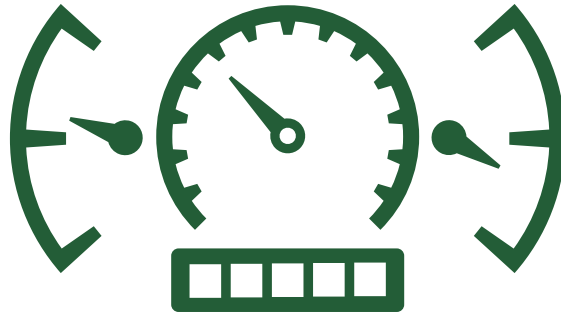


SECTION 6.3

THE DIFFERENCE BETWEEN STOCKS AND BONDS



TERMS

BOND: investment that makes you a lender. The loan amount will be paid back plus interest on the bond's maturity date.

STOCK: investment that makes you a partner. The growth of the company is intended to pay the investor overtime.

MATURITY DATE: the length of time the loan is set for before needing to be paid back.

INVESTMENT GRADE BONDS: bonds with a high credit rating which means less risk and therefore lower return, issued by corporations who are looking to raise money.

MUNICIPAL BONDS (ALSO KNOWN AS MUNIS): bonds issued by states, cities, or counties to raise money for government projects. These are lower risk and sometimes can have a tax advantage to investing in them.

HIGH YIELD BONDS (ALSO KNOWN AS JUNK BONDS): bonds that do not meet the investment grade by rating agencies and therefore carry a higher risk of default. Because the risk is higher, these bonds will pay a higher interest rate in return.

US TREASURIES BONDS: bonds issues by the U.S. Treasury Department and carry the full faith of the United States government which means they are a very safe investment. Treasuries go by different names depending on the length of time the bond is issued for before it matures.

- **Treasury Bills:** matures in less than a year (Safest)
- **Treasury Notes:** matures between 1 and 10 years
- **Treasury Bonds:** matures between 10 and 30 years

TERMS

INFLATION PROTECTION BONDS:

- **TIPS:** Type of bond intended to protect against inflation. The interest rate will have the current inflation rate incorporated into the interest rate.
- **iBond:** Type of bond intended to protect against inflation. The interest rate will have a component that is fixed and a component that adjusts with the Consumer Price Index. Theoretically, the total interest rate will rise as inflation rises.

CAPITALIZATION 'CAP': how much money a company is worth in their market. Cap is an abbreviation for market capitalization.

SMALL CAP: market value between \$250 Million and \$2 Billion.

MID CAP: market value between \$2 Billion and \$10 Billion.

LARGE CAP: market value above \$10 Billion.

GROWTH STOCK: company that you feel the price does not reflect the growth potential.

VALUE STOCK: a company that you feel the price is below the actual value.

With the Do, Re, Me and diversification principles setting the foundation of your investment strategy, it is time we discuss what you can start to invest in. To do this, we want to explain an analogy where two students are trying to start a business, lemonade stands, and need some money to get started.



Jon and Charles each stand in front of their respective mothers with the same question:

“ Mom, can I have five dollars to start a lemonade stand? ”

At school earlier that day, the boys had challenged one another to see who could raise enough money to buy the new iPhone. Their idea is if they could get some money from their mom to start a lemonade stand, then they could earn the money needed to get the phone.

With the five-dollar investments, the two boys are seeking ingredients to open lemonade stands the following weekend, and although they had asked the same question, they received different responses.

JON'S MOM (BOND)

"Absolutely. I will let you borrow the five dollars, but I want you to pay me one dollar every week for five weeks, and then, in addition to that, I want you to pay me the five dollars back after the five weeks."

CHARLES' MOM (STOCK)

"Absolutely. I will give you the five dollars, but I want to be 50/50 partners. Every week, we will split the profits or losses down the middle, and you don't have to worry about paying me the five dollars back."

Jon and Charles each received the five dollars to start their lemonade stand businesses, but how they raised the money was by taking on different relationships.

Jon's mom became a lender when she let Jon borrow the money for his business. Jon will pay his mother interest for the privilege of using her money and then after the set time, he will need to return the money he borrowed. This relationship is like a **BOND**, where one party lends money to another party and is paid interest on the principal until it is returned (Section 2.1).

Charles' mom became a partner when she invested the money in Charles' business. Charles will share the profits of the company with his mother for the privilege of using her money. This relationship is like a **STOCK**, where you pay to own a piece of the business and take part in the rise or fall of it.

WHY WOULD JON'S MOTHER WANT TO BE A LENDER?

As an investor, she will receive a consistent stream of income and has a lower risk of losing her money.

WHY WOULD CHARLES' MOTHER WANT TO BE A PARTNER?

As an investor, she has a greater upside in being a part owner, and she believes that this reward outweighs the higher risk she has of losing her money.

After a few weeks, it is amazing to see that both lemonade stands make the same amount of income, but which investor (mom) comes out ahead and which boy ends up closer to getting his iPhone?

	COMPANY INCOME	JON'S MOM (BOND)	CHARLES' MOM (STOCK)
WEEK 1	-\$4	\$1	-\$2
WEEK 2	\$0	\$1	\$0

WEEK 1:

Jon didn't make any money, in fact he lost money in week one, but he still owes the \$1 interest to his mom. The agreement was to pay this \$1 in interest every week, no matter how Jon did. Charles, on the other hand, didn't owe his mom any interest and because they lost money in week one, he split the losses 50/50 with his partner.

WEEK 2:

Jon is better off now that he didn't lose money on top of the \$1 interest payment, but not making any income is hurting with those payments still needing to be made. Charles and his mom are disappointed with the second week without making money, but at least they do not owe anyone any interest.

After weeks one and two it is transparent where the advantage in owning bonds comes in with guaranteed income to the investor. Jon's mom doesn't really care if he makes or loses money, as long as she gets paid her interest. She also is a big fan of not sharing in the losses Jon has experienced early on.

	COMPANY INCOME	JON'S MOM (BOND)	CHARLES' MOM (STOCK)
WEEK 3	\$4	\$1	\$2
WEEK 4	\$6	\$1	\$3

WEEK 3:

Finally, some money rolls in and after being hit hard at first both boys are excited as week three ends. Jon's mom (bond) still receives her \$1 in interest, but now Jon gets to keep the extra \$3 he earned. Charles on the other hand sees his (stock) \$4 income and splits it in two, giving his mom \$2.

WEEK 4:

Two weeks in a row the boys make money! Jon's mom gets her \$1 in interest and then Jon keeps \$5—booyah. Charles likes seeing the income go up but must again hand over half, \$3 to his mom.

After weeks three and four it is transparent where the advantage in owning stocks comes in with the shared upside of the company. As Charles' business keeps earning money, his mom gets to see her risk of being a partner payoff and enjoy the bigger payouts.

	COMPANY INCOME	JON'S MOM (BOND)	CHARLES' MOM (STOCK)
WEEK 5	\$6	\$1 (\$5 returned)	\$3

WEEK 5:

Jon knows his time is up and he needs to pay his mom the last \$1 in interest and then the \$5 he borrowed from her. On the bright side, this is the end of their relationship, money was loaned, then returned, and now they are done. Charles on the other hand has a partner that is not going anywhere, they shared in the risk at the start and now are along for the ride.

After week five there is a benefit to both the bond and stock. Jon's mom can take her \$5 she loaned out plus now she has \$5 more of interest and do with it as she pleases. Charles' mom on the other hand sees a growing business and more income coming that she gets to be a part of.

	COMPANY INCOME	JON'S MOM (BOND)	CHARLES' MOM (STOCK)
WEEK 6	\$4	\$0	\$2
TOTAL INCOME	\$16	\$5 BOND INTEREST	(\$8-\$5) = \$3 STOCK PROFITS

WEEK 6:

We see the bond relationship with Jon's mom drop off and now he is on his own. Charles will still move forward with his 50/50 partner.

SO, WHICH INVESTOR (MOM) CAME OUT AHEAD?

Jon's mom after five weeks: Loaned \$5 and got her \$5 back. Each week she made \$1, totaling \$5 income plus the \$5 she started with which equals \$10 total.

Charles' mom after five weeks: Invested \$5 to be a partner. She had an income of \$8 for the first six weeks, totaling \$3 income after her investment of \$5.

Jon's mom after six weeks: Made more money and now has \$10 to loan out for the next bond.

Charles' mom after six weeks: Will continue to share in the profits as the company goes forward and therefore has more future upside.

WHO MADE MORE BETWEEN JON AND CHARLES AFTER SIX WEEKS?

Jon gave out a bond—early on it was hard not making money while still having interest payments, but when the company took off, so did Jon's income, and even after the \$5 is repaid, Jon's income totals \$11.

Charles gave out stock—he got to keep the \$5 his mom invested, as well as share the income, totaling \$13. So, Charles is currently ahead, but looking forward, Jon will take all the income home and Charles will have to split with his partner.

HOW DO BONDS AND STOCKS GET VALUED?

Bonds are valued based on the interest rate the loan is sent out at and the length of time before its **MATURITY DATE**. If a \$10,000 bond is set for 3 years at 4% interest rate, the 4% interest rate is how the bond is valued. A risk factor in bonds is the 'term' or length of time until maturity. The longer the term is, the more risk involved, the shorter the term, the sooner it will be cash back in your pocket and the less risk.

Now when investors expect the Federal Funds Rate to go up, driving all interest rates higher, the price of existing bonds goes down – Future Price Up, Current Price Down. People will see the ability to get the same \$10,000 bond but at a 5% interest rate and want to purchase that instead.

Stocks are valued based on the public perception of the company as it represents future. Notice how we say 'public perception' of the future, that is a massively important piece of this investment puzzle. Where bonds have a very clear evaluation, interest rates and stocks are more subjective valuations meaning there is emotion involved. The main indicator of a stock's value will be the companies' ability to create and grow profits. If there is a stock valued at \$10 and people think the company is going to produce more profit, then someone will be willing to buy that stock at \$11.

In general, you can see larger more established companies as less risky because the public perception is stronger. Smaller, start-up companies are riskier because the public's perception is still questionable.

OK, WHICH TYPE OF BOND OR STOCK DO I WANT TO GO BUY?

Money Vehicle is not here to give you investment advice, but we do see the importance in knowing what types of investments there are in the market today. This will be a brief introduction to these types of investments and in future courses we can dive deeper into investment strategy as well as portfolio allocation, but we will also provide a clear path to start investing in Section 6.4.



TYPES OF BONDS

- **INVESTMENT GRADE:** bonds with a high credit rating which means less risk and therefore lower return, issued by corporations who are looking to raise money.
- **MUNICIPAL (ALSO KNOWN AS 'MUNIS'):** bonds issued by states, cities, or counties to raise money for government projects. These are lower risk and sometimes can have a tax advantage to investing in them.
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 - TIPS: Type of bond intended to protect against inflation. The interest rate will have the current inflation rate incorporated into the interest rate.
 - iBond: Type of bond intended to protect against inflation. The interest rate will have a component that is fixed and a component that adjusts with the Consumer Price Index. Theoretically, the total interest rate will rise as inflation rises.



TYPES OF STOCKS

'Cap' is an abbreviation for market **CAPITALIZATION** which means the size of the company.

- **SMALL CAP:** market value between \$250 Million and \$2 Billion, due to their relative size these companies are seen as riskier than the Mid or Large Cap.
- **MID CAP:** market value between \$2 Billion and \$10 Billion.
- **LARGE CAP:** market value above \$10 Billion, due to their relative size these companies are seen as less risk than the Mid or Small Cap.
- **GROWTH STOCK:** company that you feel the price does not reflect the growth potential.
- **VALUE STOCK:** a company that you feel the price is below the actual value.

GROWTH VERSE VALUE STOCK

Imagine you are sitting in the 'War Room' for the NFL draft and can select your team's next quarterback. Your two options are:

- Option 1: Seasoned Veteran who got injured last year but is a proven player. Because he is a bit older and coming off an injury you can get him in the free agent market far below what he has been previously paid.
- Option 2: The hyped up and anticipated rookie 1st round pick. You are unsure where his career will go, but the potential is off the charts.

Which do you choose? Well, these two options are a lot like value and growth stocks. The veteran player at a discount represents the value stocks and the rookie player with high potential represents the growth stocks. The choice is yours.

ACT LIKE AN INVEST-OR

The 'Re' principle in investing states the higher the risk, the higher the potential reward. As a young Invest-OR, you should begin to be comfortable taking on risks, remember you have the time horizon needed to earn the potential reward.

When you look at these two investment options, you can see how the level of risk differs in each of their return offerings.

BOND

Jon's mom had a guaranteed income and therefore less risk, which means less potential reward.

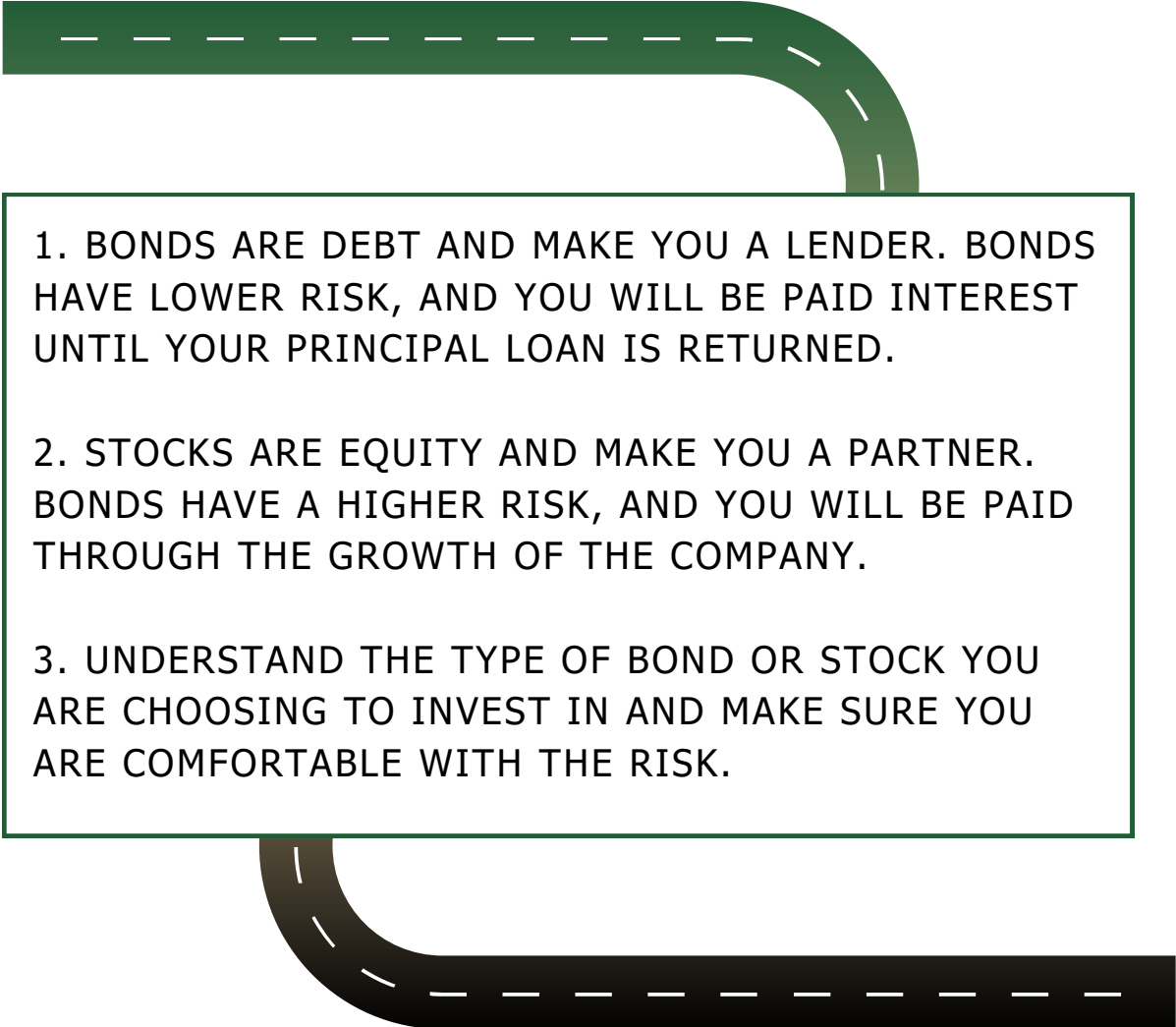
STOCK

Charles' mom had no guarantee and therefore higher risk which means more potential reward.

Jon and Charles are both so pleased with the success of their lemonade stands that they begin to wonder how they can expand their investment into more lemonade stands around the city. This concept will be addressed in Chapter 6.4.

SECTION 6.3

RECAP

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1. BONDS ARE DEBT AND MAKE YOU A LENDER. BONDS HAVE LOWER RISK, AND YOU WILL BE PAID INTEREST UNTIL YOUR PRINCIPAL LOAN IS RETURNED.
 2. STOCKS ARE EQUITY AND MAKE YOU A PARTNER. BONDS HAVE A HIGHER RISK, AND YOU WILL BE PAID THROUGH THE GROWTH OF THE COMPANY.
 3. UNDERSTAND THE TYPE OF BOND OR STOCK YOU ARE CHOOSING TO INVEST IN AND MAKE SURE YOU ARE COMFORTABLE WITH THE RISK.