Types of Investment Instruments

Diversification spreads risk across different Asset Classes

Investors can choose from a wide range of assets for their investment portfolios. The two basic types of investment instruments are fixed-income (Bonds) and equity (Stocks). Fixed-income assets provide relative safety of capital and regular interest payments, while equity provides the potential for long-term capital appreciation. The asset mix depends on short-term cash flow needs, long-term financial objectives and tolerance for market risk.

Cash

Cash instruments include savings and checking accounts, certificates of deposit and money market accounts. These safe and liquid investments earn modest returns on investment. They also provide financial flexibility because you can use them for emergencies, living expenses and buying other assets at attractive prices.

Bonds

Companies and governments issue bonds to raise capital for operational and strategic needs. Bond investors receive regular interest payments and get the principal back on maturity. Bond prices rise when interest rates fall and fall when rates rise. Government bonds are safer than corporate bonds. U.S. Treasuries are risk-free because the U.S. government backs them. Credit rating agencies assign risk ratings to bonds based on several factors, including a bond issuer's financial strength and ability to fulfill its debt obligations. Low-rated bonds have to pay higher interest rates to compensate investors for taking on the higher risk.

Equity

Companies issue stock to raise capital for various needs. Stocks trade on regulated exchanges, such as the New York Stock Exchange, or on over-the-counter markets. Investment portfolios benefit from rising stock prices but suffer during periods of market volatility. This is why diversification across different industries is so important. Some companies pay dividends, which are cash distributions to shareholders from after-tax profits. The main risk of equity investments is that deteriorating business conditions lead to falling profits and stock prices.

Mutual Funds

Mutual funds offer diversification at reasonable costs because the fund companies are able to spread the fees and expenses over a large asset base. Stock funds invest in stocks, bond funds invest in bonds and balanced funds invest in a mix of stocks and bonds. There is further specialization within these categories. For example, technology stock funds invest only in technology stocks, while international funds invest in certain regions of the world. The disadvantage is that you have no control over investment decisions but must pay fees and other expenses regardless of performance. Exchange-traded funds are similar conceptually to mutual funds, except that they trade like stocks on exchanges and track market indexes and sub-indexes. ETFs offer convenience and sector diversification at lower costs than regular mutual funds.

Commodities

You can invest in gold, silver and other commodities. Some use gold and other precious metal assets to hedge against inflation and as a storage of value during periods of economic uncertainty. Commodity prices are volatile, and there is the risk of significant capital loss in a short period. Individual investors can gain exposure to this sector cost-effectively through commodity mutual funds and exchange-traded funds.

Other

Other investment instruments include real estate, Business Development Corporations (BDCs) and small businesses. Residential and commercial real estate investments can offer investors attractive rates of return, especially during periods of economic expansion. Small businesses, such as franchise outlets or retail stores, could be a worthwhile investment of both time and money. You can also invest in derivatives, such as options and futures, to speculate or to hedge positions in stocks and other assets.

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