

# The Sgroi Financial

Volume 4 Number 2

Planning for Today and Tomorrow

## THE BASIC INVESTMENT GUIDE

*The terminology that exists in today's financial marketplace can often be confusing. At the same time it seems we are hearing it and reading it more than ever. This guide was written to help make things a little easier.*

**STOCKS** - When someone invests in stock they are actually purchasing ownership of a corporation either in full or in part. It doesn't matter if it's the corner store or General Motors. Each investor in a corporation owns a certain portion of the company. They have a "share" of the ownership. The company keeps track of the owners and how much they own by issuing certificates. These documents are called **stock certificates**.

An example of this could go as follows. ABC Inc. is owned by 10 different investors who each invested \$1,000 (\$10,000 total investment). The company issued each investor 200 shares of stock, \$5.00 per share. The shareholders then elected a Board of Directors to oversee their company. The Board hired a person to run the company, called him the president, gave him most of the \$10,000 investment and told him to have at it.

The company did well. It earned profits. Some of the profits were divided up and returned to the investors, these are called **dividends**. But most of the profit was put back into the business to expand it and buy equipment and hire more high quality employees and advertise or research new and better products or provide employee benefits or any of an endless list of business priorities. By doing all this, the value of the company increased and so the value of each share of stock increased.

Now while all of this was going on some of the original investors decided to take their profits and use that money differently. Some sold their shares to their fellow original investors. Some gave it to their relatives. Some sold it to outright strangers. Furthermore, there were times when the company

needed additional capital to fund its expansion. So new investors were sought and they were issued new shares of stock. Then later it was decided to raise a lot of money and a huge number of shares were offered to the public at large. That event was called a **Public Offering** (the first time a company does this is called an *Initial Public Offering* or **IPO**).

So, over time, ABC has grown and the number of shares in circulation, outstanding, is in the millions and the number of investors is in the thousands. Some investors may own tens of thousands of shares and some may own just one. But each is an owner of some fraction of the company. Each has the right to vote and the number of votes they have is determined by the number of shares they own. Each may attend the annual meeting, receive the annual reports and is entitled to their share of the profits.

Basically, this is how our country's economy has grown to what it is today.

**STOCK MARKETS** - When we speak of the stock market we are actually dealing with an activity more so than a place. The buying and selling of stocks goes on around the world twenty four hours a day. Much of the trading is done via computer. However there are also places, called *stock exchanges*, where certain stocks may be bought and sold.

The most well know stock exchange is the **New York Stock Exchange**, located on Wall Street in New York City. Shares of over 1800 companies are traded at this exchange, including the vast majority of America's largest corporations. It's here that one goes to buy or sell IBM, GM, Walmart, Boeing, AT&T...

**The American Stock Exchange** is also located in New York City and is the market where a large number of the country's smaller and medium sized companies are traded. This exchange used to be called "The Curb Exchange" because trading actually occurred out on the street before it was located in its own building

To buy or sell shares on either of these

exchanges simply requires the placing of an order with a member of the exchange who then takes that order onto the floor and executes the transaction. The actual trading is done through an ongoing auction, on the exchange floor, where traders for the buyers and sellers meet, establish price and exchange shares for money. This is why they are called “Stock Exchanges.”

There are also several, smaller, regional exchanges located in various cities throughout the country including Boston, Philadelphia, Cincinnati, Chicago, Salt Lake City, L.A., San Francisco and Spokane, Washington.

**The NASD and NASDAQ:** In order to function as a professional securities representative one must be registered with the the National Association of Securities Dealers, the **NASD**. The NASD is empowered by the government to set standards, regulate and police the securities business. A securities dealer as an approved member of the NASD is authorized to supervise individual representatives, do record keeping of transactions, collect and disburse money from trades, maintain insurance and a list of other activities.

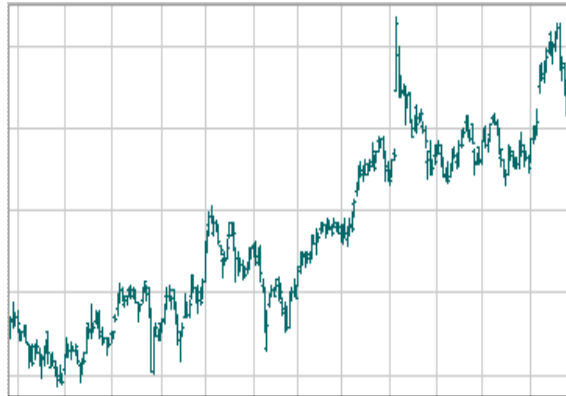
Securities Dealers may also buy stocks for their own account and resell them to the public. Let’s go back to our example of ABC Inc. When the company wanted to do its initial public offering and sell stock to the public at large, they could have contacted a Securities Dealer who would then make the opportunity known to their representatives who could then sell the stock to the public. ABC could also agree to have the Dealer purchase their stock from them and then resell it to the public at a profit. Now let’s say there are thousand of smaller companies doing just that and the Dealers have a nationwide network of computers to compile the price and sales information that facilitates the sale of these companies all across the country. These trades are not done at an auction on an exchange but instead are done “*over the counter*” with the public paying the Dealer and receiving the stock from them. This network is called the National Association of Securities Dealers Automated Quotation System, the **NASDAQ**.

**BONDS** - A bond is a type of investment vehicle classified as a loan. When a corporation wants to raise capital by borrowing it can issue bonds to investors. The investor loans the money to the corporation and receives back a certificate saying how

much was loaned, what the interest is, and when it will be paid. Bond holders have an IOU from the issuer but do not have any ownership in the company. Bonds are also issued by federal, state and local governments and government agencies.

When a corporation is well established and has “good credit” it logically expects to pay lower interest rates to its bond holders. In fact there are several credit rating organizations which investigate and rate the financial strength of commercial borrowers. The bonds themselves are given a rating usually from AAA (highly unlikely to default) to D (in default).

Bonds with a rating of BBB or higher are called **Investment Grade Bonds**. An investment grade bond is termed that because institutions that invest other peoples money, such as insurance companies or bank trust departments, may invest in only such high rated bonds. Bonds with a lower rating are called **High Yield Bonds**, as their interest rate is higher because they offer less safety. These are sometimes referred to as **Junk Bonds**. It’s not that they are a bad investment, especially in a well managed fund, it’s just that the companies who issue them are not as credit worthy as larger, more established institutions.



**Government Bonds:** Debt issued by the U.S. Government comes in three main categories: Treasury Bills, Treasury Notes and Treasury Bonds, aka T-Bills, T-Notes and T-Bonds. The difference is in the length of time the debt is issued for. Treasury Bills have a short duration, one year or less and are sold at a discount. For example, if one purchased a \$10,000 T-Bill, paying 5%, it would cost approximately \$9,523.80. One year later it could be redeemed for \$10,000.00. Treasury Notes have a duration of one to ten years and Treasury Bonds have durations of ten to thirty years. T-Notes and T-Bonds both pay interest in cash to the holder. The interest on all three is subject to federal income tax but not state or local income taxes.

**Municipal Bonds:** Bonds issued by state and local governments are termed Municipal Bonds. These bonds generally pay a lower interest rate than corporate bonds but the interest is usually exempt from all forms of income tax, be it federal, state or local. Investors seeking tax exempt income would purchase these.

**MUTUAL FUNDS** - A mutual fund is a pool of

money, provided by investors, which is then professionally managed for the investors' *mutual benefit*. Typically a mutual fund will invest in stocks or bonds or a combination of each.

An example of this could go as follows. Let's say you wanted to invest in the stock market. First you would need to decide what company to invest in, whether to buy GE or GM, Walmart or K-Mart, United or US Air. You would need information on which to base your decision. Furthermore, since individual stocks are normally purchased in blocks of one hundred, you might need a significant amount of capital just to get started. You may, of course, buy a lower number of shares, but you will often pay a higher cost per share in commissions. Also remember that all your dollars would be invested in that one stock. Finally, you would have to decide when the time came to sell (and that will usually cost a commission too).

A mutual fund, on the other hand, offers several distinct advantages. The first is professional management. When you invest in a mutual fund, there is a manager and management team who direct the investment of the fund. The manager is usually backed up by a staff of analysts. These people are looking at the companies individually, studying the annual reports, visiting them personally, seeing the facilities, factories and warehouses, checking the books and financial statements, looking at the competition and the marketing and more. The quality fund families research these companies thoroughly in an effort to decide whether that company is worth owning or not.

A second major advantage of a mutual fund is that it provides a diversified portfolio with a minimum amount invested. A typical stock fund which we recommend will own anywhere from fifty to five hundred different stocks. That provides each investor with automatic diversification from the first day they are invested. Diversification of assets is a hugely important advantage. So important that a Nobel Prize was awarded to a Dr. Joe Jones for his studies and work on this subject. What diversification does is provide the investor with greater safety of assets. *Diversification reduces investment risk.*

Another major advance with a mutual fund is that it requires a minimal investment to get started. One can open an account with anywhere from \$500 to \$1,000 and if you start with an automatic monthly investment program \$50 is all that's usually needed. On top of all this, all or part of your assets may be redeemed, normally on a daily basis, by phone, and the

fund company performs the necessary record keeping. Because each individual mutual fund is itself a separate, individual corporation, you are actually purchasing and selling shares of the fund when you invest or withdraw your money.

Mutual funds are normally offered by institutions known as fund families. Typically the fund family will offer a variety of different types of funds and investors may shift their assets between the different funds for little or no cost. These choices add an even greater degree of diversification.

***“Diversification reduces investment risk.”***

***Types of funds:*** There are over 9,000 mutual funds available in today's market. Starting one is not as hard as one might think and we estimate about three new ones

are started each day. Mutual funds mainly invest in corporate stocks and bonds but there are funds that invest only in real estate, natural resources, precious metals, and so on.

***Stock Funds:*** Mutual funds investing in corporate stocks come in a wide variety. ***Growth Funds*** invest in those stocks which the fund manager feels will increase in value. Typically the company is expanding, the profits (earnings) of the company are increasing and the stock will go up in price to reflect those improvements. ***Value Funds*** take a different approach in that they look for stocks of companies that are selling below what the manager believes they are worth. The companies may have fallen on hard times or been going through a restructuring or the industry they are involved in has experienced some decline. In any case, a value fund (also called contrarian) invests in those companies that they feel will turn their situation around and thus increase their share value. ***Growth and Income Fund*** normally invests in companies that pay a dividend to their shareholders, but the manager also feels the companies have a potential for growth. These funds may keep a part of their assets invested in bonds to enhance the income component of the fund. A ***Balanced or Total Return Fund*** has both a stock and bond portfolio, often in a fixed percentage and is designed to provide a fully diversified portfolio in one single fund. ***International Funds*** may only invest in foreign companies whereas ***Global Funds*** may invest anywhere around the world including the U.S.A. A ***Capital Appreciation Fund*** may invest in any security the manager feels will increase in value, whereas an ***Asset Allocation Fund*** must allocate certain portions of the fund into different types of investments.

Fund managers also consider a corporation's ***Market Capitalization***, which refers to the total value of a corporation's shareholder equity. Larger

capitalized companies, called **Large Cap**, are those companies with equity, or outstanding stock, valued at five billion dollars or more (\$5,000,000,000). Somewhat smaller companies, known as **Mid Cap**, would have market values of one to five billion dollars, and companies with values less than one billion would be labelled as **Small Cap**.

**Bond Funds:** Just as there are mutual funds that invest in corporate stocks there are also mutual funds that invest in Bonds. These funds have a stated objective and invest in those type of bonds which fit that objective.

A **Corporate Bond Fund** would usually invest in higher rated bonds issued by American corporations, whereas an **International Bond Fund** would invest in bonds of foreign companies. A **High Yield Fund** would invest in lower rated, higher paying corporate bonds. **Government Bond Funds** would invest in debt securities issued by the US Treasury, and **Municipal Bond Funds** would invest in bonds issued by state and local government agencies. Bond funds are quite often used to provide a tax free income source for the investor. The money raised by the sale of these bonds is often used to fund public works construction projects, like roads, schools, airports or industrial development projects.

**THE MONEY MARKET** - The stock and bond markets are where corporations and governments look to secure intermediate to long term financing. When the need for funds is *short term* they turn to the Money Market.

The institutions that issue these securities normally have a very high credit rating. In the case of the United States Government you have essentially the highest credit rating possible. Because this type of debt is short term, one year or less, there is a much higher degree of liquidity. Combined, these two factors provide a very high level of safety.

A "**Money Market Mutual Fund**" is a mutual fund that invests its money in these type of securities. The money market funds we recommend pay interest of about 5.15%, offer check writing, automatic investment and the electronic transfer of funds between accounts. These accounts are liquid, convenient and safe.

Some of the common uses for these accounts

include: a savings fund for property taxes where a monthly amount is automatically deposited, a savings fund for expenses, such as tuition bills, vacations or weddings and as an alternative for CD's and bank savings accounts.

**ANNUITIES** - An annuity is a contract between an insurance company and an individual. The individual contributes money to the plan in lump sums or periodic payments and the insurance company invests the funds. Any interest or growth of capital occurs on a tax deferred basis.

A **Fixed Annuity** has a guaranteed rate of return. It functions like a savings account at the bank. The investor contributes to the plan and receives a fixed interest payment on the balance from the insurance company. The insurance company invests the funds, usually in bonds, and assumes any investment risk. With a guaranteed return and safety of principal, these represent one of the lowest risk investments available and the interest rates are higher than you can earn at the bank.

A **Variable Annuity** differs from a fixed annuity in that the principal and returns are not fixed, they vary. They vary because they are invested in equity securities, called sub-accounts, which function like a mutual fund. With these products, the investor has discretion over what his contributions are invested in. He or she decides which of the offered sub-accounts will be invested in and how much will go into each.

An annuity, either fixed or variable, can be contributed to in two different ways. The investor may make one lump sum payment, a *single premium*, or periodic investments, *flexible premiums*. Because the interest and earnings on an annuity are tax deferred, these are referred to as **Single Premium Deferred Annuities, SPDA**, or a **Flexible Premium Deferred Annuities, FPDA**.



*We hope that you will find this information helpful and that you will keep it as a reference guide.  
If you have any questions or would like to speak with one of the professionals at **H. Joseph Sgroi and Associates**,  
please call our offices at (716) 674 - 6700 or (800) 989 - 6710.  
We are conveniently located at **965 Union Road in West Seneca, New York 14224.***



# *A personal letter from Joe*

*Dear Friend,*

*It has always been my desire to provide you with the finest financial planning services possible. Because everyone's circumstances and needs differ, it is a job that can only be done one person at a time. Furthermore, the ever increasing complexity of the financial world, and the mountains of information about it, make the job that much more challenging. That challenge though presents great opportunity.*

*It is my belief that you should understand your investments and they should fit with your objectives and financial goals. Diversification of your assets is essential. Educating you to a point of understanding allows us to function more as a team with a common purpose and creates improved results. Case study after case study has shown that our most successful clients are those who work with us the closest.*

*This newsletter continues our efforts to provide you with understandable explanations of financial concepts and products. In fact, I hope that you will keep this for a reference guide. If you would like additional copies for family or friends, please feel free to call and we'll get them right out to you. That holds especially true for those of you in education. If they can be of use for your students, please call.*

*Financial planning begins with the process of gathering information, what I call fact finding. To make suitable investment recommendations requires an accurate assessment of a persons financial and to some degree personal situation. Financial goals need to be clearly established along with tolerance for risk. At my firm we have, over the course of twenty seven years, developed what I consider to be the most thorough "Fact Finder" in the industry. Personal, employment, income, asset, insurance, real estate, and liability information are all laid out in a liquidity sequence. At that point we can start to establish the right financial plan for you. The goal is to arrive at an optimum solution to your needs and desires within the constraints of current and projected family income and assets. Actual investment products are offered only on the basis of what is most suitable for you, the client, with a full accounting of fees and the relevant tax consequences. The implementation of a financial plan takes place over an extended period of time. Patience is a real key but well worth the usual fantastic results.*

*Finally, on a personal note, Betsy and I have had the recent good fortune to become grandparents! Our son Patrick and his wife Christa had their first child, a wonderful boy, Timothy Joseph. They are all doing very well and we couldn't be happier for them. Thank you very much for the kind regards we've received from so many of you. It's truly appreciated!*

*All the best,*

picture of  
Joey