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Important differences between equities, fixed-income investment

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Third of a four-part series on investment basics.

This is the third installment of a four-part series on investment basics.

Previously, we addressed the importance of assessing overall economic conditions. We also prepared an Investment Policy Statement (IPS) to clearly establish, in writing, the important aspects and expectations of an investment program.

We are now ready to get down to the nitty gritty and learn about the two basic investment types: equities (mainly stocks) and fixed-income (mainly bonds).

Keep in mind that the term ``equity'' signifies ownership, such as ownership of a home or of a company in the form of stock.

Stock is issued by a company that needs money to run or expand the business _ many times this is accomplished through an Initial Public Offering (IPO). A limited and specified number of shares of stock are issued directly by the company.

Those same limited number of shares are then bought and sold over and over by investors through a stock exchange, the function of which is to match up buyers and sellers.

A good diversified approach to owning equities is to have a percentage of your portfolio in the different category types.

Large caps _ the ``cap'' refers to capitalization, or the total amount the company is worth _ tend to be companies that have been around a while with a proven track record, so more information is available about them.

Therefore, a larger proportion of the portfolio should be allocated to large- caps.

For example, if your long-term target asset allocation is 60 percent equities, 40 percent fixed-income and your overall total investment value is \$100,000, you might make the following equity allocation:

Large caps: \$25,000

Mid caps: \$15,000

Small caps: \$10,000

International stocks: \$10,000

Total equities: \$60,000

The main reason investors choose to buy stock is for its potential to increase in value and to grow as the company grows. An added bonus is that this growth usually compensates the investor for increases in inflation over time.

I think the biggest mistakes investors make with stock ownership are:

-- Holding too large a position in one stock or industry, often because of the investor's guess or prediction about the future. This lack of diversification is probably the No. 1 reason that investors lose money with stock ownership.

-- Holding onto a depressed-value stock investment too long, hoping for a recovery.

-- Familiarity with the company or industry which produces a kind of myopia and clouds objective thinking. This happens frequently when an investor works for and also buys the company stock.

-- Owning individual stocks and trying to understand these companies and their prospects for the future, rather than enlisting professionals to do this for them. This is the specific job of mutual-fund managers and it is what they get paid for. However, such is not necessarily the job of a stock broker.

Fixed-income investments (bonds) do not really signify ownership.

Rather, they are considered to be a loan that an investor makes on which is paid interest over time. These investments are not expected to grow at all. The two more significant risks with fixed-income investments are associated with credit worthiness (or rating) and longer time periods.

In essence, the shorter the time period that your money is lent out and the better the credit quality, the lower your interest income.

Diversifying a bond portfolio can increase yield without sacrificing too much in the way of safety.

Using the above example of \$40,000 in bonds, you might diversify the fixed-income holdings as follows:

Short-term U.S. Treasury (less than 5 years): \$8,000

Intermediate-term U.S. Treasury (5-15 years): \$8,000

High-yield corporate (5-15 years): \$8,000

GNMA (more than 15 years): \$8,000

Corporate bonds (5-15 years): \$8,000

Total fixed-income: \$40,000

Now that the framework for the investment program is in place, the next step will be to choose specific investment products, which will be covered in the next, and last, of this series.

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