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A few months ago, I started a new series of letters called "*Questions You Were Afraid to Ask.*" Each month, we look at a common question that many investors – especially new investors – have but feel uncomfortable asking. Because when it comes to your finances, there's no such thing as a bad question!

In my last few letters, we looked at bonds and terms such as yield, coupon, maturity, etc. Today, the stock market indices such as the Dow Jones Industrial Average, the S&P 500 Index, and the NASDAQ are trading at all-time highs. It seems everyone is making money in the stock market! But, what is a stock, exactly? How does it compare to other kinds of investments? Even folks with a *lot* saved for retirement aren't always sure. You see, 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. So, over the following three months, we'll break down some of the most important investment types, starting with the two most well-known. Without further ado, let's dive into:

Questions You Were Afraid to Ask:
What's better, stocks or bonds?

When you purchase a bond, you are essentially loaning a company, government, or organization money. When you buy stock, you are purchasing partial *ownership* in a company. For this reason, stocks are **equity investments** while bonds are **debt investments**. Before we answer this question, let's examine how each type works.

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.

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.[1] 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 (or cash out a potential increase in value), you must sell your stock, which can trigger a significant tax bill.

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 for something a bit more predictable: Fixed income in the form of regular interest payments.

As we discussed in previous letters, 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.

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.

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[1] *"Stocks vs. Bonds", Longtermtrends, https://www.longtermtrends.net/stocks-vs-bonds/*

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.

Stocks and Bonds Together

As you can see, stocks and bonds each have different advantages and disadvantages. That's why neither is "better" than the other. It's also why, for many investors, the real 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. For example, say the stock market goes down. Just because stocks are down doesn't mean bond values will fall, too. In fact, it's possible they go up! And of course, the inverse is also true.

(Understand that this kind of non-correlated movement is *not* guaranteed. The point is that allocating a portion of your portfolio to both stocks *and* bonds is a good way of not keeping all your eggs in one basket.)

Obviously, I could go on for pages and pages on the ins and outs of stocks and bonds. This letter just scratches the surface. But hopefully it gives you a better idea about how these two important asset classes work and why people should consider *both* when it comes to investing for the future.

Of course, choosing *which* stocks and bonds to buy is an entirely different subject…and it's why next month, we'll break down how some investors get around this problem by putting their money in **funds**.

In the meantime, have a great August!

Sincerely,

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