Building blocks for successful investing

By Sheyna Steiner • Bankrate.com

Investing sounds intimidating to the uninitiated, but a little knowledge can go a long way. If you're building a portfolio for the first time, set up a strong foundation with some of these common types of investments. Find them in a variety of places, including discount brokerage firms, mutual fund firms, banks and even the Treasury.

Investments:

- Stocks
- Mutual funds
- Bonds
- TIPS
- REITs
- ETFs
- CDs

Stocks

One share of stock represents a slice of ownership in a business. Companies generally sell pieces of the business to the public in order to raise money. In return, stockholders may receive a share of company earnings through dividends. Investors who sell their stock after it has increased in value also benefit from capital appreciation.

After an initial public offering, stocks are sold on the secondary market -- where most of the daily trading takes place.

Most financial planners recommend that individual investors put their money into stocks through mutual funds.

Advantages and disadvantages of stocks

Pros

- Individual stocks offer a potentially high rate of return, which is the reward investors expect for taking on risk. "Since the 1930s the stock market has done the best; the drawback is the volatility," says Carol Friedhoff, CFP and author of "Keep Investments Simple But Sweet."
- Stocks can make investors rich. But with individual stocks, it's difficult to accurately predict which companies will take off like a rocket and which ones will languish or even fizzle out altogether.

Cons

- Downturns in the market or within an industry can hit individual stocks pretty hard. "With an individual security you pick up something that is called nonsystemic risk, and that is the risk associated with one particular stock, associated with the management team of the company, their financial situation and the industry that they're in," says Kevin Brosious, CPA, CFP and president of Wealth Management Inc., in Allentown, Pa.
- It's a risky bet. Diversification mitigates risk, so in order to avoid exposing all of your money to the twists and turns of a few individual stocks, spreading your money over several investments makes the most sense. "If you're putting money directly into stocks, you really need to have a large amount of assets because you want to have a number of different stocks," says Mike Flower, managing partner in Financial Principles LLC, in Fairfield, N.J. "You can feel very strongly about a stock, but if it's more than 5 percent of your overall portfolio, then it really starts to direct the ship." He focuses on building a strong foundation with funds and then sprinkling in individual positions later, if at all.

Mutual funds

Mutual funds buy a bunch of different securities. Investors, in turn, buy shares of the funds. There are thousands of funds that buy lots of different things, but most of them simply own stocks or bonds or a combination of the two. Others focus on specific sectors such as commodities, REITs, technology companies or even currencies.

One particular type of mutual fund has soared in popularity in recent years: the index fund. An index is a benchmark for the market as a whole. For instance, the Standard & Poor's 500, made up of 500 large-cap stocks, can be mimicked by index funds that hold roughly the same positions in the same proportions. "The larger the company, the more they're represented in the index," says Flower.

Actively managed funds are run by a manager or a team of people who follow a particular investment strategy. They pit their investing skills against a benchmark.

"Index funds outperform some 80 percent of the actively managed funds," says Brosious. "Over the long term they will outperform."

Advantages and disadvantages of mutual finds

Pros

- "You can get instant diversification with as little as $50 or $100," says Kirk Kinder, CFP and owner of Picket Fence Financial in Bel Air, Md. That is, if you're in an automatic investment program.
- Diversification mitigates risk. For instance, by spreading money over a bunch of stocks, the effect of one poorly performing company can be negated by the other positions.
- Additionally, the burden of researching companies falls to the fund manager if it's an actively managed fund. Investors benefit from analysis by the manger or the team. "You do get professional management if that's what you want -- or low-cost management with index funds," says Kinder.
- Convenience also factors into mutual funds' popularity. "Most people elect to have their dividends and capital gains reinvested, and most mutual funds will do it for free; they just roll it right back into the fund," says Brosious.

Cons

- The expenses can add up. Some expenses to look out for include the expense ratio and the sales fee or "load." The expense ratio is stated as a percentage of the fund's net assets and is deducted from your returns. "The average annual expense for a mutual fund is about 1.5 percent, depending on which mutual fund you're in," says Brosious. Obviously, that eats into your bottom line, and over time it can make a big difference.
- Buying a no-load fund can bypass the issue of sales fees altogether, but one thing that can't be avoided are taxes if the funds are held in a taxable account. "Mutual funds are not very tax-efficient," says Kinder. "One reason is the portfolio turnover." Every time the fund manager sells one of the underlying positions, shareholders can be exposed to a capital gains tax if the trades are profitable for the fund.
- "A second reason. and this is even for index mutual funds: You can end up paying taxes based on the actions of other shareholders," says Kinder. "In order for me to sell a mutual fund share, the manager may have to sell some of the underlying positions, let's say GE or Disney, to give me my money. The capital gains created by that sale aren't just passed to me directly, but they're passed to all of the shareholders equally. So if I'm selling, you may end up paying a fortune in my capital gains taxes."

Bonds

Whereas equities represent ownership in corporations; bonds represent loans made by investors to the issuer. Corporations, municipalities and the government issue bonds to raise money.

"You're loaning money to an entity; it could be the government or a corporation. And they agree to pay you interest and then pay you back your principal at the end of the term," explains Kinder.

The issuer repays the original investment after a stated amount of time, known as the term to maturity. Bonds mature at varying times; between five years and 30 years are the most common. Longer term bonds produce higher yields. "The longer the maturity, the more that investors demand in return," says Kinder.

While maturities influence the yield, or the interest rate, that investors receive on bonds, quality also matters. The highest rated bonds are from the Treasury because they are virtually risk-free. "The higher the quality, the lower the interest they're going to pay you, because of the higher guarantee you'll get your money back," says Kinder.

For those who like to live dangerously, junk bonds (also called high-yield bonds) generally offer the highest yields -- as well as a higher probability that the company will default on its loans. However, most advisers recommend bonds as a conservative anchor in an investment strategy and some like to just stick to the basics.

"In the bond market, it's not like you can make a huge return, so why not go with some type of Treasury where you have a guarantee of the full faith and credit of the U.S. government behind the bond, and receive income that has historically been between 4 (percent) and 6 percent and be very safe," says Flower. "It really acts as stability for an overall portfolio."

The value of the bond can also fluctuate throughout the term, but that only affects bondholders if they sell their bonds prematurely. "If interest rates increase, the bond that you hold is probably going to be worth less because people know that they can go out and get a bond that pays a better interest rate -- and if rates go down, your bond now has a higher interest rate than other ones out there and it becomes a bigger value," says Flower. "But you're always receiving that income from the interest rate attached to that bond."

Advantages and disadvantages of bonds

Pros

- Bonds can be very low-risk and offer a fixed rate of return. In a balanced portfolio, bonds provide a buffer of constant yields when the stock market falters.
- "The returns on bonds will not move in the same direction as the returns on stocks, says Brosious. "So that tends to smooth out your portfolio earnings. One year you might have bonds gaining 5 percent and stocks maybe losing 10 percent. The next year you might have stocks gaining 15 percent and bonds being a little flat."
- In general, bonds offer less return for less volatility, says Kinder.

Con

- The dreaded "I" word: inflation. Because they offer a fixed return, the cost of goods and services could rise beyond what the interest will buy in the future. "If you have spikes in inflation, the interest you're earning off of bonds won't buy as much as it did before," says Kinder. One type of fixed income investment, Treasury Inflation-Protected Securities or TIPS, can temper the effect of rising inflation, similar to the I bond.

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REITs

The National Association of Real Estate Investment Trusts defines REITs as companies which own or operate income-generating commercial real estate. The structure of the company allows investors to buy into real estate the same way they could purchase a mutual fund. In order to qualify as a REIT, the company must derive a certain portion of its income from real estate and provide 90 percent of its earnings to shareholders every year.

REITs hold all kinds of real estate-related holdings. "Sometimes people get confused and think they are all the same," says Kinder. Some hold mortgage loans or they can be apartment buildings, shopping malls, warehouses or even timberlands, he says.

Advantages and disadvantages of REITs

Pros

- According to Kinder, because REITs provide 90 percent of their earnings to their shareholders every year, they avoid taxation at the corporate level and pass basically all of their earnings on to the shareholders.
- Commonly used as a tool for diversifying within a portfolio, REITs and other asset classes, such as commodities and natural resources, have a low correlation to the stock market. "Noncorrelating means that returns don't move in the same direction all the time. That tends to smooth out your portfolio earnings," says Brosious.
- Actively managed funds, index funds and ETFs enable investors to get exposure to the real estate market.

Con

- "They aren't tax-efficient because they do pay a higher dividend," says Kinder. Plus, these dividends are taxed at ordinary rates. "It doesn't get the 15 percent dividend pass that stocks do. So if you hold it in a taxable account it can hurt you as opposed to an IRA or a 401(k)," says Kinder.

ETFs

Exchange-traded funds, or ETFs, have been gaining in popularity in recent years, though they have been around for a while, says Brosious. Good for tax-conscious investors looking to pay less in expenses, ETFs work essentially like a mutual fund with some characteristics of stocks. "These actually trade like an individual security but they are a basket of individual securities, just like a mutual fund," Brosious explains.

ETFs follow market indexes in their investing strategy. Because of this, their operating expenses are less costly than those of the average mutual fund, says Flower.

Advantages and disadvantages of ETFs

Pros

- Like mutual funds, ETFs bring instant diversification with one investment. Unlike mutual funds, "they are very tax-efficient," says Kinder. "For two reasons: one, low turnover because they are mostly index-based, but secondly, you don't have taxes based on other peoples' actions."
- Generally, ETFs minimize investors' exposure to taxes until the shares held are sold. Lower fees also sweeten the pot. Their expense ratios are comparable to those of index funds.

Cons

- ETFs can be bought and sold at any time during the trading day. Because they are traded like stocks, each transaction comes with a broker's fee. "If you set up a brokerage account you're going to pay a transaction cost to buy it every time right upfront," says Kinder.
- ETFs also lack a little bit of the convenience of mutual funds. "Because they trade like a stock, the option of having dividends and capital gains automatically reinvested is unavailable," says Brosious.

CDs

Certificates of deposit provide a fixed interest rate for a stated amount of time. Most CDs have a minimum purchase amount and charge a penalty for withdrawing the principal early. Because of their modest guaranteed return and low risk, they add stability to an investment portfolio.

In general, longer-term CDs pay a higher return than their short-term counterparts. Correlated with the interest rate moves by the Fed, CD yields vary over time. Laddering CDs can guard against the fluctuations of interest rates over time. Rates, investing time frame and the direction of the economic tides could determine the length of a CD ladder.

"If I'm doing a 24-month ladder, I may end up buying three or four different CDs with varying maturities, six months, 12 months, 18 months and 24 months," says Howell. "That way I have a CD coming due every six months and as that CD comes due, I check the interest rates and see what kind of yields are available. And if that at that point we're still keeping a 24-month ladder, I'll roll it into another 24-month CD."

Like rebalancing your portfolio at the end of every year, reinvesting in the longest term in your ladder smoothes out returns and removes the guesswork of market timing.

Advantages and disadvantages of CDs

Pro

- Insured by the FDIC, CDs are low-risk, guaranteed investments.

Con

- Low liquidity. "Nowadays there are online banking accounts which get a pretty aggressive rate of return and they are more liquid," says Friedhoff. "I would recommend that if you're going to need the money, you go with a savings account. Or if you're going to put money aside for a number of years, you may be better off with bonds or the stock market."