

THE STAN CLARK FINANCIAL TEAM'S

P E R S P E C T I V E S

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Financial Planning

STOCKS VS. BONDS: WHAT'S THE DIFFERENCE?

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Previously we've discussed both Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSA's). It's also important to talk about what to invest in.

There are many types of investments: individual stocks, bonds, preferred shares, mutual funds, exchange-traded funds... The list seems endless. We can't cover every type of investment here, but we'd like to look at the two main groups of investments or asset classes: *stocks* and *bonds*. Almost every type of investment is made up of one or the other, or a mixture of the two. Stocks and bonds are very different, and the balance between them can really affect your returns and your risk.

First, let's examine the difference between stocks and bonds. Then, second, how best to allocate money between them.

Stocks

In simple terms, stocks represent ownership in a company. If a company does well, it's likely that the stock price will go up. The reverse is also true: If a business performs poorly, the stock price will likely go down. When we talk about doing well or poorly, the most important measure is the company's *profits*, a.k.a. its earnings, which are simply its revenues less its expenses. Those earnings belong to the owners of the company, those who own its stock.

The tricky thing is, it's not just the past earnings that determine how a company's stock price fares. It's mostly what investors think the future earnings will be. Another important factor is the dividends you can expect, that is, the part of the earnings that a company decides to pay out to its owners.

With stocks you will participate in the company's ups and downs. But future company results are uncertain. Add in human psychology and you get volatile stock markets. It's true that, over the short term, anything can happen with stocks. But over the long term – that is, over 10+ year periods – stocks as a whole have been reasonably safe. That's because earnings across all companies tend to be very persistent. And, over the long term, the large short-term price swings tend to cancel each other out. In the long term, stocks have provided the best returns for any major asset class.

Bonds

With bonds, you are lending money to a government or company for

a specified term. The bonds pay you interest. Then, at the end of the term, you get your money back.

Bonds are generally viewed as safe investments, as you should be getting all your interest payments and principal back. But bonds are not all the same, especially corporate bonds. Bonds have credit ratings to indicate the risk level of not getting the interest you expected, or even of not getting all your money back.

If the interest rate on a corporate bond is a lot higher compared to an ultra-safe bond, it's a good indication that the risks are also a lot higher. And, that things might not go as expected. Remember: There's no free lunch!

The right mix

Now that we generally know what stocks and bonds are, how to decide what amount of money to have in each? Each group has its advantages and drawbacks. Since everyone's circumstances are different, the mix of how much to have in each varies from person to person.

From the outset it might seem that stocks are the way to go. They're often a more exciting route and the potential returns are attractive. However, a balance is important, and the mix has a huge impact on your portfolio. The right mix depends on a lot of factors, but essentially revolves around your needs, how long you are investing for and how much volatility you can handle. One of the worst things to happen would be suddenly needing your savings and being forced to sell your stocks in a down market. It's a scenario you'd find very difficult to recover from.

When you are younger, you can usually take some risks. If you are saving for retirement and it's a long time from now, you might be comfortable taking more risks with your investments. But what if you are saving for something in the near future, like a car or a place of your own, or a growing family? In that case, it makes sense to be more conservative. Again, everyone is different. We encourage you to create a mix that is right for your unique situation.

As we get older, things change and our mix can change, too. It's important to pause every so often to see where things are at, and then reassess as needed.

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