

# Stocks, Bonds and ETF's: It's a Family Affair

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**“To know value is to know the meaning of the market.” Charles Dow**

Tri Pillar Investment's Chief Investment Officer, Laurie Skwerer, has provided an excellent overview of TPI's 7Twelve investment strategy. You can review her articles by accessing TPI's website at [www.TriPillarInvestments.com](http://www.TriPillarInvestments.com) and searching under 'About TPI'. Once there, select the 'Weekly Update' bullet. Over the next several weeks, we will compare and contrast the investment opportunities found within each of the asset classes. We will review their potential advantages and ultimately discuss why TPI recommends certain investment tools when constructing a well diversified portfolio.

We begin by examining stocks and bonds, the investment tools of which most people are familiar. ETF's are a more recent investment option. We will outline the various reasons why EFT's are gaining in popularity. It is important to understand how these investment methods are affected by market conditions, as well as what role they play in providing financial revenue in a portfolio.

## Stocks

Historically, individual investors have utilized stocks as the primary tool upon which to build and preserve wealth. Stocks are issued by companies when they need to raise capital. By purchasing stock, an investor obtains partial ownership in that particular company and assumes the same risks and payoffs as the current and previous owners.

The future value of a stock is governed by supply and demand, the fundamental principal of economics. The primary factors that drive supply and demand are earnings and expectations of future earnings. Stock prices are also influenced by the general state of the economy and interest rates.

In an economic boom, stock prices rise as companies earn higher profits. In contrast, rising interest rates cause businesses and consumers to borrow less. They also cause businesses and consumers to spend less, which causes economic growth to slow. Human emotion is another significant factor that drives the stock market. Fear and greed are two powerful emotions that can have a negative impact on investors. In the late 1990's, internet technology stocks doubled and tripled in just a few months. The fear of being left behind, coupled with greed generated by the above-average gains, leads to what is known as a "speculative bubble". A speculative bubble elevates an assets' price to levels that cannot be sustained. Eventually, the bubble bursts and is followed by a rapid decline in price.

Companies can choose to reinvest profits in their business or acquire other businesses. Additionally, the Board of Directors may decide to distribute a portion back to the shareholders in the form of a dividend. Dividend payments and price appreciation are the two key means by which stock investors make money.

## Bonds

When a company sells bonds, it actually borrows money from investors. The advantage of issuing bonds is that a company does not have to give up ownership. A bond is an IOU. The issuer borrows money from an investor and agrees to pay it back at a specific time. The investor is paid a fixed interest rate called the coupon rate or coupon yield. Although bond investments are a lower risk, they are not risk free. As interest rates change, the price of bonds fluctuates. An investor may purchase a bond and then find that bonds issued afterwards are paying a higher rate. If the investor wishes to sell the original bonds in this scenario, they will have to sell below the original face value to be competitive. Bonds do not adjust for an increase in the cost of living. As a result, bonds can potentially lose purchasing power.

There are three main types of bonds; U.S. Government Bonds, Corporate Bonds, and Municipal Bonds. U.S. government Treasuries are loans that investors make to the government for general budget purposes. Government agencies can also issue their own bonds for specific purposes. Municipalities are a form of local government that issues bonds in order to raise capital for services and governance.

Government bonds are backed by the full faith and credit of the U.S. Treasury department and are considered to have no default risk. They are typically issued in \$1,000 denominations, (known as par value). Maturity ranges from 4 weeks to 30 years. Usually bonds with a longer maturity pay a higher interest rate. Interest earned is exempt from state and local tax. Corporate bonds usually have a higher interest rate return than Treasuries, but they have a higher risk of default. Corporate bonds are backed **only** by the full faith and credit of the company. They are fully taxable at the federal, state, and local levels.

## Mutual funds

Mutual funds are investment companies that have a manager who makes investment decisions on behalf of a pool of investors. The pooled money is used to buy stocks, bonds or other assets. Each investor is an owner of the fund's shares, which fluctuate in value based on the securities held in the fund.

A stock or bond mutual fund typically invests in at least 25 companies, with some investing in more than 100. A mutual fund can provide various levels of diversification, depending on the characteristics of the assets within its fund. There are thousands of funds with different goals and objectives. They are designed to focus on various aspects of the market. These aspects can include stocks, bonds, real estate, commodities, currencies, or a combination thereof. Mutual funds have operating expenses, such as trading fees and investment manager's fees. Fees can vary greatly between funds, and they have a considerable effect on the overall return on an owners investment.

## *Exchange Traded Funds*

Exchange Traded Funds, or ETF's, are a popular alternative to mutual funds. They have been available in the U.S. since 1993. EFT's are a pool of securities and other assets that are traded on the stock exchange during normal trading hours. This is in contrast to mutual funds. Mutual funds are bought and sold through institutions, with their value being based on the end of day trading price. ETF's typically have lower expenses. ETF's can be more tax efficient than a mutual fund, because they are made up of a fixed group of securities.

TPI's 7Twelve Allocation Strategy develops portfolios made up of non- correlated assets. The ultimate goal is to minimize risk. All investments have some level of risk. The cornerstone of TPI's risk management is diversification. Stocks and bonds behave in a non-correlated fashion, and therefore provide a foundation for portfolio diversification.

Mutual funds and ETF's also provide internal diversification opportunities within the individual asset classes. This is because they are made up of a pool of stocks or bonds. Stock mutual funds have the propensity to behave more unpredictably. They offer the investor the opportunity for unlimited gains, but also have the potential for losses. Bond mutual funds provide more predictable returns than stocks, but with a lower potential rate of return.

TPI utilizes an array of carefully reviewed and analyzed stock and bond mutual funds, as well as ETF's, in our client's portfolios. Each of these investment tools have a role to play in a portfolio. Selection of a particular fund is based on a multitude of factors, including a client's demographics and investment objectives. Ultimately, the makeup of the overall portfolio must fulfill the 7 Twelve criteria to be successful.

Stocks and bonds work together like the famous comedy team of Jerry Lewis and Dean Martin. They have contrasting personalities, can work well individually, but the cumulative result is synergistic and dynamic. The percentage allocation of stocks and bonds in a portfolio will fluctuate based on the investment goals and objectives. Our next report will discuss the role of Real Estate in the 7Twelve strategy.