



CommonWealth Sense

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Basics of Investing

by

**John E. Comello, CFA Senior Vice President and Chief Investment Officer
First Commonwealth Bank – Trust Division**

If one of your New Year's resolutions is to get serious about saving money – and maybe take the first steps toward making some investments – but you're not sure where to begin . . . this might be the perfect place to get started! This month's CommonWealth Sense article focuses on the basics of investing, including definitions for some of the more commonly used terminology, so that you'll have a head start on this complex topic for your next 'water cooler discussion' or phone call to the Jim Kramer show.

BASIC DEFINITIONS

So, what is investing? Simply put, investing is the creation and implementation of a plan to create wealth. "Investing" should be viewed differently than "Savings" and should not be confused with "Speculation."

- Savings – entails placing money in an account that is very safe and traditionally offers a low rate of return. An individual typically places money in savings to protect the money with little concern for its growth. Savings is a component of a good investment plan, but it should not be considered the entire plan.
- Investing – involves the development of a thoughtful and prudent plan. When investing, an individual knowingly takes on a higher level of risk with the expectation of earning a higher rate of return in order to grow their assets and achieve a defined financial goal(s).
- Speculation – is comparable to gambling in that an individual takes on a high level of risk, without a plan, and hopes that he earns a high rate of return quickly.

PORTFOLIO BUILDING BLOCKS

What are some of the basic building blocks used when implementing an investment plan and building a portfolio? The primary asset classes, or building blocks, used to construct an investment portfolio are stocks, bonds and cash investments.

- Stocks / Equities – are essentially shares of ownership in a particular company. Historically, they have provided the highest long-term returns; however, stocks can be very volatile, particularly over short time periods.
- Bonds / Fixed Income – are essentially loans that the investor is extending to a government or a company. Historically, they have provided modest average long-term returns, but they are generally less risky than stocks.
- Cash / Cash Alternative Investments – include CDs, U.S. Treasury bills and money market funds. While cash investments have historically provided the lowest average annual returns, they are among the safest investments.



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INVESTMENT RISK

What are some of the risks tied to these different asset classes? In an ever-changing world, there are multiple risks that may influence the outcome of an investment plan and the way in which the asset classes/building blocks mentioned above will perform. Below are a few types of risk that influence how the various asset classes perform:

Stock/Equity Risks Include:

- **Market Risk** – Market volatility is a significant risk. Historically, stock prices have skyrocketed and plummeted over short periods of time. Market risk can be reduced by holding stock investments for a long period of time, at least 10 years.
- **Company Specific Risk** – Individual companies experience unique risks. For example, a company may not successfully complete a major project, which would negatively impact the company's ability to generate sales. This development would put it at a disadvantage compared to its competitors and may negatively impact its stock price relative to peers. Company specific risk can be reduced by diversifying. A portfolio that is not well-diversified – is concentrated in just a few stocks – presents company-specific risk.

Bond/Fixed Income Risks Include:

- **Interest Rate Risk** – Bond prices fall when interest rates rise, and they rise when interest rates fall. The longer a bond's maturity, the greater the interest rate risk. Interest rate risk can be reduced, but not eliminated, by investing in shorter-term bonds.
- **Credit Risk** – Bond investors can lose money if a bond issuer defaults or a bond's credit rating is lowered.
- **Call / Reinvestment Risk** – If a bond is called, or repaid, before it matures, an investor must reinvest the proceeds - often at a lower yield.

Cash Investment Risks Include:

- **Inflation Risk** – Rising prices can erode the value or purchasing power of investments. Historically, stock returns have beaten inflation by a wider margin than have the returns of bonds and cash investments.
- **Opportunity Risk** – By investing too many assets in cash investments, an investor may miss the opportunity to earn a better longer-term rate of return in other asset classes.

ASSET ALLOCATION

What is Asset Allocation? Asset allocation is the process of spreading investments among various asset classes such as stocks, bonds and cash investments. This process is considered one of the keystones of a successful investment strategy. The theory behind asset allocation is that allocating money across a mix of different investments helps to reduce risk and positions your portfolio for greater long-term investment success. This technique is valuable because predicting which asset class will perform the best is extremely difficult as performance varies from year to year.

CONCLUSION

The key to structuring a successful portfolio is creating the right mix of assets. To determine the best asset allocation for you is dependent upon your unique circumstances, including risk tolerance. If you are ready to learn more about what First Commonwealth Advisors can do for you, please contact one of our Financial Advisors to get the conversation started. You can reach us at 800-459-3282 or visit us on the web at fcbanking.com.

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