Questions You Were Afraid to Ask

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Most people have probably heard the phrase, “The only bad question is the one left unasked.” But, when it comes to your finances, there’s no such thing as a bad question!
At some point, everyone has a question that they keep to themselves. Maybe it’s because they’re afraid the question is so basic it would be embarrassing to ask. Maybe it’s because they feel they should know the answer already and don’t want to look ignorant.
This report will hopefully answer some questions you may have had, but have been afraid to ask.

Question #1. What’s the Difference Between the Dow, S&P 500, and NASDAQ?

You hear these terms every day when you turn on the news – ‘The Dow closed at 31,000 today’. Or ‘The S&P closed at 3900’. Or ‘The NASDAQ rose 1.6% as tech shares…..’ You know that all those terms refer to “the stock market.” But what, exactly, do they mean? Why is the Dow always so much higher than the S&P? Does that mean it’s better? And what makes the NASDAQ different from the others? The good news is that the answers to these questions are really quite simple. We just need to define some terms! The Dow, S&P 500, and NASDAQ Composite are all indexes. An index tracks the performance of a group of securities, like bonds or – in this case – stocks. Indexes are handy tools because they enable investors to compare current price levels for different segments of the market with past ones, so they can measure performance over time. Some indexes track extremely narrow segments of the market, like companies of a specific size or sector. Others are much broader. What makes the Dow, S&P 500, and NASDAQ different from another is what each index measures.

So, let's take each one at a time.

1. The Dow Jones Industrial Average: This index tracks the performance of 30 of the most prominent companies listed on stock exchanges in America. (Think companies like Apple, Coca Cola, and Walmart.) Because it is so narrow, the Dow isn't always a good indicator of how the overall stock market is doing. But because the companies inside the Dow are so important or well-known, many people have money invested in them. That's why the media pays so much attention to how the Dow is doing.
2. The S&P 500: This index measures 500 of the largest companies listed on American stock exchanges. Now, a quick note: A stock exchange is where traders actually buy and sell stocks. The New York Stock Exchange is the biggest and most famous, but there are many exchanges across the world. Because the S&P 500 tracks so many more companies than the Dow, across a broad range of industries, it is often considered a more reliable snapshot of the overall economy than the Dow.
3. NASDAQ Composite: This index tracks nearly all the stocks listed on the Nasdaq Stock Exchange and is heavily weighted towards technology companies.
4. There are plenty of other indices, too. For example, one of the most important is the…

   Russell 3000: You don't hear about the Russell as much as the previous three, but this index represents nearly the entire U.S. stock market. It includes 3,000 of the country's largest publicly held companies. (There's also the Russell 1000 & the Russell 2000)
5. S&P/TSX Composite: This is the most important index in Canada. It tracks the performance of the 250 largest companies listed on the Toronto Stock Exchange. You can think of it as the Canadian equivalent to the S&P 500.

Question #2. Why is the price of the Dow so much higher than the S&P 500?

Ok. Before answering this, go to your phone or your computer, and open your internet browser and search for "S&P 500." The first result will show the current price of the index. Make a note of the number. Next, search for "Dow Jones." I'm sure you notice how much higher it is? As in, tens of thousands of dollars higher. As you know from the last segment, the Dow tracks the performance of 30 of the most prominent companies listed on stock exchanges in America. The S&P 500, meanwhile, measures 500 of the largest companies listed on American stock exchanges. This is why many investors often wonder why the Dow's total price is so much higher than the S&P, even though the latter contains hundreds more companies. The answer has to do with how these two indices are calculated.

The Dow, for example, is calculated by taking the 30 stocks in the average, adding up their prices, and then dividing the total by the "Dow Divisor." Early in the Dow's history, this divisor was simply the number of companies within the average. Today, the divisor is adjusted regularly to factor in changes to the list of companies, stock splits, and other events that could have an impact on the overall average. As of this writing, the Dow Divisor is 0.15172752595384. Because the divisor is less than one means it technically functions as a multiplier so in effect, calculating the Dow's value essentially means multiplying the sum of each company's price by roughly 6.5. Every $1 change in price to a particular stock within the Dow equates to a movement of 6.59 points on the Dow. This multiplication effect is partly why the Dow's value is so much higher than the S&P 500's. So even though the S&P contains hundreds more companies, its overall price is lower because of how it's weighted.

In an unweighted index, every company has the same impact on the overall index, no matter its price or how many shares are available. The price of the index is determined by simply adding up every company's stock price, then dividing by the total number of companies in the index. For example, imagine an unweighted index containing only three companies. If Company A went up 15%, Company B went up 10%, and Company C went up 5%, the index itself would be up 10%.

Most indices don't work like this, however. That's because not all companies are equal. Some are worth much more than others or have a much higher volume of shares available to buy or sell. For that reason, a simple mean average is a pretty unnuanced way of looking at the overall index. For this reason, most indices are weighted. This means the average is calculated by putting more importance – or weight – on some numbers than others. It's a more accurate way of looking at data. The S&P is a capitalization-weighted index, and the Dow, by contrast, is a much simpler price-weighted index. That means each company is weighted according to its market capitalization……which is the company's share price multiplied by the number of shares available to buy or sell. As you know, some companies are simply bigger than others. Typically, this means they have more outstanding shares, which means a higher market capitalization and more weight within the S&P 500.

So, what's the result? The price movement of these companies has a much bigger impact on the S&P than that of smaller companies. For these reasons, the divisor that the S&P 500 uses is much higher than for the Dow. In fact, it's currently higher than 8,000. And the equation the S&P uses is much more complex. This is all done to keep the value of the index down to a more manageable level, and to prevent the price movement of a few companies from having an even bigger impact on the overall index than they already do.

Question #3. What's better, stocks or bonds?

So, what is a stock, exactly? And how does it compare to other kinds of investments? Even folks with a lot saved for retirement aren't always sure. MANY Americans build wealth and save for retirement through their employers. Maybe they take advantage of a company 401(k) or are awarded company stock as part of their compensation. Either way, they don't spend much time thinking about their investment options, because it's simply not required in order to start investing. As a result, many Americans may have heard of different investment types, or asset classes as they are also known, without truly knowing how they differ, or what the pros and cons of each type are.

When you purchase a bond, you are essentially loaning money to a company, government, or organization.

When you buy stock, you are purchasing partial ownership in a company.

For this reason, stocks are equity investments while bonds are debt investments.

So, before we answer this question, let's examine each.

1) **How Stocks Work**. When you buy a company's stock, you buy a share in that company. And the more shares you buy, the more of the company you own. Generally speaking, stocks can be held for as short or long a time as you wish, but many experts recommend holding onto your shares for longer-term if you anticipate their value will rise over time. For example, let's say ACME Corporation – which makes roadrunner traps – sells their stock for $50 per share. You invest $5000 into the company, which means you now own 100 shares. Now, fast forward five years. ACME's business has grown, investors like what they see, which consequently puts their stock in higher demand. As a result, the stock price is now $75 per share. Because you own

equity in the company, you benefit from its growth, too – and your investment is now worth $2,500 more, for a total of $7,500.

2) **The Pros and Cons of Investing in Stocks**. Every investment has its strengths and weaknesses, and stocks are no exception. The single biggest benefit to investing in stocks is that, historically, they outperform most types of investments over the long term. Because stocks represent partial ownership in a business, finding a strong company that performs well over the course of years and decades can be a powerful way to save for the future. Additionally, stocks are a fairly liquid investment. That means it can potentially be easier to both buy and sell them whenever you need cash. Many other investment types, like bonds, can be more difficult or costly to sell, in some cases locking you in for the long term. But these pros are just one side of a double-edged sword. You see, with the possibility of a higher return comes added risk. While the stock market has historically risen over the long-term, individual stock prices can be extremely volatile, climbing and falling daily, sometimes dramatically. For example, if a company underperforms relative to its expectations, the stock price can go down. Sometimes, companies can even fail altogether, and it's possible for investors to lose everything they put in. As the saying goes, risk nothing, gain nothing — but it's equally true that if you risk too much, you can leave with less. Furthermore, to actually realize any gains you've made, you must sell your stock, which can trigger a significant tax bill.

3) **How Bonds Work.** Bonds potentially rise in value and might be sold for a profit, but generally speaking, that's not what most investors are looking for. Instead, bondholders are hoping something a bit more predictable: Fixed income in the form of regular interest payments. As previously mentioned, bonds are a

loan from you to a company or government. That loan might last days or years – sometimes even up to 100 years – but when the bond matures, the company pays you back your initial investment. In the meantime, the company typically pays you regular interest, just like you would when you take out a loan. Depending on the type of bond you buy, these payments can be annual, quarterly, or monthly. Interest payments are why investors often look to bonds as a source of income.

4) **The Pros and Cons of Bonds.** Income isn't the only "pro" when it comes to bonds. Bonds tend to be less volatile than stocks. Also, since the company that issued the bond is technically in your debt, you would be among the first in line to get at least some of your money back even if the company enters bankruptcy. That's not the case with stocks. But just because bonds are less volatile doesn't mean they're risk-free. Bonds may rise or fall in face value as interest rates change. Face value is typically calculated by seeing what others would likely be willing to pay to take over that debt from you. So, for example, if you bought a bond in Year 1 only to see interest rates go up in Year 2, the value of your bond will likely fall. That's because you are missing out on the higher interest rate payments you would have had if you bought the bond in Year 2 instead. That's important, because if you wanted to sell your bond before it reached maturity, you would probably have to settle for a lower price than what you initially paid.
5) **Stocks and Bonds Together**. As you can see, stocks and bonds each have different advantages and disadvantages. It's why, for many investors, the answer is, "Why not both?" Far from being competitive, stocks and bonds are actually considered complementary. That's because each brings things to the table the other doesn't. Furthermore, stocks and bonds are what's

known as non-correlated assets. That means they don't necessarily move in tandem. Which means just because stocks are down doesn't mean bond values will fall, too. This kind of non-correlated movement is not guaranteed, just as what's true in the stock market right now.

Questions You Were Afraid to Ask #4: What's the Difference Between Passively Managed Funds and Actively Managed Funds?

If you're investing in, say, an IRA, most of the fund choices you'll see will fall under one of two categories: Passive vs Active. Let's start with the latter. An actively managed fund is exactly what it sounds like: A fund where a manager takes an active role in selecting which securities to buy or sell, and when. Different managers have varying styles and philosophies. For example, some may specialize in finding companies they believe are undervalued, which means they can be bought at what is believed to be a good price. Others may try to find companies they think are likely to grow by a significant amount. Some managers may specialize in certain industries or market sectors. You get the idea. Either way, with active management, you are paying for one of two things:

1) The possibility that the fund will "outperform" the market. This means the fund could do better over a specified period than a benchmark index – like the S&P 500 – that it measures against.
2) The possibility that the manager will be able to protect you against undue risk or limit losses during times of market volatility. This idea more generally fits the purpose of hedge funds than the standard mutual funds you'll usually see in your IRA or company 401(k)

The possibility of outperforming the market comes with some tradeoffs, however:

1) Actively-managed funds often come with more – and higher – fees than passively managed funds. That's because the manager must charge for his or her services.
2) While it's possible for a manager to outperform, it's also possible to "underperform." When that happens, you are essentially paying more for less.

Now, let's look at passively managed funds. Here, there is no "active" or research-based management decisions to the buying or selling of holdings. Instead, the fund invests in a specifically designed portfolio and then stays put. The fund may "rebalance" at some other set time frame, often quarterly or annually. This is to reset to its original objective or to match its index better. Otherwise, everything is held for the long-term. These days, many passive funds are index funds. This is when the fund's portfolio is built to try to match a target index, like the S&P 500. So, if you essentially want to replicate a broader stock market, again like the S&P 500, index funds could be the way to go.

Passive funds come with the following advantages:

1) Typically, much lower cost, especially with index funds. Because there's nobody actively picking stocks, the fund could come with fewer expenses, and thus, lower fees.
2) However, the target index performs, with occasional variances, that's how you're likely to perform, too. Given that indices like the S&P 500 have historically risen in value over the longterm, that could make index funds a good option for those who want to invest and forget it for a long period of time.

On the other hand…
There's little chance of outperforming the market. That's an issue if you need more aggressive returns. In addition, index funds come with no specific protection against extreme volatility. Note that when you make your selections in a 401(k) or IRA, you can tell whether a fund is active or passive by reading its summary. It should also be noted that passive vs active doesn't have to be a binary choice. Many investors take advantage of both options in their portfolio! While most funds are either active or passive, there are many types of funds within those two categories.

Questions You Were Afraid to Ask #5: What Differentiates Mutual Funds, Exchange-Traded Funds, and Hedge Funds?

Let's start with mutual funds, one of the oldest and most common ways that people invest. Here's how the Securities and Exchange Commission (SEC) defines mutual funds: A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates. As we've already covered, mutual funds can be either actively managed or passively managed. Regardless of which umbrella the fund falls under, though, many investors flock to mutual funds because they offer several potential benefits:

1) Simplification. Mutual funds can simplify the process of investing because instead of devoting time to researching dozens – or even hundreds – of individual companies to invest in, the fund does it for you. (Note, of course, that you or your financial advisor should still research which fund is right for you.)
2) Diversification. Mutual funds often invest in a wide range of companies and industries to meet the funds stated objective. This could lower your overall risk. This means that if one company/industry does poorly, you may not experience the same kind of loss you would if you invested all your money in that company or industry.

There are potential issues with mutual funds, though. For example, sometimes, it can be difficult to understand what or how the fund actually invests (Mutual funds can differ drastically depending on their objectives, investing style, time horizon, and other factors.) Mutual funds are required by law to provide a prospectus to investors that explains how the fund works, but if you don't know what you're looking at, this information may confuse more than enlighten. This is why it's important to do your homework. This is also true for ETFs and hedge funds.

Mutual funds can also sometimes come with more expenses than other funds, too. They might include management fees, purchase fees, redemption fees and tax costs. These expenses can eat into your returns, thereby lowering your overall profit. Finally, mutual funds may not be a great choice if immediate liquidity is a high priority. All mutual fund trades run at the end of day. So, for example, if you wanted to sell a mutual fund at the beginning of the day, hoping to avoid what you think the market will do, you will still get the end of day price.

For this reason, some investors turn instead to…

1) Exchange-Traded Funds ETFs, as they are often called, can be actively managed. More often, however, they track the companies in a specific index, just like an index fund. Otherwise, ETFs differ from mutual funds in a few ways. For one thing, the shares each investor has in an ETF can be traded on the open market. That means you can buy or sell your shares in an ETF just like you would an individual stock. You can't do that with regular mutual- or index funds. That's a big advantage for investors who value flexibility and liquidity. Most ETFs also come with lower expenses than mutual funds. ETFs fully disclose all holdings held. This makes it easier to see exactly what you are investing in. It also makes it easier to see where you have overlap. But of course, nothing's perfect. Since ETFs can be traded like common stock, that might lead to trading too often. You may find yourself paying more than you anticipated in trading fees. Then, too, some ETFs are thinly traded, meaning there's just not a lot of activity between buyers and sellers. This could make it difficult to sell your shares.
2) Hedge Funds Most people will never invest in a hedge fund. They're generally not an option when investing through a 401(k) or IRA. But I include them in our discussion because I sometimes get asked about them – and for good reason! You often hear about hedge funds in the media, and they're the subject of multiple films. While mutual funds and ETFs can be either passive or actively managed, hedge funds are always active. The idea behind hedge funds is that the manager can use all sorts of strategies and tactics to help investors beat the market while "hedging" – hence the name – against risk. Hedge funds often invest in non-traditional assets beyond stocks and bonds, too. The

reason hedge funds are not an option for most investors is because of the huge cost associated with them. Legally, to invest directly in a hedge fund you must be an accredited investor. Meaning, you must have a net worth of at least $1 million or an annual income over $200,000 to invest in one. Plus, you must be willing to stomach paying all sorts of fees that are much higher than your average mutual fund. For these reasons, while hedge funds may be right for some people, they're simply not necessary for the average investor to save for retirement or reach their financial goals.

Questions You Were Afraid to Ask #6: How do I know which investment options are right for me?

There is no one-size-fits-all answer. No single "best" option. Only the one that is best for **you**, based on your wants, your needs, your nature. This might seem like a no-brainer, but it's critical all the same. That's because, as an investor, you will often hear the media say otherwise. You will hear people claim that the Dow is more important than the S&P (or vice versa). That stocks are better than bonds, or bonds are safer than stocks. That passive is better than active (or vice versa), or that ETFs are always better than mutual funds (or vice versa). As we've seen, the truth just isn't that simple.

Now, I have six questions for **YOU** to consider the answer to. Six questions you must not be afraid to ask. Questions only you can answer. Those questions are as follows: Who, What, When, Where, Why, and How.

1) Who am I? Are you cautious by nature or a risk-taker? Are you a family-oriented person, or more of a lone wolf? An adventurer or a caretaker? Someone with a few simple wants, or big, bold dreams? Or – as many people tend to be – are you a mixture of all these things?
2) What kind of lifestyle do I want? Simple or extravagant? Always trying new things, or staying in your comfort zone? One focused on work and personal accomplishment, or one focused on family and community? Or again – and I can't stress this too much – a mixture of these things, depending on what stage you're at in life?
3) When will I most need money? Do you need it soon because you're buying a new home or starting a new business? Or do you need it later when you're about to retire?
4) Where do I see myself in ten years? Or twenty? Life is all about change and growth. That means you need to ensure you're investing for long-term growth to reach your long-term goals.
5) Why do I need to invest? To help send your kids to college? To retire? To see the world? To give to charitable causes? To feel like you always have a safety net?
6) How will I pay for retirement? This is key. Because, regardless of your other goals, there's probably going to come a time when you want to stop working. But you can't just pick a day to not show up at work. Retirement creates a massive lifestyle change, one that will be quite upsetting to your finances if you don't prepare for it.

To get a second opinion on your retirement outlook and portfolio, give us a call at 800-277-0025 or send an email to asknoel@theprovestperspective.com.

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