The Basics of 401(k) Investing: Four Main Types of Investments

401(k) money management is critical to your long-term financial security. For participants, the return on their investments could be several times the amount they save. In most 401(k) plans, your employer will offer you a range of investment funds from which to choose. Some 401(k) plans also offer other types of options, like a brokerage window or a professionally managed account.

Generally, four types of assets make up the investment funds in a 401(k) plan: stocks, bonds, cash, and real estate. Each of these has different traits, such as rate of return, purpose, risk, and appropriate time span for investment.

Stocks

Average Rate of Return:	Approximately 10%
Purpose:	Growth
Risk:	High
Time Span:	Long term, typically 10 years or more

If you own a company's stock, you are a part owner in that company. Because you are a part owner, you have a piece or share of the equity in that company. That is why stocks are also called equities. If the company has 100 shares of stock and you own one share, you own 1/ 100th of the company. The value of a share of stock is the total market value of the company divided by the number of shares. The stocks of public companies are traded on a stock exchange and you can look up their value in your daily newspaper. The stock of a privately held company is owned by an individual or small group and is not actively traded.

Stocks generate return in two ways. First, successful companies increase in value. This means that the value of the stock also increases, increasing the wealth of stockholders. Second, some companies pay some or all of their profits to their stockholders. These payments are called dividends. The size of a dividend will vary with the short-term success of the company. Dividends are usually not paid during periods when a company is not profitable. While increases in value as seen daily can be volatile, dividends (when available) are much more consistent.

Stocks provide a high rate of return (on average, approximately 10 percent). However, the value of stock can change dramatically in a short period of time. For this reason, if you invest in stocks you should be investing for the long term.

Bonds

Average Rate of Return:	Approximately 6%
Purpose:	Set return
Risk:	Medium
Time Span:	Intermediate, typically four to 10 years

Bonds are issued by the government, by corporations, and by financial institutions. When you buy a bond you are lending money to the issuer in exchange for a set amount of interest paid until a specific date, at which time the bond is said to mature and the principle is repaid. Typically, bonds pay interest every six months, but other payment schedules are possible. Some bonds pay all of the interest on the date they mature.

Until a bond matures, its value will fluctuate because of market interest rates, which rise and fall based on the outlook for inflation. It may seem contradictory, but if interest rates go up, bond prices go down. If interest rates go down, bond prices go up. This occurs because a bond's interest rate is a set percentage of the value of the bond when it was issued. If during the life of the bond interest rates go down, the value of the bond goes up. This is because at this point in time it takes a bigger investment to get the same amount of interest. The opposite happens as interest rates go up, the bond becomes less valuable. Think of a teeter-totter, with bond values on one side and interest rates on the other.

However, if you buy an individual bond, the amount of your original investment is always returned to you on the bond's maturity date (unless the bond issuer defaults on the promise to pay you back). As a result, bond values are not as volatile as stocks. Because bonds give you a set rate of return for a known period, they can be especially valuable as a retirement investment. They are well suited for investing to obtain a predictable stream of income. But because bond returns on average are 5 to 6 percent, bonds should not be the major component of a long-term investment program.

Cash

Average Rate of Return:	Approximately 3%
Purpose:	Safe
Risk:	Low
Time Span:	Short, typically three years or less

Some part of every portfolio is invested in cash. Cash investments are investments that are safe from loss of principal. Money market funds and certificates of deposit are both types of cash investments. These are the most stable investments, but they provide the least return on your money. Cash investments are a good place to hold your funds temporarily while you seek a better investment choice, or if you plan to take out the money in a relatively short period. Money in cash options is safe, but should not be left there for long. After two or three years, inflation will start to erode the purchasing power of your investment.

Real Estate

Average Rate of Return:	Varies
Purpose:	Diversification
Risk:	Medium to High
Time Span:	Long term, typically 10 years or more

In addition to stocks, bonds, and cash, you may also be able to invest in real estate. If you own your home, you are already a real estate investor. A real estate investment can increase in value and generate rental income. On the other hand, real estate investments are often hard to sell, have high fees at purchase and sale, and require considerable management. The advantage of real estate is that it gives you another type of asset that reacts to market conditions differently than stocks, bonds, and cash. Real estate is well suited for investing to obtain a stream of income from rents or growth in the value of the property. Due to the high cost to purchase and sell a property, if you invest in real estate you should be investing for the long term.