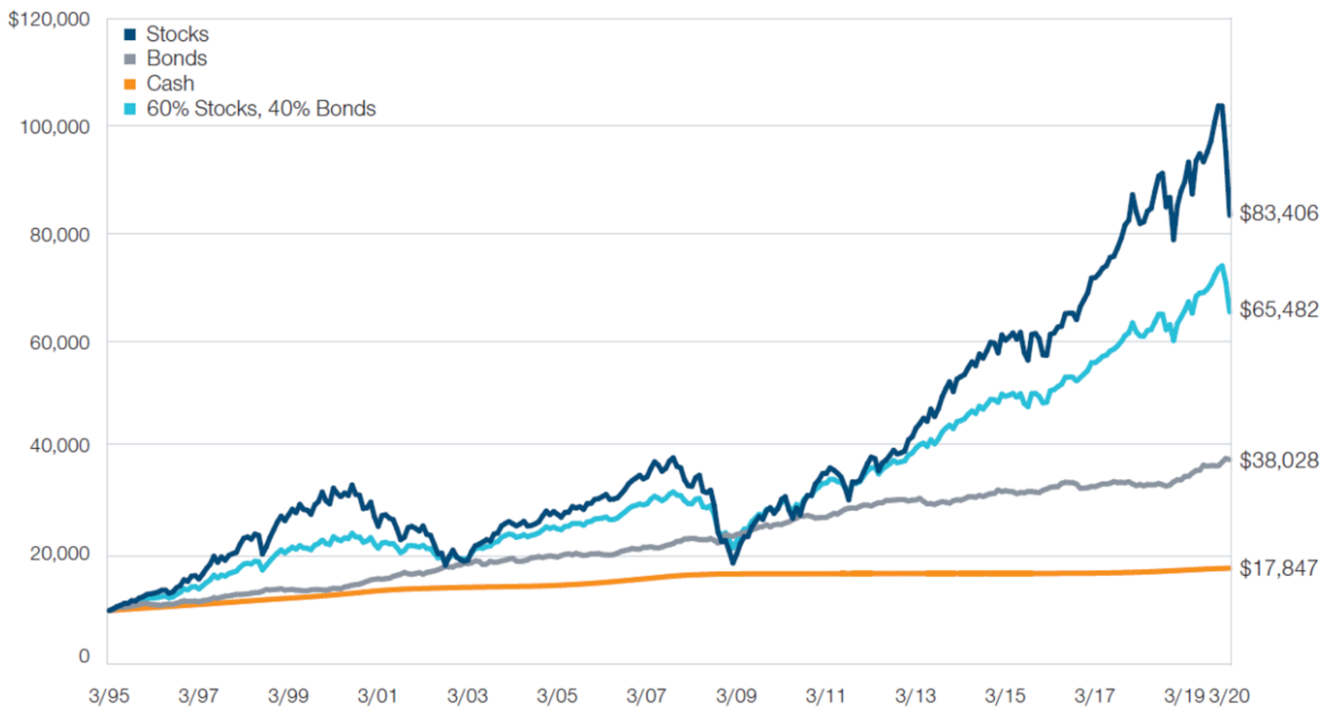
The below chart shows the RETURN and the VOLATILITY of stocks (red) and bonds (blue) over time.

As the chart is **inflation adjusted**, it's the primary purpose is to show the peaks and valleys. If there were no adjustments for inflation, you would see how both stocks and bonds were increasing in value over time.



Source: GFM Asset Management.

The below chart illustrates how $10,000 would have risen over 25 years if invested in different asset classes and is NOT inflation adjusted.



For more charts and analysis, see: https://www.longtermtrends.net/stocks-vs-bonds/
https://personal.vanguard.com/us/insights/saving-investing/model-portfolio-allocations

SUMMARY

- Stocks over time produce the highest return.
- Stocks are the most volatile
- Bonds produce a higher return than cash savings accounts, but less than stocks.
- Bonds are less volatile than stocks.

The most important decision an investor will make is what percentage of their funds should be in stocks and what percentage in bonds, often called the stock/bond ratio.

That decision should be based on
WHEN the investor will need their money

NEXT See 12.02 Recommended Asset Allocation Based on When You Need Your Money

VOCABULARY:

1. Asset Class
2. Investment Portfolio = basket of assets that hold cash, stocks, bonds
3. Cash = (checking, savings, money market, certificate of deposit)
4. FDIC = Federal Deposit Insurance Corporation = $250,000 insurance per depositor per bank
5. Stocks = Equities
6. Public vs. Private Companies
7. Shares
8. Initial Public Offering = IPO
9. REITs = Real Estate Investment Trust
10. Commodities = Metals, Grains, Foreign Currencies
11. Dividends = Distributions = profit returned to shareholders in cash
12. Initial Public Offering (IPO)
13. Market Capitalization
14. Giant-Cap, Large-Cap, Mid-Cap, Small-Cap, Micro-Cap
15. Volatility
16. Bond = Fixed Income Security = a promise to pay (a debt)
17. Bond Issuer = entity borrowing the money
18. Treasury Bonds = bonds issued by the federal government
19. Municipal (Munis) Bonds = issued by a municipality, i.e., state, county, or city
20. Corporate Bonds = type of bond issued by a corporation
21. Bond Interest Income
22. Bond Term = length of time before full repayment of principal, is required
23. Bond Face Value = Original Issue = Par Value = amount borrowed
24. Bond Discount = difference between the face value and market value