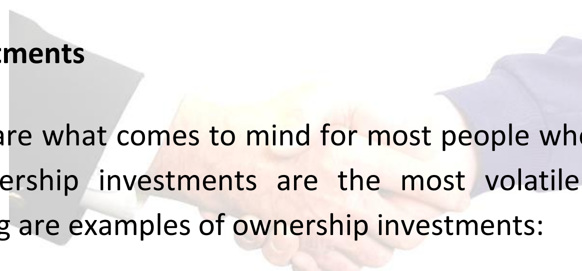
Three Types of Investment

The word "investment" has become muddled with overuse. Referring to a stock or a bond as an investment is still in regular use, but now people make "investments" in their education, their cars and even their flat screen TVs.

In this article, we will look at the three basic types of investment as well as some of the things that are definitely not investments - no matter what the commercial says.

The Three Types of Investment

Investment, as the dictionary defines it, is something that is purchased with money that is expected to produce income or profit. Investments can be broken into three basic groups: ownership, lending and cash equivalents.



1. **Ownership Investments**

Ownership investments are what comes to mind for most people when the word "investment" is batted around. Ownership investments are the most volatile and profitable class of investment. The following are examples of ownership investments:

a. **Stocks**

   Stocks are literally certificates that say you own a portion of a company. More broadly speaking, all traded securities, from futures to currency swaps, are ownership investments, even though all you may own is a contract. When you buy one of these investments, you have a right to a portion of a company's value or a right to carry out a certain action (as in a futures contract).

Your expectation of profit is realized (or not) by how the market values the asset you own the rights to. If you own shares in Sony and Sony posts a record profit, other investors are going to want Sony shares too. Their demand for shares drives up the price, increasing your profit if you choose to sell the shares.

b. Business

The money put into starting and running a business is an investment. Entrepreneurship is one of the hardest investments to make because it requires more than just money. Consequently, it is also an ownership investment with extremely large potential returns. By creating a product or service and selling it to people who want it, entrepreneurs can make huge personal fortunes. Bill Gates, founder of Microsoft and one of the world's richest men, is a prime example.

c. Real Estate

Houses, apartments or other dwellings that you buy to rent out or repair and resell are investments. The house you live in, however, is a different matter because it is filling a basic need. The house you live in fills your need for shelter and, although it may appreciate over time, it shouldn't be purchased with an expectation of profit. The mortgage meltdown of 2008 and the underwater mortgages it produced are a good illustration of the dangers in considering your primary residence an investment.

Precious Objects

Gold, Da Vinci paintings and a signed LeBron James jersey can all be considered an ownership investment - provided that these are objects that are bought with the intention of reselling them for a profit. Precious metals and collectibles are not necessarily a good investment for a number of reasons, but they can be classified as an investment nonetheless. Like a house, they have a risk of physical depreciation (damage) and require upkeep and storage costs that cut into eventual profits.

2. Lending Investments

Lending investments allow you to be the bank. They tend to be lower risk than ownership investments and return less as a result. A bond issued by a company will pay a set amount over a certain period, while during the same period the stock of a company can double or triple in value, paying far more than a bond - or it can lose heavily and go bankrupt, in which case bond holders usually still get their money and the stockholder often gets nothing.

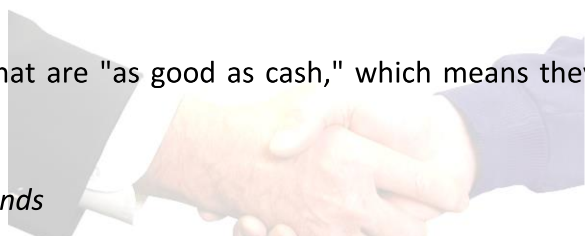
3. *Your Savings Account*

Even if you have nothing but a regular savings account, you can call yourself an investor. You are essentially lending money to the bank, which it will dole out in the form of loans. The return is pitiful, but the risk is also next to nil because of the Federal Deposit Insurance Corporation (FDIC).

a. Bonds

Bond is a catchall category for a wide variety of investments from Treasuries and international debt issues to corporate junk bonds and credit default swaps (CDS). The risks and returns vary widely between the different types of bonds, but overall, lending investments pose a lower risk and provide a lower return than ownership investments.

b. Cash Equivalents



These are investments that are "as good as cash," which means they're easy to convert back into cash.

c. Money Market Funds

With money market funds, the return is very small, 1% to 2%, and the risks are also small. Although money market funds have "broken the buck" in recent memory, it is rare enough to be considered a black swan event. Money market funds are also more liquid than other investments, meaning you can write checks out of money market accounts just as you would with a checking account.

Close, but Not Quite

Your education is called an investment and many times, it does help you earn a higher income. A case could be made for you "selling" your education like a small business service in return for income like an ownership investment.

The reason it's not technically an investment is a practical one. For the sake of clarity, we need to avoid the ad absurdity of having everything be classified as an investment. We'd be "investing" every time we bought an item that could potentially make us more productive, such as investing in a stress ball to squeeze or a cup of coffee to wake you up. It is the attempt to stretch the meaning of investment to purchases, rather than education, which has obscured the meaning.

Not Investments

Consumer purchases - beds, cars, TVs and anything that naturally depreciates with use and time - are not investments. As an example, you don't invest in a good night's sleep by buying a foam pillow. Unless you're very famous, and even then, it's a stretch, since you can't reasonably expect someone to pay more for your pillow than the initial purchase cost. Don't take it personally, but there's very little demand in the second-hand pillow market.

The Bottom Line

There are three types of investments: ownership, lending and cash equivalents. There is no fourth category of consumer purchases.

Admittedly, it's a clever piece of advertising that removes some of the guilt from impulse purchasing; you're not spending money frivolously, you're investing! The decisive test is whether there is a potential to turn a profit. The important word is "potential" because not every legitimate investment makes money.

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