

CHAPTER ONE

INTRODUCTION TO INVESTMENT

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Learning Objectives

The objective of this chapter is providing an understanding of:

- Concept of Investment and investing activities
- Securities market
- Stock exchanges and their trading systems

1.1. What is investment?

For most of your life, you will be earning and spending money. Rarely, though, will your current money income exactly balance with your consumption desires. Sometimes, you may have more money than you want to spend; at other times, you may want to purchase more than you can afford. These imbalances will lead you either to borrow or to save to maximize the long-run benefits from your income.

When current income exceeds current consumption desires, people tend to save the excess. They can do any of several things with these savings. One possibility is to put the money under a mattress or bury it in the backyard until some future time when consumption desires exceed current income. When they retrieve their savings from the mattress or backyard, they have the same amount they saved.

Another possibility is that they can give up the immediate possession of these savings for a future larger amount of money that will be available for future consumption. This tradeoff of *present* consumption for a higher level of *future* consumption is the reason for saving. What you do with the savings to make them increase over time is *investment*.

Those who give up immediate possession of savings (that is, defer consumption) expect to receive in the future a greater amount than they gave up. Conversely, those who consume more than their current income (that is, borrow) must be willing to pay back in the future more than they borrowed.

The rate of exchange between *future consumption* (future dollars) and *current consumption* (current dollars) is the *pure rate of interest*. Both

people's willingness to pay this difference for borrowed funds and their desire to receive a surplus on their savings give rise to an interest rate referred to as the *pure time value of money*. This interest rate is established in the capital market by a comparison of the supply of excess income available (savings) to be invested and the demand for excess consumption (borrowing) at a given time. If you can exchange \$100 of certain income today for \$104 of certain income one year from today, then the pure rate of exchange on a risk-free investment (that is, the time value of money) is said to be 4 percent ($104/100 - 1$). Present consumption for a higher level of *future* consumption is the reason for saving. What you do with the savings to make them increase over time is *investment*.

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The investor who gives up \$100 today expects to consume \$104 of goods and services in the future. This assumes that the general price level in the economy stays the same. This price stability has rarely been the case during the past several decades when inflation rates have varied from 1.1 percent in 1986 to 13.3 percent in 1979, with an average of about 5.4 percent a year from 1970 to 2001. If investors expect a change in prices, they will require a higher rate of return to compensate for it. For example, if an investor expects a rise in prices (that is, he or she expects inflation) at the rate of 2 percent during the period of investment, he or she will increase the required interest rate by 2 percent. In our example, the investor would require \$106 in the future to defer the \$100 of consumption during an inflationary period (a 6 percent nominal, risk-free interest rate will be required instead of 4 percent).

Further, if the future payment from the investment is not certain, the investor will demand an interest rate that exceeds the pure time value of money plus the inflation rate. The uncertainty of the payments from an investment is the *investment risk*. The additional return added to the nominal, risk-free interest rate is called a *risk premium*. In our previous example, the investor would require more than \$106 one year from today to compensate for the uncertainty. As an example, if the required amount were \$110, \$4, or 4 percent, would be considered a risk premium.

Definition of Investment

From our discussion, we can specify a formal definition of investment. Specifically, an **investment** is the current commitment of dollars for a period of time in order to derive future payments that will compensate the investor for (1) the time the funds are committed, (2) the expected rate of inflation, and (3) the uncertainty of the future payments. The “investor” can be an individual, a government, a pension fund, or a corporation. Similarly, this definition includes all types of investments, including investments by corporations in plant and equipment and investments by individuals in stocks, bonds, commodities, or real estate. This text emphasizes investments by individual investors. In all cases, the investor is trading a *known* dollar amount today for some *expected* future stream of payments that will be greater than the current outlay. At this point, we have answered the questions about why people invest and what they want from their investments. They invest to earn a return from savings due to their deferred consumption. They want a rate of return that compensates them for the time, the expected rate of inflation, and the uncertainty of the return. This return, the investor’s **required rate of return**, is discussed throughout this book. A central

question of this book is how investors select investments that will give them their required rates of return.

1.2. Investment Alternatives

Investors have to main investment alternatives to invest their capital by acquiring real assets or financial assets.

Real Assets versus Financial Assets

The material wealth of a society is ultimately determined by the productive capacity of its economy, that is, the goods and services its members can create. This capacity is a function of the **real assets** of the economy: the land, buildings, machines, and knowledge that can be used to produce goods and services.

In contrast to such real assets are **financial assets** such as stocks and bonds. Such securities are no more than sheets of paper or, more likely, computer entries and do not contribute directly to the productive capacity of the economy. Instead, these assets are the means by which individuals in well-developed economies hold their claims on real assets. Financial assets are claims to the income generated by real assets (or claims on income from the government). If we cannot own our own auto plant (a real asset), we can still buy shares in General Motors or Toyota (financial assets) and, thereby, share in the income derived from the production of automobiles.

While real assets generate net income to the economy, financial assets simply define the allocation of income or wealth among investors. Individuals can choose between consuming their wealth today or investing for the future. If they choose to invest, they may place their wealth in financial assets by purchasing various securities. When investors buy these securities from companies, the firms use the money so raised to pay for real assets, such as plant, equipment, technology, or inventory. So investors' returns on securities ultimately come from the income produced by the real assets that were financed by the issuance of those securities.

Taxonomy of Financial Assets

It is common to distinguish among three broad types of financial assets: fixed income, equity, and derivatives. **Fixed-income** or **debt securities** promise either a fixed stream of income or a stream of income that is determined according to a specified formula. For example, a corporate bond typically would promise that the bondholder will receive a fixed amount of interest each year. Other so-called floating-rate bonds promise payments that depend on current interest rates. For example, a bond may pay an interest rate that is fixed at 2 percentage points above the rate paid on U.S. Treasury bills. Unless

the borrower is declared bankrupt, the payments on these securities are either fixed or determined by formula. For this reason, the investment performance of debt securities typically is least closely tied to the financial condition of the issuer.

Nevertheless, fixed-income securities come in a tremendous variety of maturities and payment provisions. At one extreme, the *money market* refers to debt securities that are short term, highly marketable, and generally of very low risk. Examples of money market securities are U.S. Treasury bills or bank certificates of deposit (CDs). In contrast, the fixed-income *capital market* includes long-term securities such as Treasury bonds, as well as bonds issued by federal agencies, state and local municipalities, and corporations. These bonds range from very safe in terms of default risk (for example, Treasury securities) to relatively risky (for example, high yield or “junk” bonds). They also are designed with extremely diverse provisions regarding payments provided to the investor and protection against the bankruptcy of the issuer.

Unlike debt securities, common stock, or **equity**, in a firm represents an ownership share in the corporation. Equity holders are not promised any particular payment. They receive any dividends the firm may pay and have prorated ownership in the real assets of the firm. If the firm is successful, the value of equity will increase; if not, it will decrease.

The performance of equity investments, therefore, is tied directly to the success of the firm and its real assets. For this reason, equity investments tend to be riskier than investments in debt securities. Equity markets and equity valuation are the topics of Part Five.

Finally, **derivative securities** such as options and futures contracts provide payoffs that are determined by the prices of *other* assets such as bond or stock prices. For example, a call option on a share of Intel stock might turn out to be worthless if Intel’s share price remains below a threshold or “exercise” price such as \$30 a share, but it can be quite valuable if the stock price rises above that level. 2 Derivative securities are so named because their values derive from the prices of other assets. For example, the value of the call option will depend on the price of Intel stock. Unlike debt securities, common stock, or **equity**, in a firm represents an ownership share in the corporation. Equity holders are not promised any particular payment. They receive any dividends the firm may pay and have prorated ownership in the real assets of the firm. If the firm is successful, the value of equity will increase; if not, it will decrease.

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1.3. Securities Market

What is a market?

This section provides the necessary background for understanding different securities markets around the world and the changes that are occurring. The first part considers the general concept of a market and its function. The second part describes the characteristics that determine the quality of a particular market. The third part of the section describes primary and secondary capital markets and how they interact and depend on one another.

A **market** is the means through which buyers and sellers are brought together to aid in the transfer of goods and/or services. Several aspects of this general definition seem worthy of emphasis. First, a market need not have a physical location. It is only necessary that the buyers and sellers can communicate regarding the relevant aspects of the transaction. Second, the market does not necessarily own the goods or services involved. For a good market, ownership is not involved; the important criterion is the smooth, cheap transfer of goods and services. In most financial markets, those who establish and administer the market do not own the assets but simply provide a physical location or an electronic system that allows potential buyers and sellers to interact. They help the market function by providing information and facilities to aid in the transfer of ownership. Finally, a market can deal in any variety of goods and services. For any commodity or service with a diverse clientele, a market should evolve to aid in the transfer of that commodity or service. Both buyers and sellers will benefit from the existence of a smooth functioning market.

Characteristics of a Good Market

Throughout this book, we will discuss markets for different investments, such as stocks, bonds, options, and futures, in the United States and throughout the world. We will refer to these markets using various terms of quality, such as *strong*, *active*, *liquid*, or *illiquid*. There are many financial markets, but

they are not all equal—some are active and liquid; others are relatively illiquid and inefficient in their operations. To appreciate these discussions, you should be aware of the following characteristics that investors look for when evaluating the quality of a market.

One enters a market to buy or sell a good or service quickly at a price justified by the prevailing supply and demand. To determine the appropriate price, participants must have timely and accurate information on the volume and prices of past transactions and on all currently outstanding bids and offers. Therefore, one attribute of a good market is **timely and accurate information**.

Another prime requirement is **liquidity**, the ability to buy or sell an asset quickly and at a known price—that is, a price not substantially different from the prices for prior transactions, assuming no new information is available. An asset's likelihood of being sold quickly, sometimes referred to as its *marketability*, is a necessary, but not a sufficient, condition for liquidity. The expected price should also be fairly certain, based on the recent history of transaction prices and current bid-ask quotes.

A component of liquidity is **price continuity**, which means that prices do not change much from one transaction to the next unless substantial new information becomes available. Suppose no new information is forthcoming and the last transaction was at a price of \$20; if the next trade were at \$20.05, the market would be considered reasonably continuous.² A continuous market without large price changes between trades is a characteristic of a liquid market.

A market with price continuity requires *depth*, which means that numerous potential buyers and sellers must be willing to trade at prices above and below the current market price. These buyers and sellers enter the market in response to changes in supply and demand or both and thereby prevent drastic price changes. In summary, liquidity requires marketability and price continuity, which, in turn, requires depth.

Another factor contributing to a good market is the **transaction cost**. Lower costs (as a percent of the value of the trade) make for a more efficient market. An individual comparing the cost of a transaction between markets would choose a market that charges 2 percent of the value of the trade compared with one that charges 5 percent. Most microeconomic textbooks define an efficient market as one in which the cost of the transaction is minimal. This attribute is referred to as *internal efficiency*.

Finally, a buyer or seller wants the prevailing market price to adequately reflect all the information available regarding supply and demand factors in

the market. If such conditions change as a result of new information, the price should change accordingly. Therefore, participants want prices to adjust quickly to new information regarding supply or demand, which means that prices reflect all available information about the asset.

In summary, a good market for goods and services has the following characteristics:

1. Timely and accurate information is available on the price and volume of past transactions and the prevailing bid and ask prices.
2. It is liquid, meaning an asset can be bought or sold quickly at a price close to the prices for previous transactions (has price continuity), assuming no new information has been received. In turn, price continuity requires depth.
3. Transactions entail low costs, including the cost of reaching the market, the actual brokerage costs, and the cost of transferring the asset.
4. Prices rapidly adjust to new information; thus, the prevailing price is fair because it reflects all available information regarding the asset.

Organization of the Securities Market

Before discussing the specific operation of the securities market, you need to understand its overall organization. The principal distinction is between **primary markets**, where new securities are sold, and **secondary markets**, where outstanding securities are bought and sold. Each of these markets is further divided based on the economic unit that issued the security. The following discussion considers each of these major segments of the securities market with an emphasis on the individuals involved and the functions they perform.

The primary market is where new issues of bonds, preferred stock, or common stock are sold by government units, municipalities, or companies to acquire new capital

Government Bond Issues

All U.S. government bond issues are subdivided into three segments based on their original maturities. **Treasury bills** are negotiable, non-interest-bearing securities with original maturities of one year or less. **Treasury notes** have original maturities of 2 to 10 years. Finally, **Treasury bonds** have original maturities of more than 10 years. To sell bills, notes, and bonds, the Treasury relies on Federal Reserve System auctions

Municipal Bond Issues

New municipal bond issues are sold by one of three methods: competitive bid, negotiation, or private placement. **Competitive bid** sales typically involve

sealed bids. The bond issue is sold to the bidding syndicate of underwriters that submits the bid with the lowest interest cost in accordance with the stipulations set forth by the issuer. **Negotiated sales** involve contractual arrangements between underwriters and issuers wherein the underwriter helps the issuer prepare the bond issue and set the price and has the exclusive right to sell the issue. **Private placements** involve the sale of a bond issue by the issuer directly to an investor or a small group of investors (usually institutions).

Note that two of the three methods require an *underwriting* function. Specifically, in a competitive bid or a negotiated transaction, the investment banker typically underwrites the issue, which means the investment firm purchases the entire issue at a specified price, relieving the issuer from the risk and responsibility of selling and distributing the bonds. Subsequently, the underwriter sells the issue to the investing public. For municipal bonds, this underwriting function is performed by both investment banking firms and commercial banks.

The underwriting function can involve three services: origination, risk bearing, and distribution.

Origination involves the design of the bond issue and initial planning. To fulfill the risk bearing function, the underwriter acquires the total issue at a price dictated by the competitive bid or through negotiation and accepts the responsibility and risk of reselling it for more than the purchase price. Distribution means selling it to investors, typically with the help of a selling syndicate that includes other investment banking firms and/or commercial banks. In a negotiated bid, the underwriter will carry out all three services. In a competitive bid, the issuer specifies the amount, maturities, coupons, and call features of the issue and the competing syndicates submit a bid for the entire issue that reflects the yields they estimate for the bonds. The issuer may have received advice from an investment firm on the desirable characteristics for a forthcoming issue, but this advice would have been on a fee basis and would not necessarily involve the ultimate underwriter who is responsible for risk bearing and distribution. Finally, a private placement involves no risk bearing, but an investment banker could assist in locating potential buyers and negotiating the characteristics of the issue.

Corporate Bond Issues

Corporate bond issues are almost always sold through a negotiated arrangement with an investment banking firm that maintains a relationship with the issuing firm. In a global capital market that involves an explosion of new instruments, the origination function, which involves the design of the security in terms of characteristics and currency, is becoming more important

because the corporate chief financial officer (CFO) will probably not be completely familiar with the availability and issuing requirements of many new instruments and the alternative capital markets around the world. Investment banking firms compete for underwriting business by creating new instruments that appeal to existing investors and by advising issuers regarding desirable countries and currencies. As a result, the expertise of the investment banker can help reduce the issuer's cost of new capital.

Corporate Stock Issues

In addition to the ability to issue fixed-income securities to get new capital, corporations can also issue equity securities—generally common stock. For corporations, new stock issues are typically divided into two groups: (1) seasoned equity issues and (2) initial public offerings (IPOs). **Seasoned equity issues** are new shares offered by firms that already have stock outstanding. An example would be General Electric, which is a large, well-regarded firm that has had public stock trading on the NYSE for over 50 years. If General Electric decided that it needed new capital, it could sell additional shares of its common stock to the public at a price very close to the current price of the firm's stock.

Initial public offerings (IPOs) involve a firm selling its common stock to the public for the first time. At the time of an IPO offering, there is no existing public market for the stock, that is, the company has been closely held. An example would be an IPO by Polo Ralph Lauren in 1997, at \$26 per share. The company is a leading manufacturer and distributor of men's clothing. The purpose of the offering was to get additional capital to expand its operations.

New issues (seasoned or IPOs) are typically underwritten by investment bankers, who acquire the total issue from the company and sell the securities to interested investors. The underwriter gives advice to the corporation on the general characteristics of the issue, its pricing, and the timing of the offering. The underwriter also accepts the risk of selling the new issue after acquiring it from the corporation

Secondary Financial Market

In this section, we consider the purpose and importance of secondary markets and provide an overview of the secondary markets for bonds, financial futures, and stocks. Next, we consider national stock markets around the world. Finally, we discuss regional and over-the-counter stock markets and provide a detailed presentation on the functioning of stock exchanges. Secondary markets permit trading in outstanding issues; that is, stocks or bonds already sold to the public are traded between current and potential owners. The proceeds from a sale in the secondary market do not go to the

issuing unit (the government, municipality, or company) but, rather, to the current owner of the security

Why Secondary Markets are Important

Before discussing the various segments of the secondary market, we must consider its overall importance. Because the secondary market involves the trading of securities initially sold in the primary market, *it provides liquidity to the individuals who acquired these securities*. After acquiring securities in the primary market, investors want the ability to sell them again to acquire other securities, buy a house, or go on a vacation. The primary market benefits greatly from the liquidity provided by the secondary market because investors would hesitate to acquire securities in the primary market if they thought they could not subsequently sell them in the secondary market. That is, without an active secondary market, potential issuers of stocks or bonds in the primary market would have to provide a much higher rate of return to compensate investors for the substantial liquidity risk.

Secondary markets are also important to those selling seasoned securities because the prevailing market price of the securities is determined by transactions in the secondary market. New issues of outstanding stocks or bonds to be sold in the primary market are based on prices and yields in the secondary market. Even forthcoming IPOs are priced based on the prices and values of comparable stocks or bonds in the public secondary market

Third Market

As mentioned, the term **third market** describes OTC trading of shares listed on an exchange. Although most transactions in listed stocks take place on an exchange, an investment firm that is not a member of an exchange can make a market in a listed stock. Most of the trading on the third market is in well-known stocks such as General Electric, IBM, and Merck. The success or failure of the third market depends on whether the OTC market in these stocks is as good as the exchange market and whether the relative cost of the OTC transaction compares favorably with the cost on the exchange. This market is critical during the relatively few periods when trading is not available on the NYSE either because trading is suspended or the exchange is closed.

Fourth Market

The term **fourth market** describes direct trading of securities between two parties with no broker intermediary. In almost all cases, both parties involved are institutions. When you think about it, a direct transaction is really not that unusual. If you own 100 shares of AT&T Corp. and decide to sell it, there is

nothing wrong with simply offering it to your friends or associates at a mutually agreeable price (for example, based on exchange transactions) and making the transaction directly. Investors typically buy or sell stock through brokers because it is faster and easier. Also, you would expect to get a better price for your stock because the broker has a good chance of finding the best buyer. You are willing to pay a commission for these liquidity services. The fourth market evolved because of the substantial fees charged by brokers to institutions with large orders. At some point, it becomes worthwhile for institutions to attempt to deal directly with each other and bypass the brokerage fees. Assume an institution decides to sell 100,000 shares of AT&T, which is selling for about \$25 per share, for a total value of \$2.5 million. The average commission on such a transaction prior to the advent of negotiated rates in 1975 was about 1 percent of the value of the trade, or about \$25,000. This cost made it attractive for a selling institution to spend some time and effort finding another institution interested in increasing its holdings of AT&T and negotiating a direct sale. Currently, such transactions cost about 5 cents per share, which implies a cost of \$5,000 for the 100,000-share transactions. This is lower but still not trivial. Because of the diverse nature of the fourth market and the lack of reporting requirements, no data are available regarding its specific size or growth.

1.4. Investment Companies

The investment alternatives described so far are individual securities that can be acquired from a government entity, a corporation, or another individual. However, rather than directly buying an individual stock or bond issued by one of these sources, you may choose to acquire these investments indirectly by buying shares in an investment company, also called a **mutual fund**, that owns a portfolio of individual stocks, bonds, or a combination of the two. Specifically, an **investment company** sells shares in itself and uses the proceeds of this sale to acquire bonds, stocks, or other investment instruments. As a result, an investor who acquires shares in an investment company is a partial owner of the investment company's portfolio of stocks or bonds. We will distinguish investment companies by the types of investment instruments they acquire.

Money Market Funds **Money market funds** are investment companies that acquire high quality, short-term investments (referred to as *money market* instruments), such as T-bills, high grade commercial paper (public short-term loans) from various corporations, and large CDs from the major money center banks. The yields on the money market portfolios always surpass those on normal bank CDs because the investment by the money market fund is larger and the fund can commit to longer maturities than the typical individual. In addition, the returns on commercial paper are above the prime rate. The typical minimum initial investment in a money market fund is \$1,000, it

charges no sales commission, and minimum additions are \$250 to \$500. You can always withdraw funds from your money market fund without penalty (typically by writing a check on the account), and you receive interest to the day of withdrawal. Individuals tend to use money market funds as alternatives to bank savings accounts because they are generally quite safe (although they are not insured, they typically limit their investments to high-quality, short-term investments), they provide yields above what is available on most savings accounts, and the funds are readily available. Therefore, you might use one of these funds to accumulate funds to pay tuition or for a down payment on a car. Because of relatively high yields and extreme flexibility and liquidity, the total value of these funds reached more than \$1.8 trillion in 2000.

Bond Funds: Bond funds generally invest in various long-term government, corporate, or municipal bonds. They differ by the type and quality of the bonds included in the portfolio as assessed by various rating services. Specifically, the bond funds range from those that invest only in risk-free government bonds and high-grade corporate bonds to those that concentrate in lower rated corporate or municipal bonds, called **high-yield bonds** or *junk bonds*. The expected rate of return from various bond funds will differ, with the low-risk government bond funds paying the lowest returns and the high-yield bond funds expected to pay the highest returns.

Common Stock Funds: Numerous common stock funds invest to achieve stated investment objectives, which can include aggressive growth, income, precious metal investments, and international stocks. Such funds offer smaller investors the benefits of diversification and professional management. They include different investment styles, such as growth or value, and concentrate in alternative-sized firms, including small-cap, mid-cap, and large capitalization stocks. To meet the diverse needs of investors, numerous funds have been created that concentrate in one industry or sector of the economy, such as chemicals, electric utilities, health, housing, and technology. These funds are diversified within a sector or an industry, but are not diversified across the total market. Investors who participate in a sector or an industry fund bear more risk than investors in a total market fund because the sector funds will tend to fluctuate more than an aggregate market fund that is diversified across all sectors. Also, international funds that invest outside the United States and global funds that invest in the United States and in other countries offer opportunities for global investing by individual investors.

Balanced Funds: **Balanced funds** invest in a combination of bonds and stocks of various sorts depending on their stated objectives.

Index Funds: Index funds are mutual funds created to equal the performance of a market index like the S&P 500. Such funds appeal to *passive* investors

who want to simply experience returns equal to some market index either because they do not want to try to “beat the market” or they believe in efficient markets and do not think it is possible to do better than the market in the long run. Given the popularity of these funds, they have been created to emulate numerous stock indexes including very broad indexes like the Wilshire 5000, broad foreign indexes like the EAFE index, and non stock indexes including various bond indexes for those who want passive bond investing.

Exchange-Traded Funds (ETFs): A problem with mutual funds in general and index funds in particular is that they are only priced daily at the close of the market and all transactions take place at that price. As a result, if you are aware of changes taking place for the aggregate market due to some economic event during the day and want to buy or sell to take advantage of this, you can put in an order but it will not be executed until the end of the day at closing prices. In response to this problem, the AMEX in 1993 created an indexed fund tied to the S&P 500—that is, an exchange-traded fund, ETF—that could be traded continuously because the prices for the 500 stocks are updated continuously so it is possible to buy and sell this ETF like a share of stock. This concept of an ETF has been applied to other foreign and domestic indexes including the Morgan Stanley Capital International (MSCI) indexes. Barclay’s Global Investors (BGI) have created “i shares” using the MSCI indexes for numerous individual countries

Real Estate

Like commodities, most investors view real estate as an interesting and profitable investment alternative but believe that it is only available to a small group of experts with a lot of capital to invest. In reality, some feasible real estate investments require no detailed expertise or large capital commitments. We will begin by considering low-capital alternatives.

Real Estate Investment Trusts (REITS): A **real estate investment trust** is an investment fund designed to invest in various real estate properties. It is similar to a stock or bond mutual fund, except that the money provided by the investors is invested in property and buildings rather than in stocks and bonds. There are several types of REITs.

Construction and development trusts: lend the money required by builders during the initial construction of a building. *Mortgage trusts* provide the long-term financing for properties. Specifically, they acquire long-term mortgages on properties once construction is completed. *Equity trusts* own various income-producing properties, such as office buildings, shopping centers, or apartment houses. Therefore, an investor who buys shares in an equity real estate investment trust is buying part of a portfolio of income-

producing properties. REITs have experienced periods of great popularity and significant depression in line with changes in the aggregate economy and the money market. Although they are subject to cyclical risks depending on the economic environment, they offer small investors a way to participate in real estate investments

Direct Real Estate Investment: The most common type of direct real estate investment is the purchase of a home, which is the largest investment most people ever make. Today, according to the Federal Home Loan Bank, the average cost of a single family house exceeds \$115,000. The purchase of a home is considered an investment because the buyer pays a sum of money either all at once or over a number of years through a mortgage. For most people, those unable to pay cash for a house, the financial commitment includes a down payment (typically 10 to 20 percent of the purchase price) and specific mortgage payments over a 20- to 30-year period that include reducing the loan's principal and paying interest on the outstanding balance. Subsequently, a homeowner hopes to sell the house for its cost plus a gain.

Raw Land: Another direct real estate investment is the purchase of raw land with the intention of selling it in the future at a profit. During the time you own the land, you have negative cash flows caused by mortgage payments, property maintenance, and taxes. An obvious risk is the possible difficulty of selling it for an uncertain price. Raw land generally has low liquidity compared to most stocks and bonds. An alternative to buying and selling the raw land is the development of the land.

Land Development: Land development can involve buying raw land, dividing it into individual lots, and building houses on it. Alternatively, buying land and building a shopping mall would also be considered land development. This is a feasible form of investment but requires a substantial commitment of capital, time, and expertise. Although the risks can be high because of the commitment of time and capital, the rates of return from a successful housing or commercial development can be significant.

Rental Property: Many investors with an interest in real estate investing acquire apartment buildings or houses with low down payments, with the intention of deriving enough income from the rents to pay the expenses of the structure, including the mortgage payments. For the first few years following the purchase, the investor generally has no reported income from the building because of tax-deductible expenses, including the interest component of the mortgage payment and depreciation on the structure. Subsequently, rental property provides a cash flow and an opportunity to profit from the sale of the property.