ROUND TABLE
WEALTH MANAGEMENT

A MOMENT OF CLARITY

Stocks vs. Bonds

BY THEODORE SCHNEIDER

Stocks and Bonds are two financial instruments that are typically the core of any investor's portfolio. But do you know exactly what constitutes a stock or bond, or whether you should invest in a stock, a bond, or both? This primer gives a brief overview of what stocks and bonds are, their benefits and drawbacks to an investor, their relationship with each other, and how an investor may pair them together in an investment portfolio.

Bonds

What is a bond?

A bond is a debt instrument (loan) issued by an individual entity or institution that pays the lender (you) interest over time with repayment of the principal amount (loaned amount) at a specified date in the future. Bonds are generally referred to as "fixed income" due to the fixed interest payments they provide. Bonds are most often issued by governments, corporations, or municipalities.

What are the benefits of investing in bonds?

Bonds promise a fixed return amount in addition to repayment of original principal, making bond investments more predictable. Bondholders also take priority on the capital structure of a company, meaning that they receive preference at the time of repayment above any equity holders.

What are the drawbacks to investing in bonds?

Bondholders do not own any interest in the company and therefore do not participate in the company's financial growth. Similarly, bondholders do not have voting rights and thus have limited-to-no influence on the company's operations and governance. Additionally, the interest paid on bonds is taxed as ordinary income and as a result taxation is generally higher than that of a stock.

What is the potential risk vs. return in bonds?

Bonds are subject to less relative risk (volatility) when compared to stocks. The lower-risk of bonds leads to lower overall returns when compared to stocks. Bonds are generally used as a low-risk investment for investors that desire income, have a low-risk tolerance and/or have a shorter-term investment horizon.

Stocks

What is a stock?

A common stock is a financial instrument issued by individual companies that gives ownership interest to the stockholder. Stocks are generally referred to as "equity" because they provide equity ownership in the company.

What are the benefits of investing in stocks?

The benefit of a stock is the ability to actively participate in the success of the company. If the company experiences significant growth, the price of the stock should rise in accordance with that growth, benefitting stockholders. Generally, stockholders also receive voting rights, allowing them to take a more active role in the how the company is operated and governed. Additionally, returns on a stock are generally taxed at a lower rate than the income received from bonds.

What are the drawbacks to investing in stocks?

Equity stock holders sit on the lowest rung of a company's capital structure, meaning that they are the last to get repaid in a bankruptcy or liquidity event. Unlike bonds, stocks make no promises of future returns. Stocks take on a higher level of risk than bonds and thus are less predictable and more susceptible to the future financial success of the company.

What is the potential risk and return in stocks?

Stocks are subject to a higher risk than bonds since they are positioned lower on the capital structure and make no guarantees relating to future returns. To compensate for the higher level of risk, stocks offer potential for higher returns through the combination of dividends and capital appreciation (gain in stock price). Stocks are used by investors seeking to generate increased returns who have a higher risk tolerance and/or have a longer-term investment horizon.

What Should I Invest in – Stocks, Bonds, or Both?

While stocks and bonds display many contrasting characteristics, they can make an advantageous pair in an investment portfolio. In most circumstances, it is prudent for investors to invest in a combination of stocks and bonds to gain the benefits of each investment instrument as well as to help offset their drawbacks. Stocks and bonds act as compliments in an investment portfolio and can be used to find the right balance of risk and return to achieve an investor's objectives.

Stocks and bonds have historically exhibited an inverse relationship regarding investment performance—when stocks have a challenging year, bonds tend to do well (or maintain their value) and vice versa. This relationship is useful to help smooth out the performance of an investment portfolio over a given time horizon. Interesting fact: The S&P 500 Index, the most referenced U.S. stock index, and the Bloomberg Barclays U.S. Aggregate Bond Index, the most referenced U.S. bond index, have never both reported a negative return in the same calendar year!

Your Round Table Wealth Advisor can help you determine the appropriate mix of stocks and bonds for your investment portfolio and financial goals.

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Stocks vs. Bonds Comparison

	Bond	Stock
Definition:	A debt instrument issued by an individual entity or institution that pays the lender interest over time with repayment of the principal amount (loaned amount) at a specified date.	A financial instrument issued by individual companies that gives ownership interest to the stockholder.
Financial Instrument:	Debt	Equity
Pros:	Priority in repayment, predictable returns, current income.	Voting Rights, ownership stake, participation in company growth.
Cons:	No ownership, no voting rights, interest payments taxed are ordinary income rate.	Last to get repaid, no promise of future returns, participation in company failure (capital depreciation).
Risk:	Lower Risk	Higher Risk
Return:	Lower Expected Return	Higher Expected Return
Tax Treatment:	Ordinary Income Rate (10%-37%)	Capital Gains/Qualified Dividend Rate (0%-20%)

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