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How Will Your Investment Make Money?

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Congratulations! After two years of saving and sacrifice - sweat and overtime - you have finally accumulated enough money to begin investing outside of your retirement accounts. You have just spent the afternoon with your new broker, while he or she went over a myriad of investment choices with you, explaining each one in detail and causing your head to swim.

Your broker presented you with several hypothetical scenarios outlining the overall rate of return that you could expect to receive in each case, until finally you decided to purchase some stock in a local company that you're somewhat familiar with. But, as you drive away from his office, the ocean of information that was presented to you is already beginning to recede from your overtaxed brain. *What exactly am I going to get out of this, and how am I going to get it?* This article defines the basic types of investment income and which asset classes pay them.

Interest

Interest income is paid on any kind of debt instrument as compensation for loaning the investor's principal to the borrower, or issuer. This type of income is paid by several different types of investments, listed as follows:

- Fixed-income securities, such as CDs, bonds and mortgage-backed securities (MBS). The rate of interest is usually preset and lasts until the security matures, or is called or put.
- Demand deposit accounts, such as checking, savings and money market accounts. Depositors receive interest as compensation for parking their cash in the account from the depository institution.
- Fixed annuities, which pay a set rate of interest on a tax-deferred basis until maturity.
- Seller-financed mortgages, where the seller charges an agreed-upon rate of interest on the principal that is loaned to the buyer.
- Mutual funds that invest in the above vehicles.

No form of equity pays interest of any kind. Each of these debt instruments pays a stated rate of interest. This rate is usually fixed, but can be variable depending upon the terms of the investment. The rates for demand deposit accounts usually fluctuate, according to changes in interest rates, while the rates for bonds, CDs and fixed annuity contracts usually stay constant until maturity. Interest-bearing investments are always tied to current interest rates, and cannot by nature pay rates high enough to beat inflation over time, unless they are high-risk vehicles such as junk bonds. (Don't be fooled by the name - junk bonds may be for you if you know how to analyze them. Be sure to read *Junk Bonds: Everything You Need To Know*, to learn more.)

Most interest-bearing securities carry a rating, such as AAA or BB, assigned by one of the major rating agencies, such as Standard and Poor's (S&P). If this rating declines after a security is issued, this could be a possible indicator that the issuer will default on their obligation. A noticeable decline in revenues, profits or liquidity could be another warning sign. Of course, in many cases, these changes will result in a lower rating. (Read *What Is A Corporate Credit Rating?* to learn how a credit rating is an essential tool for investors considering buying debt securities.)

Dividends
Dividends are a form of cash compensation for equity investors. They represent the portion of the company's earnings that are passed on to the shareholders, usually on either a monthly or quarterly basis. Dividend income is similar to interest income in that it is usually paid at a stated rate for a set length of time. But dividends are only paid on stocks, or from mutual funds that invest in stocks. However, not all stocks pay dividends. In general, only established corporations pay dividends, while small cap enterprises usually retain their cash for future growth. (Be sure to read *How and Why Do Companies Pay Dividends?* to explore the arguments for and against company dividend policy.)

Dividends are paid on both common and preferred stocks, although the rate is usually higher on preferred stocks than common. Dividends can also be either ordinary, which are taxed as ordinary income, or qualified, which are taxed as long-term capital gains. In most cases, companies are not required to pay dividends, at least on common stock. Because dividends are a function of corporate revenue, poor cash flow or profit margins can signal an upcoming reduction or absence of dividend payments to shareholders. Dividend yields can vary, according to the type of security upon which they are paid; common stock dividends tend to fluctuate with a company's current profitability, while preferred stock dividends are generally tied to interest rates. Because they are considered higher-risk investments than bonds, the yields on preferred stocks tend to float at a rate above that of CDs or most types of bonds, except perhaps junk bonds. (Read *The Importance Of Dividends*, to learn more about the usefulness of this lucrative distribution.)

Capital Gains
Capital gains represent the appreciation in the price of a security or investment from the time that it was purchased. These gains can be either long or short term, depending upon whether the instrument sold was held for more than a year. Both equity and fixed-income securities can post gains (or losses). However, while fixed income securities can appreciate in price in the secondary market, they are designed primarily to pay current interest or dividends while stocks and real estate provide the bulk of their reward to investors in the form of capital gains. Historically, the gains posted by stocks and real estate are the only investment returns that have outpaced inflation over time, which is one of their chief advantages. Of course, the markets move in two directions, and any security or investment capable of posting a gain can also result in a loss. Equities rise and fall with the overall markets as well as from corporate performance.

Tax Advantages
A few types of investments produce tax-advantaged income of various kinds. Working interests in oil and gas leases generate revenue that may be 15% tax-free because of the depletion allowance. Limited partnerships, which usually invest in either real estate or oil and gas, can pass through passive income, which is income generated from partnership activities that the investor is not actively involved in managing. Passive income can be written off with passive losses, which are usually expenses associated with operating the income-generating activities of the partnership. (Asset location is a tax

minimization strategy that takes advantage of the face that different types of investments get different tax treatments. Read *The Importance Of Asset Location* to learn more.)

Total Return

Of course, many types of investments provide more than one type of investment return. Common stocks can provide both dividends and capital gains. Fixed-income securities can also provide capital gains in addition to interest or dividend income. And partnerships can provide any or all of the above forms of income on a tax-advantaged basis. Total return is calculated by adding capital gains (or subtracting capital losses) to dividend or interest income and factoring in any tax savings.

Conclusion

Different types of investments post different types of returns. Some pay income in the form of interest or dividends, while others offer the potential for capital appreciation. Still others offer tax advantages in addition to current income or capital gains. All of these factors together comprise the total return of an investment.

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Mark P. Cussen has over 13 years of experience in the financial industry, which includes working with investments, insurance, mortgages, taxes and financial planning. He has two years of experience in writing and editing insurance and securities test training manuals, as well as other financial topics. He has also worked in in retail, discount and bank brokerage systems and been involved in a venture capital enterprise in the oil and gas sector. Cussen has a Bachelor of Science in English from the University of Kansas and completed his CFP®; coursework at the Bloch School of Business at the University of Missouri-Kansas City in August of 2001.