Investing Basics

Holding steady in an unpredictable market

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If you’ve been listening to the news lately, you might be wondering how anyone still has the stomach for investing. Market swings have been severe, and can be quite disconcerting. But these up-and-down market cycles are normal. Historically, leaving your investments alone has proven a smart investment strategy in most circumstances. But if you’re starting to have doubts, it’s a good idea to brush up on your understanding of the markets and determine your motivation for investing in the first place.

Let’s begin with some basics.

How the stock market works

The stock market allows everyone the opportunity to participate in both national and international economies by investing in businesses. Many people consider investing in the stock market one of the best ways to create wealth. It is not, however, a sure thing. The generation of wealth does not come without risk.

The reason for fluctuations in the stock market is that it reflects the rise and fall of the companies that participate in it. When the economy is prospering and companies are doing well, the stock market generally reflects that. When the economy is faltering, like it has been recently, the stock market reflects that as well.

If you are invested in the stock market, you own shares of companies. To “get your money out,” you have to sell your shares. There are good times to do this, like when the price has risen and you can sell the stock for more than you paid for it, and there are not-so-good times. A declining stock market is generally not a particularly good time to sell stocks. To sell your shares during a downturn will likely defeat your purpose for investing. It could mean that you will receive less than you originally paid for a stock.
What is a stock?

A stock is a piece of ownership in a corporation. Each unit of ownership is called a share. When companies need to raise money to grow their businesses, they can either borrow from banks or issue stock. By selling stock, they actually issue units of ownership in their companies.

Stock prices change as a result of many factors that cause them to constantly shift. But ultimately, the price of a stock is similar to the price of your house — it's only worth what somebody else is willing to pay for it. If a company releases a popular new product, for instance, investors may feel confident about the company’s prospects for success and will be willing to pay more for its stock. But if that product fails to sell, the price of the company’s stock may suffer.

What is a bond?

A bond is another way for a company to raise money, but it’s more like a loan. Basically, it’s an IOU issued by a corporation or government. When you purchase a bond from a corporation, you loan that corporation money. In return, the corporation agrees to repay the money to you at a specified date in the future, and make interest payments to you in the meantime. The amount of interest is called the “coupon,” and it’s usually a fixed percentage. For this reason, bonds are often referred to as “fixed-income” securities. However, a bond’s market value can fluctuate as interest rates change. As interest rates rise, bond prices will fall.
What are cash equivalent investments?

Cash equivalents typically offer lower rates of return than longer-term equity or fixed-income securities; however, they provide a level of liquidity and price stability not usually available in these other investments. Some common cash equivalents are:

**Bank certificates of deposit and money market accounts** — Bank CDs and money market accounts offer the protection of federal deposit insurance up to $100,000.¹

**U.S. Treasury bills** — These IOUs are backed by the full faith and credit of the United States government.

**Money market mutual funds** — Money market funds invest in certain high-quality, short-term investments issued by the U.S. government, U.S. corporations and state and local governments and are subject to strict diversification and maturity standards.²

What is a mutual fund?

Mutual funds are collections of stocks, bonds, or money market instruments, designed to meet a specific financial objective. The funds pool investors’ money and, depending on their objectives, they invest in one of these types of securities or a combination of them. Mutual fund investors, or shareholders, own a proportional unit, or “share,” of all the securities owned by the fund.

Mutual funds are a popular way to invest because they provide a simple way to create a diverse portfolio of stocks or bonds. Even if you choose just one mutual fund, you’ll typically be investing in a variety of securities. The funds are managed by professionals who monitor the investments constantly and are supported by teams of analysts and researchers. This alleviates the burden on the individual investor of creating and maintaining a diverse portfolio of investments.³

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¹ Under FDIC coverage, if a bank or savings association fails, each depositor generally is insured for up to $100,000 ($250,000 effective Oct. 3, 2008, through Dec. 31, 2009) for non-retirement accounts, and up to $250,000 for IRAs and certain other retirement accounts.

² An investment in money market funds is neither insured nor guaranteed by the FDIC or any other government agency. Although money market funds seek to preserve the value of your investment at $1 per share, it is possible to lose money by investing in these funds.

³ Diversification does not ensure a profit or protect against loss in a declining market.
No matter what the markets are doing, there are some basic rules that can help you become a more successful investor.

**Diversification and asset allocation**

Experts advise that putting all your money into just one stock, bond, or mutual fund is generally a bad idea. You’d be taking a very big gamble that just one investment could provide you with the financial returns you seek. That’s why most suggest that you choose a number of different investments and diversify your portfolio. Although it does not guarantee a profit or protection against loss in a declining market, diversification can help to reduce risk. When one investment is experiencing a downturn, another might offset it by performing strongly.

Asset allocation is a term used to describe the action of spreading your money among different investments to reduce your overall risk.

**Risk and time horizon**

Every investment contains some level of risk. Before you consider investing, it’s important that you know, and are comfortable with, that risk.

Generally, the combination of investments you choose has the largest effect on your overall risk. A stock generally contains more risk than a bond, and a bond is generally riskier than a money market instrument. But along with the risks come potential rewards. Usually, the more risk you take, the more potential you have for reward. The chart on the next page illustrates the returns for the different asset classes over time.
By choosing varied investments, whether stocks, bonds or mutual funds, you lessen the risk of any one investment type dominating your portfolio.

To help your investment strategy be successful, you’ll need time. In fact, choosing your investments should be based heavily on when you’ll actually need to use your money. If you’ll need it soon, you’ll probably want to stick with conservative investments with a relatively low level of risk. But if you have 10 or 15 years until you’ll need the money, and you’re reasonably sure that you can stick with your strategy through the market’s cycles in the interim, you may want to consider investments with more growth potential.
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