



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

The Sound Investor

By Ed Hynes, CFA

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What are Stocks and Bonds?

This article is the first in a series focusing on the basic terms and concepts of investing. Today we will discuss stocks and bonds, what they are and how they differ.

Maybe the easiest way to explain differences between stocks and bonds is to use an example of me starting a small business. If I am the only person putting money into the business, I own all the company's stock. And since I own all the stock I have all the potential risk and reward resulting from how the business performs. It might fail or be a wonderful success – and as a stockholder that is the return I will get on my investment.

If my uncle wanted to invest in the business, I could slice my stock into shares and sell him half. Then we would each own 50% of the company. Just like when I owned the whole company, the success of my investment depends on how the business performs, but now I only have 50% of the risk and potential reward.

When an investor buys a share of stock in a company like IBM they are an owner of IBM just like my uncle and me owning our small business. The return on their investment will depend on how IBM performs. There are no “promises” they will make money or even get their money back.

With bonds on the other hand, investors do have a “promise” that they will get their money back plus interest. Let's go back to the example - as the business grows it might borrow money from a bank to buy larger equipment. The bank would charge interest on the loan and expect the money to be returned on a certain date. The bank is taking the risk that I will keep my “promise” and they will get their money back and for that risk they charge interest. If they think my “promise” is pretty safe, the interest rate will be lower than if they think my “promise” is risky.

The bank will also protect itself by insisting that it has the first claim on any assets the company has, like the equipment, if I break my “promise” and default on the loan. You can see that if the business fails, the bank has less risk than my uncle and me. We get what is left after they take what they are owed and we might be left with nothing. On the flip side, if the business does well the bank will not make any extra money - the shareholders (my uncle and I) get all the profits.

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Just like we split stock into shares, a loan can be split into individual bonds. So when you buy a bond you are agreeing to lend money just like a bank officer. You expect to receive interest payments and get your money back at a certain time. And if the company fails – you are first in line to claim the company’s assets.

So which is riskier, purchasing stock in my small business or lending it money by purchasing a bond? The stock is clearly more risky. If the business fails, shareholders will get little or nothing while the bondholders will at least get the value of the assets. Which has the highest potential reward? Again, it is the stock. The “best” outcome for bondholders is getting their money back, plus interest. Shareholders get all profits.

All this leads to an important investment lesson. Investments which have higher potential returns have higher risk than investments which offer lower potential returns. Safe investments will not have high returns. If someone calls you and says they have very safe investments which have very high returns, do not believe it. High returns only come with high risk.

Most investors are well served by owning both stocks and bonds in a portfolio which balances expected risk and return. In future columns I will discuss how investors can control risk by splitting their savings between stocks and bonds as well as using dollar-cost averaging to buy or sell them.

End Note: Investors often get confused by terms. Instead of “stock” many people say “shares” or “equity.” People also use the term “stock” to refer to stock in an individual company, like IBM, or to index funds which own stocks in a number of companies. When we discuss asset allocation at a later date, we will talk about splitting your assets between stocks and bonds and will be referring to the entire spectrum of the stock and bond markets.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This article and others are available at farmcreeksecurities.com. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of any fund. Remember past performance is not an indication of future performance and that there are risks to investing including the loss of principal.