

Financial Markets

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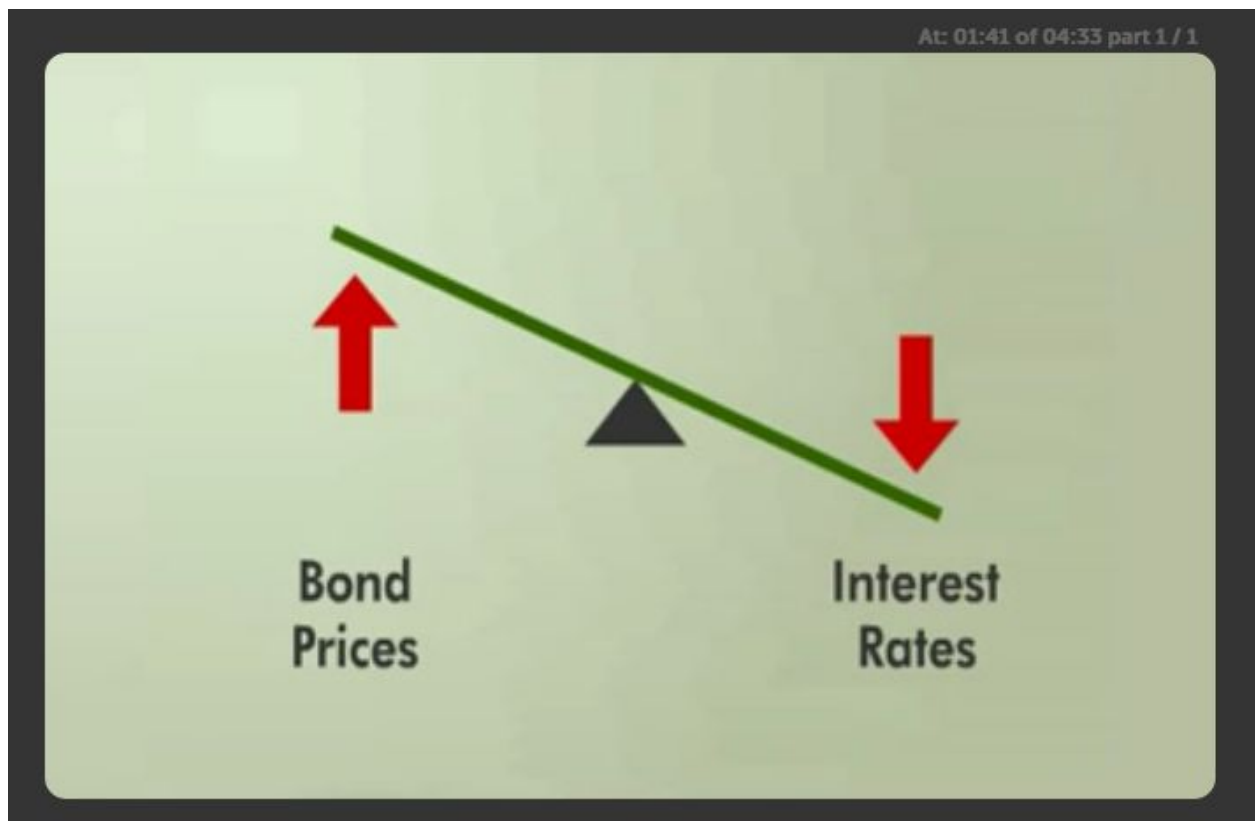
Financial markets are markets in which people come together to buy and sell financial assets. The most common financial assets are stocks, bonds and mutual funds. If you are like most people, you want to invest your money for retirement so it continues to grow. Different financial assets have different characteristics, and it is important to know the differences when making investment decisions.



When you purchase stock, you are buying ownership in a company. How much ownership depends on how many shares of stock you own.

As an owner in the company, you share in the profits and losses of the company. When a company has profits, there are two ways that you benefit. First, a profitable company can distribute income by paying dividends. A dividend is a payout of money for each share that you own. The second way is to sell your stock for more than you paid for it. This is called a capital gain. However, if a company is not profitable, you can lose money. For example, if you bought shares of stock for \$3 a share and sell them for \$2 a share, you will lose \$1 for each share you sold. When you purchase a bond, you are loaning money to a government or business. The

government or business promises to pay you back the amount you loaned plus some amount of interest.



Bonds pay a fixed rate of return. Bonds are subject to fluctuations in interest rates. As interest rates go up, bond values fall, and as interest rates go down, bond values rise. Therefore, bonds, like stocks, can have capital gains and losses. Another risk of bonds is inflation. If inflation is higher than the rate of return for your bond, the money you invested in your bond will be worth less when it matures. While the stock market is, historically, more volatile than the bond market, stocks have, historically, outperformed bonds over the long run. However, this is no guarantee that you will make money by purchasing stocks. Stock can fluctuate, losing value and then gaining it back. The time when you purchase the stock can make a big difference. Many investors reduce this risk by having a diverse portfolio. They purchase many different stocks so if one goes down, it affects their overall investment much less than if it was the only stock they owned. They also buy a mix of stocks and bonds. However, diversifying can be expensive and difficult to manage.

Mutual funds are a way to diversify and reduce risk. Buying a share of mutual fund is like buying a tiny piece of hundreds, or sometimes thousands, of companies. Mutual funds are run by professional fund managers who decide which stocks and bonds to add to or subtract from the fund. The primary benefit of a mutual fund is that it helps the nonprofessional investor diversify to reduce risk. When you invest in only one company, a 30% drop in that company's stock

equals a 30% loss in your investment. However, when you diversify through a mutual fund, a 30% loss in the stock of that company will have a smaller impact on your overall investment.

For those who are not experienced in researching companies and buying stocks and bonds, mutual funds are a way to have a diversified and professionally managed portfolio. However, different mutual funds have different results. But which of these financial assets is the right choice for an investor? That depends. Different people have different goals when choosing their investment strategy. Each investor must evaluate risk and reward when deciding where to invest. Risk is the uncertainty that you will receive the expected reward. The greater the risk you take with your investments, the higher the potential rate of return but the greater chance that you might not receive the return.



Here is a pyramid of risk and reward. However, risks and rewards change over time. You can see that the higher the investment is on the pyramid, the greater the risk, as well as the potential reward.