Investing 101: Fundamentals of investing

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Welcome!

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Agenda

Understanding your options:

- What you can own
- Where you can hold it
- How to own it

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Understanding your options

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What you can own

- A “security” is a basic unit for investing that represents ownership
- Generally speaking, securities are divided by asset class
- Each asset class has its own risk level and expectations on returns:
  - Fixed-income securities
  - Equities such as common shares or stocks
  - Mutual funds
  - Exchange-traded funds (ETFs)
  - And more…

Investing (n): The ownership of an asset with the expectation of a financial return.

Fixed-income securities

Characteristics of fixed-income securities:

- Easy access to your capital – you can buy and sell when you need liquidity (per the term of the security).
- Investment growth is in the form of interest earned over time.
- They are often a source of regular income in your portfolio.
- They include:
  - Cash and cash equivalents – interest savings accounts, Guaranteed Investment Certificates (GICs)
  - Bonds – Treasury bills (T-bills), corporate bonds, government bonds, banker's acceptances (BAs)

When you purchase a fixed-income security, you are making a loan to the bank, a government or corporation. In return, you receive interest.

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What are bonds?

- Bonds represent a loan to bond issuers such as governments and corporations for a pre-determined length of time (“term”)
- The issuer promises to repay the principal at the end of the term (the "maturity date") and until then typically pays interest at fixed intervals
- Bonds can be bought and sold during the term
- The expected return from the time of purchase to its maturity (end of term) is the “yield to maturity”
- The yield to maturity includes interest, plus any capital gain or loss realized if the bond was purchased above or below its face value
- The “credit rating” of a bond is its creditworthiness – the likelihood the loan will be repaid

Term (n): The pre-determined life of a bond, between when it is first sold and when it matures
Yield to maturity (n): Expected return during the term of the bond
Face value (n): Initial dollar value stated by the bond issuer

Interest rates and bond prices

The market price of a bond is determined by:

- **Interest rates**: bond yields and prices rise and fall inversely with interest rates
- **The term of the bond**: long-term bonds are more sensitive to interest rate risk
- **Market/economic conditions**: a poor economy can affect an issuer's ability to make interest payments or pay back the lender (called "default risk")
  - Poor market conditions can also influence demand for bonds and issuer supply

Bond issuers

Governments

- Issue bonds to finance major projects such as road reconstruction or school board projects
- The federal government issues long-term bonds such as Canadian Savings Bonds
- Treasury bills (T-bills) are similar to government bonds, but are short-term and low-interest

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Bond issuers

Financial institutions

- Guaranteed Investment Certificates (GICs) have relatively low interest rates with lower risk for various terms
  - Most GICs are insured by the Canada Deposit Insurance Corporation (CDIC) for interest and principal totaling up to $100,000 per issuer
- Banker's acceptances (BAs) are bonds issued by a corporation but guaranteed by a financial institution – often shorter term and lower interest but more secure than corporate bonds

Bond issuers

Corporations

- Investment-grade bonds – issued by well-established companies, generally higher-quality and lower risk of default
- High-yield bonds – issued by newer or growing companies that are still building creditworthiness and offer higher interest rates in return for increased risk

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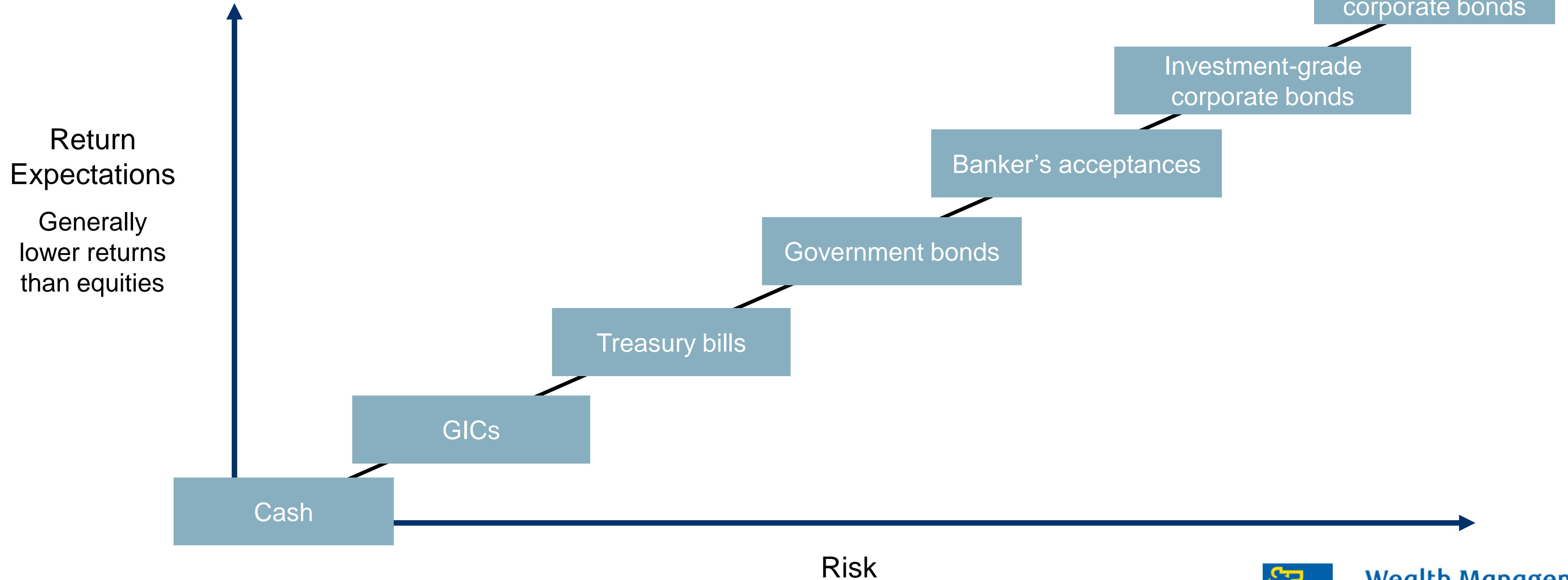
Fixed-income securities



Fixed-income securities

In summary

- Generally lower risk compared to equities
- Principal and interest guarantees
- Helps diversify overall investment portfolio to reduce volatility
- Provides regular interest payments that can reinvested or withdrawn, e.g. as a source of retirement income
- Potential insurance (GICs)
- Liquidity when required
- Ability to earn capital gains depending on market prices

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Equity securities

Characteristics of equities

- Companies issue shares/stocks to raise funds for long-term growth of their business and to increase their presence in the market
- Returns come in the form of capital gains or dividends (regular income from the investment)
- Many equities, including income trusts, preferred shares and higher-quality stocks (“blue chips”) pay out dividends
- Equity securities provide greater potential for long-term growth in an investment portfolio, but are more volatile and tend to carry greater risk than fixed-income securities

Equity securities are stocks and shares of public or private companies. By owning part of a company’s stock, you can participate in the company’s growth (or losses).

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Equity securities

- Equity securities can be bought and sold easily in the market
- Examples:
  - Common and preferred shares
  - Income trusts and royalty trusts
  - Real estate investment trusts (REITs)

What types of equities can you own?

Common shares

- The most common type of equity, issued by companies to raise capital
  - Often companies will issue dividends to shareholders
  - Shareholders receive “voting rights” (ability to vote on major corporate policy, board member appointments, etc.)
  - Shares can be purchased on initial offering (a “new issue”) or on the secondary market (such as the Toronto Stock Exchange)

Preferred shares

- Similar to common shares but they are “preferred” because they have prior claim on assets, earnings and dividends, ahead of common shareholders – but do not receive voting rights
  - Often pay higher regular dividends than common shares

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What types of equities can you own?

Income trusts

- Another form of ownership in a company, offered in the form of trust units
- Profits are given to investors rather than re-invested back in the business
- Business trusts are based on an underlying business:
  - Royalty trusts, based on the profits of an underlying resource or energy assets
  - Real Estate Investment Trusts (REITs), based on the profits of the underlying real estate

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Stocks in the market

- Stocks are listed on an exchange, such as the Toronto Stock Exchange (TSX) or the New York Stock Exchange (NYSE)
- Stocks are bought and sold on the stock exchange throughout the day
- Prices change regularly, often at a moment's notice
- One way to measure if a price is high or low is a company's "price-to-earnings ratio" (P/E ratio):
  - A higher or lower P/E relative to peer companies can indicate whether a company is "undervalued" or "overvalued"

Price-to-Earnings ratio (P/E) = price per share divided by earnings per share

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Stock indices

- Investors measure the overall market success by looking at a stock index
  - A stock index is used as a benchmark to measure the current state of the market
  - Indices you may be familiar with include the Dow Jones Industrial Average (the Dow or DJIA),
    the S&P 500 and the S&P/TSX Composite

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What affects the value of a stock?

- Sales, profits and growth potential
- Perceived strength of a company's product, service, industry and management quality
- Economic conditions and investor sentiment
- Competitor behaviour
- Many factors can affect stock prices in the short term, but over the long term earnings are one of the most important drivers of stock prices

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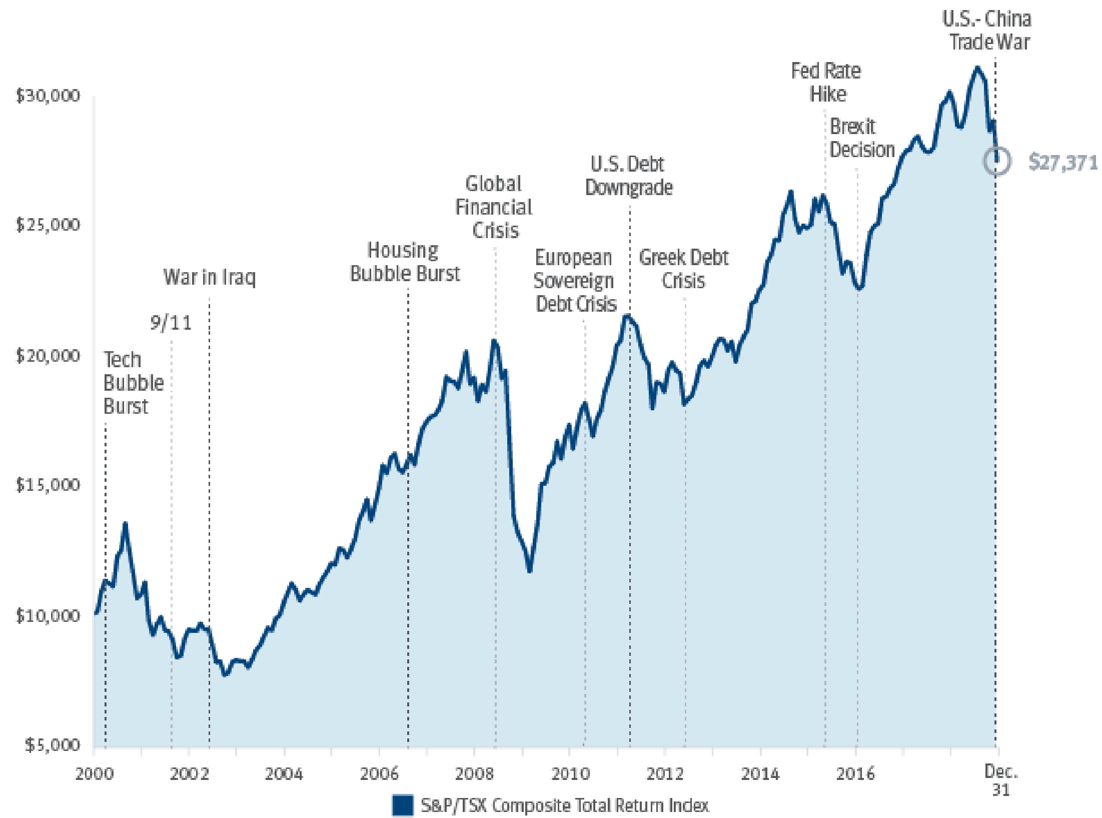
The growth of $10,000 since 2000



Earnings and stock prices generally follow each other, especially over the long term.

In the short term, investment sentiment or economic conditions can have a more significant influence on stock prices.

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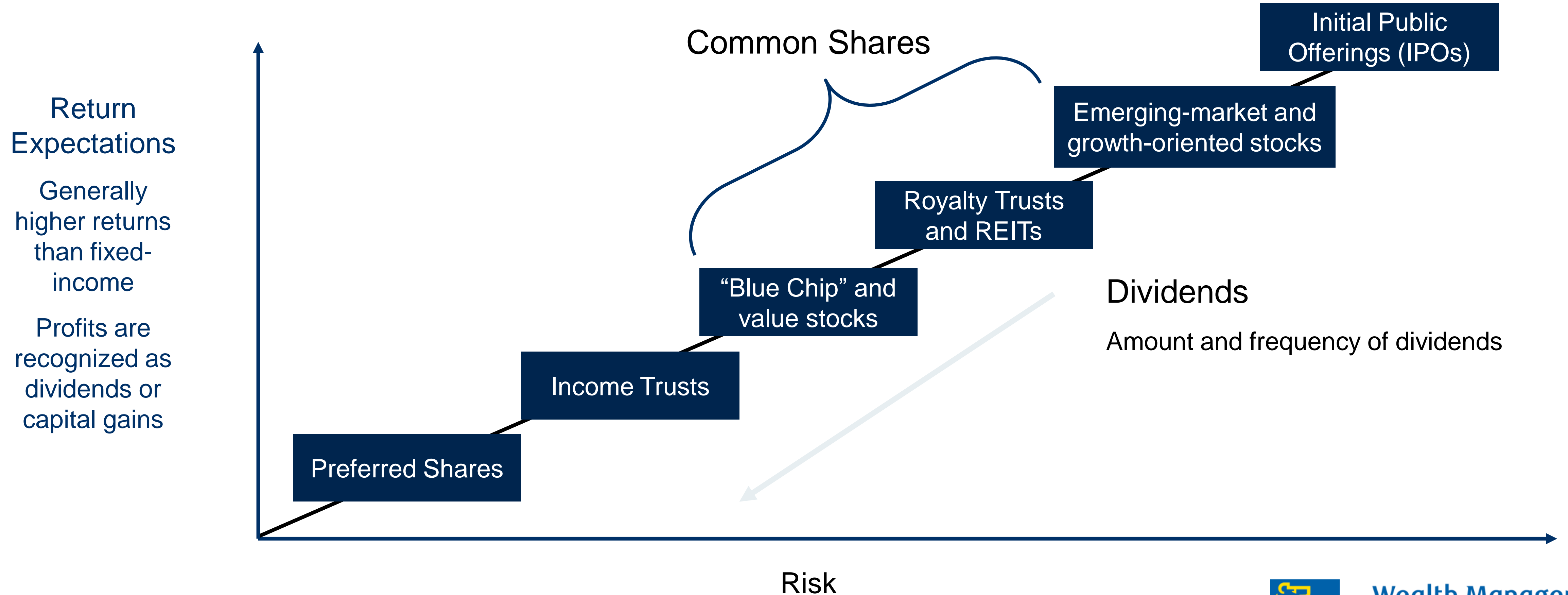
Equity securities

Relative risk and expected return



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So why invest in equities?

To build your income

- Certain equities like income trusts can enhance your income
- The income generated by equity investments is taxed more favourably than interest income
- Setting aside a certain percentage of your portfolio to equities can enhance your after-tax income

To help protect your wealth

- Because fixed-income investments offer lower interest rates, they offer little protection from taxes and inflation that can erode your wealth over time
- Adding equities to your portfolio can help protect your portfolio’s value over the long term

So why invest in equities?

To save for the long term

- Equities can provide greater long-term returns compared to cash and fixed-income investments
- Typically fluctuate more in value – fluctuations tend to smooth out over time, but it's important to take a long-term perspective when investing in equities

In summary

- Equities can play an important role within a diversified portfolio
- Equities can help with building your savings and growing your wealth

Mutual funds

Characteristics of mutual funds

- Investors pool their money into a fund managed by a professional portfolio manager
- In turn, the fund issues units to the investor
- Diversification is built in across asset classes and sectors and is scalable regardless of how much is invested
- The value of the fund unit is based on the pooled assets (less any manager fees)
- They are easy to buy and sell in the market
- Require very little investment to start with

Mutual funds are a collection of securities or a pool of one or more asset classes, each managed with a specific purpose (investment mandate).

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Mutual funds

Accessibility	Market exposure/Risk	Income potential
Exchange Traded Funds	Equity Mutual Fund	Fixed Income Mutual Funds
Equity Mutual Funds	Balanced Mutual Funds	Balanced Mutual Funds
Fixed Income Mutual Funds	Exchange Traded Funds	Equity Mutual Fund
Balanced Mutual Funds	Index Mutual Funds	Index Mutual Funds
Index Mutual Funds	Fixed Income Mutual Fund	Exchange Traded Funds

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Mutual funds

Type of fund (mandate)	What it invests in
Fixed Income	Various fixed income vehicles, often staggering the maturities and yields. Often used for capital preservation and income.
Balanced	Fixed-income and equity securities. Often used when both preservation and growth are needed.
Equity	Invest in various equities. Often used for greater growth potential over longer-term time frames.
Geographic	Equities or fixed-income within a specific region or country.
Sector	Invest in specific economic sectors, such as energy or health care.
Style	Invest according to a specific investment style, such as “value” where the fund manager looks for securities priced below fair market value.
Index	Invests in the securities to mimic or track an index like the TSX, Dow Jones or S&P 500.

Each mutual fund has an investment mandate to follow, so you can choose the one that fits your personal goals and risk tolerance.

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Mutual funds vs. individual securities

	Investment funds	Portfolio of securities
Holdings	Hold hundreds or thousands of securities in one portfolio because they have access to a large amount of capital (from many investors)	Typically hold fewer than 100 securities in an individual portfolio
Availability	Banks, financial planning firms and several other institutions sell mutual funds	Licensed advisors and institutions can buy, sell and manage portfolios
Cost	Pay portion of investment to portfolio manager and often a fee to access funds	Pay per transaction or yearly management fee
Management	A professional manager makes all decisions for you within certain guidelines, offering greater convenience	You can choose to buy, sell or hold specific individual securities, giving you more control

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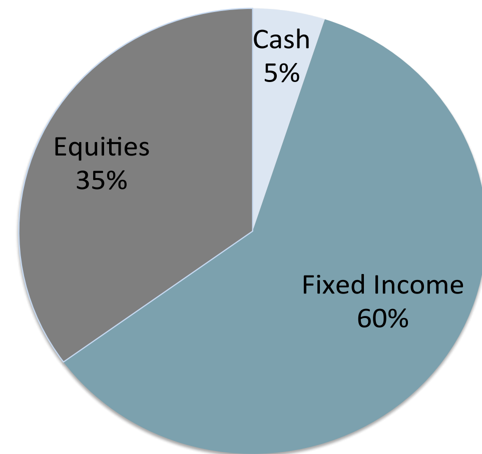
Diversification

A balanced case study

- An investor is focusing on wealth preservation in their portfolio, over a 3- to 10-year time horizon, with a moderate risk tolerance
- The investor chooses a balanced portfolio (combination of cash, fixed-income and equity investments) to provide growth and protect against inflation
- Fixed-income securities will provide a "store" of value and reduce risk



Asset allocation	%
Cash	**5**
Fixed income	**60**
Government	26
Corporate – Investment Grade	26
Corporate – High Yield	4
Emerging Markets	4
Equity	**35**
Canadian	21
U.S.	9
International	5
Emerging markets	0
TOTAL	**100**

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Why invest in mutual funds?

Diversification

- Instant diversification and asset allocation, without the larger amounts of cash needed to create an individual portfolio comprised of the same securities

Professional management

- All investment research and buy/sell decisions are made by the fund manager

Divisibility

- Smaller denominations of mutual funds (usually $100 to $1,000) provide mutual fund investors the ability to make periodic investments through monthly purchase plans while taking advantage of dollar-cost averaging

Liquidity

- Funds can be sold over the short term without significant difference between the sale price and the most current market value

Exchange traded funds (ETFs)

- ETFs are mutual funds that mimic a stock index, commodity or “basket” of assets
- By investing in an ETF, you own many securities within the fund
- ETFs can be bought and sold on a stock exchange

	Mutual funds	Exchange traded funds
Management	A portfolio manager that buys and sells within the fund according to the investment mandate.	The fund mimics an index (market indicators) so little management is needed.
Availability	Banks, financial planning firms and several other institution sell mutual funds.	Licensed advisors and institutions can buy, sell and manage.
Value & liquidity	Mutual funds are priced per day, so depending on market conditions you may be over or under paying.	ETFs are traded on the stock exchange and can be bought and sold all day at current value.
Cost	Pay portion of investment to portfolio manager and often a fee to access funds.	Pay per transaction or yearly management.

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