

THE FUNDAMENTALS OF INVESTING

PART ONE: ASSET CLASSES AND INVESTMENT ACCOUNTS

A basic understanding of investment asset classes is one of the first steps towards financial literacy. Even if you decide to have a professional advisor create an investment portfolio for you, it's important to understand why they have chosen various investment vehicles and how the investments in your portfolios work in combination with each other.

Setting Clear Investment Goals

The first step in creating an effective investment strategy is to define exactly what you are trying to accomplish. Begin by writing down your short-, intermediate- and long-term goals and assign priorities to each of them. This lays the groundwork for virtually all of the investment decisions to follow.

Intermediate Term

As you look out three to 10 years, you may have larger goals that require more substantial funding. Perhaps you want to buy a house, or start a business. In this range, you may be willing to accept a little investment volatility in search of higher returns.

Long Term

As you look out 10 years and beyond, the returns on your investments become an increasingly important determinant in whether you will reach your goals. It may be advisable to accept more short-term risk to increase the probability of long-term gains.

Short Term

Generally, you want to be very conservative with the funds you need to pay major expenses within the next couple of years. Your college bills, a new car, a special vacation... If it's important to you and coming soon, you'll want to be sure the money is there to pay for it.



DIVERSIFICATION AND ASSET ALLOCATION

Diversification is the financial term for not putting all of your eggs in one basket. The reason why that is important is that it is hard to predict which types of investments, or asset classes, will outperform others from year to year. By allocating your investments across different asset classes, you increase your chances of being in asset classes that are doing well and diminish the impact of asset classes that are performing poorly.

The goal of asset allocation is not necessarily to create the lowest volatility portfolio, nor the one with the highest potential returns. It is to find a combination of assets that gives you a high probability of reaching your goals. Different types of investments do different things well. Some produce more current income. Some have higher return (and higher loss) potential. The idea is to combine them together to produce better risk-reward characteristics than any would have on their own.

UNDERSTANDING VOLATILITY

Volatility is a statistical measure of how much an investment goes up and down over a given period of time. For investors, volatility is essentially synonymous with risk. That’s because the more an investment varies in performance, the more difficult it is to predict where it will go next.

ASSET ALLOCATION BEYOND INVESTMENT PORTFOLIOS

It’s important to understand that virtually anything that creates and/or retains value can be considered an asset class. In some cases, the value of holdings outside of your investment portfolios can greatly exceed the value within them, and should be factored into your overall investment strategy.

ASSET CLASS¹	BEST YEAR	WORST YEAR	10-YRS (‘00-’20) ANN. RETURN
Emerging Market (high volatility)	79.0%	-53.2%	9.9%
High Yield (moderate volatility)	68.3%	-32.2%	8.0%
US Debt (US Bonds) (low volatility)	16.9%	-2.0%	4.8%

For Illustrative Purposes Only

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results.

*Diversification and Asset Allocation does not assure a profit or protect against loss in declining financial markets.



BASIC ASSET CLASSES

Asset class is the financial term for a type of investment, or more formally, a group of securities that have similar financial characteristics. Most investment portfolios are composed of three primary asset classes: cash equivalents, equities and fixed income. Many institutional and ultra high net worth individual portfolios also include alternative asset classes like hedge funds and private equity partnerships. It is important to note that asset allocation does not assure a profit or protect against loss in declining financial markets.

CASH EQUIVALENTS

For our purposes, this includes the money you have in money market accounts, checking and savings accounts, CDs and even the cash in your wallet. Generally, the money you hold in cash equivalents is meant to be the stable and liquid part of your holdings.

EQUITIES (STOCKS)

When you buy a share of stock, you become part owner of a corporation. If the company increases in value, your stock will appreciate. Many companies also pay quarterly dividends, which are the portion of profits distributed to its shareholders.

There are two main types of stock:

- Common Stock usually entitles the owner to vote at shareholder meetings (or by proxy) and an equal share of future earnings.
- Preferred Stock does not usually have voting rights but does have a higher claim on assets than common shares. The dividend of preferred shares has priority over common shares, and preferred shareholders may be able to recover part of their investment if the company fails.²

When a corporation issues stock, they receive the initial proceeds from the sale. The first time they do this, it’s called an Initial Public Offering (IPO). After that, shares of stock are traded among investors on various stock exchanges. Many factors may influence the price of a stock. Some are specific to the company itself and some are broader political and macroeconomic concerns. The following are just some of the factors involved:

- The profitability of the company
- How quickly the company is growing
- The amount of debt the company carries
- Changes that impact the prospects for future profitability (e.g., a product launch, a new CEO, or a regulatory change)
- Interest rates (higher rates on bonds make the dividends on stocks less attractive)
- Uncertainty in the geopolitical climate

Remember that only one factor truly sets the actual price of a stock: the most recent trade. That trade simply reflects the opinions of one buyer and one seller about the stock’s value. No matter how rational the markets may behave over a long period of time, perception in the stock market is reality.

FIXED INCOME (BONDS)

When you buy a bond from a corporate or governmental issuer, you are lending them money, most commonly for a fixed amount of time for a fixed rate. This rate is referred to as the bond’s coupon. The interest payments are paid out periodically over the term of the bond, and when that term ends, the principal should be returned (though that is not guaranteed). There are other types of bonds that are sold at a discount to their face value and, instead of issuing a regular interest payment, should pay full face value at maturity (again, not guaranteed). For example, short-term, U.S. government T-bills work in this fashion.

ADDITIONAL ASSET CLASSES:

ALTERNATIVE INVESTMENTS While anything that is not a stock, bond or cash is technically an alternative investment, the term is most commonly used to describe two types of funds run by professional managers: hedge funds and private equity funds or partnerships. Because you must generally commit large sums of money for a relatively long period of time, alternatives are generally used by institutional and accredited ultra high net worth individual investors as part of their long-term strategies.

REAL ESTATE In addition to the investment you might make in owning your own home, there are multiple ways to incorporate real estate holding into your asset allocation. If you have the time, knowledge and inclination, you may choose to invest directly in an investment property. You can also invest indirectly through a publicly traded Real Estate Investment Trust (REIT) or a limited partnership (LP).

COMMODITIES Pretty much anything you grow, raise or dig out of the ground is a tradeable commodity. Agricultural commodities, like wheat, pork and corn, are typically traded for business purposes, or by highly specialized firms. Precious metals, particularly gold, are used by many investors as a hedge against inflation and as a defensive measure in case of extreme economic troubles. Most commodities, particularly agricultural commodities, are traded in the form of futures. These are speculative investments on the future price of the commodity.

ART AND COLLECTIBLES The vast majority of art and collectibles is held in the form of the objects themselves. In certain cases, it may be wise to consider the value of an art collection as an asset class. With high transaction costs and a need for very specialized knowledge, the average art buyer is well-advised to purchase art primarily for aesthetic, rather than investment, reasons.

FACTORS IMPACTING THE VALUE OF BONDS

Just like with stocks, most bonds are originally bought from issuers, then traded among investors. The value of the bond will rise and fall largely based on changes in the creditworthiness of the issuer and changes in interest rates. If interest rates rise, bond prices tend to fall and vice versa.

MARKET INTEREST RATES AND PRICES OF FIXED-RATE BONDS MOVE IN OPPOSITE DIRECTIONS



For Illustrative Purposes Only

Higher market interest rates ► lower fixed-rate bond prices
Lower market interest rates ► higher fixed-rate bond prices

RATINGS: A bond rating is an opinion on the creditworthiness of the issuer. There are three dominant rating agencies: Standard & Poor’s, Moody’s and Fitch. As ratings become progressively worse, the issuer has to pay a higher coupon to compensate for the greater risk. U.S. Treasury issues are not rated, though the U.S. government is.

CALLS: Callable bonds, including most corporate bonds and some municipal and agency bonds, may be repaid earlier at the discretion of the issuer. They must post a schedule showing when, and how often, they retain the right to call the bond.

BOND CHARACTERISTICS³

BOND TYPE	MATURITY PERIOD	TAX STATUS	RISKS AND RETURNS
Corporate Bonds Issued by companies to finance expansion and other activities.	1 to 30 years	Interest and capital gains are taxable.	Considered higher risk than government bonds, particularly where issuers have higher potential for default. To compensate, they typically have higher coupons.
Municipal Bonds Issued by state and local governments to pay for construction and other projects.	1 to 3 years for short-term bonds 10+ years for long-term bonds	Exempt from federal, state and local income taxes under certain conditions ⁴	Risks vary considerably depending on fiscal health of the issuing state or municipality. Lower pretax rates than comparable corporate bonds due to tax exemption.
T-Bonds Issued by the federal government as a major source of long-term financing.	20 and 30 years	Exempt from state and local income taxes	Very low risk of default because they are backed by the U.S. government, though the long maturities increase inflation risk and interest rate risk. Generally lower rates than comparable corporate or municipal bonds.
T-Notes Issued by the federal government to fund operations and pay interest on the national debt.	1 to 10 years	Exempt from state and local income taxes	Considered low risk, with commensurately low coupons.
T-Bills Issued by the federal government for immediate spending needs.	4 to 52 weeks	Exempt from state and local income taxes	Generally considered the lowest risk, lowest return of all fixed income investments due to government backing and short maturities.
Agency Bonds Issued by U.S. government agencies or government-sponsored agencies.	1 year	Varies depending on issue	Considered marginally higher risk and higher interest than Treasury bonds.

¹ Source Notes: FactSet as of date
• Emerging Market Equities measured by MSEX Index ; MSCI Emerging Markets Index
• High Yield measured by Bloomberg Barclays High Yield
• US Bonds measured by Bloomberg Barclays Agg. US Bonds
² James Royal, PhD and Arielle O’Shea, What is Preferred Stock? Available at: <https://www.nerdwallet.com/blog/investing/what-is-preferred-stock/>. April 2023
³ Adam Hayes. Bond. Available at: <https://www.investopedia.com/terms/b/bond.asp>. March 2023
⁴ Interest income from municipal bonds issued by a taxpayer’s home state is exempt from federal, state and local income taxes under certain conditions but capital gains taxes may apply if the bond is sold and not held until maturity. Certain other taxes may apply (e.g., Alternative Minimum Tax).

TYPES OF INVESTMENT ACCOUNTS

There are a wide variety of investment account types to accommodate an equally wide variety of needs. Some are quite broad in nature, while others are for more specific purposes. They also may differ in the types of investments they allow you to make.

BROKERAGE ACCOUNTS

There are several types of brokerage accounts; for instance, Cash and Margin accounts, both of which are available from both discount brokers and full-service brokers. With a discount broker, you typically make all of your own investment decisions. They often supply third-party investment research and some screening tools on their websites to help in these decisions. Full-service brokers provide these services, plus the assistance and guidance of an investment professional. The following accounts can be owned individually, jointly, or via other entities such as trusts, partnerships, etc.

CASH ACCOUNTS allow you to trade securities on a cash basis. You must pay, in full and by the settlement date, the amount due on any transactions.

MARGIN ACCOUNTS allow you to borrow money from the broker-dealer to gain leverage. (In essence, you use securities bought with cash as collateral for a loan used to buy more securities.) If the value of those securities drops, you must meet a "margin call," adding enough cash to return to your margin limits. Margin accounts require you to sign special agreements and keep minimum amounts of invested capital.

ACCOUNTS AT MUTUAL FUND MANAGERS

Many mutual funds can be bought directly from the fund company, as well as through a brokerage account.

TAX-ADVANTAGED RETIREMENT AND COLLEGE SAVINGS ACCOUNTS

To encourage citizens to save for their retirement and children's education, the government has established a variety of

tax-deferred accounts. Most brokers and many mutual fund companies offer the following types of accounts:

TRADITIONAL IRA: If you have sufficient earned income, you can make contributions of up to \$7,000 (\$8,000 if age 50 and over) per year (contribution limits may be subject to inflation adjustments in later years). Your IRA contributions may be tax-deductible, depending on your income, filing status, and whether or not you (or your spouse) is covered by an employer-sponsored retirement plan at work. Any appreciation on your investments under your Traditional IRA is not taxed until it is withdrawn.

ROTH IRA: If you qualify based on your income and filing status, you can make after-tax contributions of up to \$7,000 (\$8,000 if age 50 and over) per year (contribution limits may be subject to inflation adjustments in later years), provided you have sufficient earned income. Any appreciation on your investments under your Roth IRA is not taxed, but may be taxed on withdrawal. Qualified distributions of earnings are not subject to federal income taxes.

SEP-IRA: Similar to traditional IRAs but accepts employer contributions under an employer-sponsored SEP plan. Contributions an employer can make to an employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation, or \$69,000 for 2024. Note that salary deferrals and catch-up contributions are not permitted in SEP plans established after 1996. There are also special contribution rules if you are self-employed. SEP IRAs can also accept Roth contributions.

401(K) PLANS are employer-sponsored plans that allow employees to make pre-tax or Roth contributions of up to \$23,000 (\$30,500 age 50 and over if allowed by the plan). Many companies match their employees' contributions up to a specified amount.

403(B) PLANS are essentially 401(k) plans for employees of certain non-profit organizations and public schools.

529 PLANS A 529 plan is a flexible, tax-advantaged savings vehicle which allows you to invest for future education expenses, including college. Earnings in a 529 plan can be tax-deferred, with withdrawals being exempt from federal and in most cases state income taxes if you use the funds for qualified expenses, such as tuition, fees, room and board and supplies. Many states provide additional state tax deductions or tax credits. Additionally, 529 plans typically have high contribution limits and assets are generally treated as outside of the account owner's estate for estate tax purposes.



GETTING STARTED

STUDY THE MARKETS: Start reading financial publications, watching the business news and speaking with experienced investors to learn how the markets work.

START SMALL: Invest small sums of money and keep a journal. Track not only your gains and losses, but also your reactions, so you can start to learn how your behavior impacts your investing intentions.

DO YOUR HOMEWORK: Focus initially on a small number of investments, so you can thoroughly research them, learning what to ask and where to look.

BE DISCERNING: Learning what to avoid is as important as learning when to pull the trigger.

BECOME TAX SAVVY: Profits on sales of investments held for at least one year are taxed at lower long-term capital gains rates. Think in terms of after-tax results, not just prices.

Investors should consider many factors before deciding which 529 Plan is appropriate. Some of these factors include: the Plan's investment options and the historical investment performance of these options; the Plan's flexibility and features; the reputation and expertise of the Plan's investment manager; Plan contribution limits and the federal and state tax benefits associated with an investment in the Plan. Some states, for example, offer favorable tax treatment and other benefits to their residents only if they invest in the state's own Qualified Tuition Program. Investors should determine if their home state offers a 529 Plan that may offer such favorable tax treatment and benefits to residents or beneficiaries of that state that may not be available to investors or beneficiaries of other states. Investors should consult with their tax or legal advisor before investing in any 529 Plan or contact their state tax division for more information. Morgan Stanley Smith Barney does not provide tax and/or legal advice.

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Companies paying dividends can reduce or cut payouts at any time.

REITs: A security that is usually traded like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. The risks of investing in Real Estate Investment Trusts (REITs) are similar to those associated with direct investments in real estate: lack of liquidity, limited diversification, and sensitivity to economic factors such as interest rate changes and market recessions.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are appropriate only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

Investing in commodities entails significant risks. The commodities markets may fluctuate widely based on a variety of factors including, but not limited to, changes in supply and demand relationships; governmental programs and policies; national and international political and economic events, war and terrorist events; changes in interest and exchange rates; trading activities in commodities and related contracts; pestilence, technological change and weather; and, the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Investing in physical commodities, such as gold and silver, exposes the investor to other risk considerations such as potentially severe price fluctuations over short periods of time and storage costs that exceed the custodial and/or brokerage costs associated with the investor's other portfolio holdings.

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