STANDARD &POOR'S

THE

# STANDARD & POOR'S GUIDE TO

# Long-Term Investing


## 7 KEYS TO BUILDING WEALTH

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JOSEPH R. TIGUE

# THE Standard & Poor's Guide to Long-Term Investing

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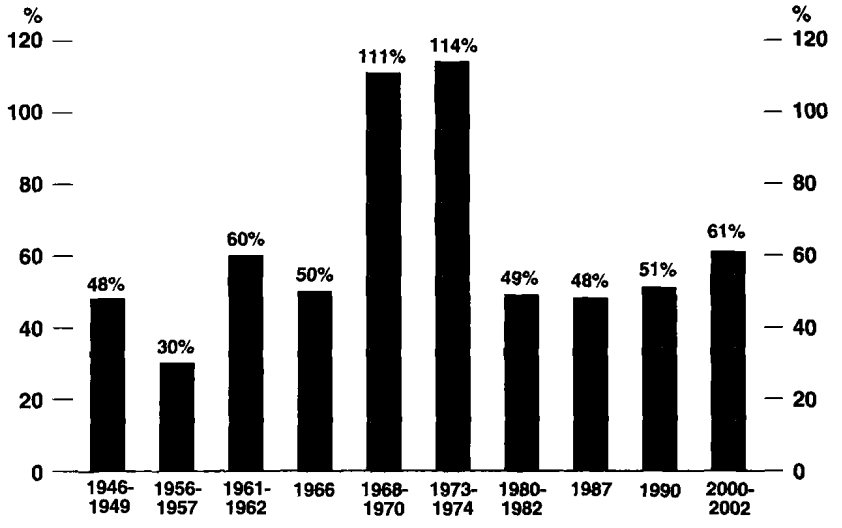
# Preface

Throughout the 1990s investors were witness to the mother of all bull markets. The S&P 500 index, considered *the* market benchmark by professionals, soared 417 percent from October 12, 1990, to its peak on March 24, 2000 (from 1995 to 1999, the "500" was up at least 20% in each year). More spectacular was the performance of the Nasdaq, where many of the hot technology and Internet stocks are traded. That index rocketed upward more than 1400% from mid-October 1990 to mid-March 2000. Many stockholders became millionaires virtually overnight—though in many cases, only on paper. The subsequent market crash resulted in the greatest loss of wealth in investing history. About seven trillion dollars—more than five times the GDP of Russia—went down the drain, with euphoria turning to deep despair.

The bear market, which started in March 2000 and reached a low in early October 2002, took the S&P 500 down 49 percent. Nasdaq plunged 78 percent, the steepest decline for any major U.S. market index since the 1930s. The many revelations of corporate dishonesty—Enron, Arthur Andersen, Global Crossing, WorldCom, Xerox, and Tyco, to name the more infamous—also shook investor confidence. In 2002, the S&P 500 and Dow Jones Industrials fell for the third consecutive year, only the fourth time that has happened since 1900. Nevertheless, it's likely that stocks will continue to be the investment of choice over time. See Figure P-1.

The market's ups and downs notwithstanding, stocks should play a key role in helping you to reach your financial goals. Over the long term, stocks have outperformed other assets, including bonds, gold, and real estate by a wide margin. From 1928 to 2002, stocks, as measured by the S&P 500, delivered an average annual return of 11.9% (price changes plus dividends reinvested).

**FIGURE P-1. What the Bear Has Taken Back**




Every bear market of the last 56 years has taken back at least 30% of what the S&P 500 Index gained in the previous bull market.

The key term in any successful game plan is "stick-to-it-ness." No two ways about it, it's important that you continue to invest through thick and thin.

In the long run, bull markets have had more staying power than bear markets. Put more colorfully, the bulls always gore the bears. Bear markets, usually defined as at least a 20% decline in major stock indexes, such as the S&P 500 and Dow-Jones Industrials, are relatively few. Since the end of World War II, we've seen only ten of these down markets, with the average length a comparatively modest 16 months. Typically, stock market cycles are shorter and sharper in a bear phase than in an upswing, since selling tends to be concentrated and therefore relatively rapidly exhausted. The average loss in the last ten bear markets was 31%. On the other hand, the ten bull markets since World War II lasted an average of 56 months, with the gain averaging a hefty 155%.

Why do bull markets more than offset bear markets? Stocks reflect companies' underlying earning power, which tends to grow, on balance, over time. Corporate earnings increase because the economy expands for longer periods than it contracts. Since 1900, the economy was in a slump an average of 15 months, while the number of expansions averaged 43 months. Since 1945, recessions averaged 11 months and economic expansions averaged 59.

So don't be discouraged or be tempted to sell your stock positions when the market is in a downtrend. Keep buying the solid blue chips and mutual funds that are recommended in this book. The corny song from the musical *Annie* has a lot of truth to it: "Tomorrow, tomorrow, the sun will come out tomorrow."

# Introduction

The plethora of investment information on the Internet, in books, newspapers, and magazines, as well as on TV and radio, often results in more confusion than clarification. The word *overload* comes immediately to mind.

The purpose of this book is to demystify and simplify the investing process. I believe that with a little study and due diligence, anyone can be their own investment advisor. You don't have to rely on stockbrokers or so-called financial planners. Many of these people are more interested in feathering their own nests than in giving you advice that is right for you in terms of your investment objectives, time horizon, and risk tolerance. A friend once told me he asked his father what investments he had purchased over the years. The father replied, "I never bought anything, but I was sold a lot!"

This book, in effect, sets forth an investment approach that has done well by me over the 40-odd years I've been in the stock market. Essentially, the program is a no-brainer, which some have said couldn't possibly work because it's too easy. The more complicated and arcane the investment process is made, it appears, the more successful many think it should be. My philosophy has always been: less is more. Why complicate things or gild the lily when simplicity usually is the best answer?

With the advent in 2000 of the worst bear market since the Great Depression, however, my "simplistic" approach seems to be slowly catching on. Investors have become painfully aware that following the crowd can have disastrous repercussions and that you have as much of a chance of getting rich quickly as the likelihood of a blizzard developing in the Sahara. As investors hopped onto the Internet/technology bandwagon, and as stock prices and valuations soared, the thinking was that this time it's different—trees indeed

can grow to the sky. The subsequent loud bursting of the bubble that began in March 2000 proved that it's not different this time. It also showed that earnings do matter. Many of the Internet companies never earned a penny—the stocks were valued on revenues and pipe dreams. The bear market, moreover, should have reinforced this basic lesson: shares of companies that do have earnings but trade at 80, 90, or 100 times those profits should be sold, not bought or held.

You will see as you read this book that I advocate buying reasonably priced, dividend-paying stocks and solid mutual funds (preferably low-cost index funds) on a regular basis, which gives you the benefits of dollar cost averaging (see Chapter 6). Since most of us don't have the discipline to sit down and write a check each month to buy stocks and/or mutual funds, setting up an automatic investment plan, whereby money is taken out of your checking or banking account, is a must. Over the long term there is more risk in being out of the market than in it.

I sincerely believe that if you adopt these seven keys, you will reach your financial goals, and most important, you will do so worry-free:

Key 1—Pay Yourself First

Key 2—Hold Stocks for the Long Term

Key 3—Buy What You Know

Key 4—Dollar Cost Average

Key 5—Keep Your Costs Down

Key 6—Know When to Sell

Key 7—Start Now

There's nothing mysterious or complicated here. The same is true of the details on each of these seven keys, as well as on other important investment concepts and insights. The summary at the end of each chapter will help you to quickly review what you've learned. As you read this book, keep in mind that key number 7 is the master key—Start Now!

# Acknowledgments

This book would not have been possible without the help and support of many of my former colleagues at Standard & Poor's. The ideas and critiques by Jim Dunn, a consultant for Standard & Poor's and former vice president and treasurer of GTE Corp., have been invaluable. The impressive graphics are the work of Chris Peng, who gathered the data, and LiWah Lai, Susanna Lee, Annabel Alafriz, and Debby Lee, whose talent and artistry can be seen in the charts and tables. Howard Silverblatt, Standard & Poor's datameister, is responsible for all the information on the S&P 500 index and the computer screens. His data massaging is without peer. Mark Arbter, S&P's chief market technician, supplied the charts illustrating technical analysis.

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# Contents

CHAPTER 1

# The First Key: Pay Yourself First

We all have to sit down each and every month and pay our bills: mortgage or rent, gas, electric, telephone, car payment, credit cards, and so on. It's not exactly a picnic in the park. But how many of us ever consider *paying ourselves* before we write checks to First Homestead Bank or Allpower Energy?

Paying yourself first simply means saving or investing on a *regular* basis. It's certainly not a new concept, but if you follow it faithfully, you'll wind up financially successful. The number one rule for meeting your long-term investment goals—and its importance can't be emphasized enough—is to set up a plan whereby money periodically goes into some kind of a savings account.

If you or your spouse have a 401(k) or similar plan at work, this should be funded first, especially if your company matches your contributions. But even if there is no match, putting money into a 401(k) each payday makes sense from three standpoints: (1) You reduce your taxes, since contributions are pretax, (2) you enjoy the benefits of tax deferral, and your money goes in on a dollar cost averaging basis (which we'll discuss in Chapter 6), and (3) your money grows tax free, which boosts the power of compounding.

Compounding, which will be emphasized throughout the book, is often preceded by the words "magic of." It's the way your investment increases as it earns a return on the initial money you invested and on the interest or dividends earned. When Albert Einstein was asked what the most important thing he learned from mathematics was, he

## FIGURE 1-1. The Power of Compounding*

| Year | Early Funding Contribution | Year-end Value | Late Funding Contribution | Year-end Value |
|---|---|---|---|---|
| 1 | $2,000 | $2,200 | $0 | $0 |
| 2 | 2,000 | 4,620 | 0 | 0 |
| 3 | 2,000 | 7,282 | 0 | 0 |
| 4 | 2,000 | 10,210 | 0 | 0 |
| 5 | 2,000 | 13,431 | 0 | 0 |
| 6 | 2,000 | 16,974 | 0 | 0 |
| 7 | 2,000 | 20,871 | 0 | 0 |
| 8 | 2,000 | 25,158 | 0 | 0 |
| 9 | 0 | 27,674 | 2,000 | 2,200 |
| 10 | 0 | 30,441 | 2,000 | 4,620 |
| 11 | 0 | 33,485 | 2,000 | 7,282 |
| 12 | 0 | 36,834 | 2,000 | 10,210 |
| 13 | 0 | 40,517 | 2,000 | 13,431 |
| 14 | 0 | 44,569 | 2,000 | 16,974 |
| 15 | 0 | 49,026 | 2,000 | 20,871 |
| 16 | 0 | 53,929 | 2,000 | 25,158 |
| 17 | 0 | 59,322 | 2,000 | 29,874 |
| 18 | 0 | 65,254 | 2,000 | 35,061 |
| 19 | 0 | 71,779 | 2,000 | 40,767 |
| 20 | 0 | 78,957 | 2,000 | 47,044 |
| 21 | 0 | 86,853 | 2,000 | 53,948 |
| 22 | 0 | 95,583 | 2,000 | 61,643 |
| 23 | 0 | 105,092 | 2,000 | 69,897 |
| 24 | 0 | 115,601 | 2,000 | 79,087 |
| 25 | 0 | 127,161 | 2,000 | 89,196 |
| 26 | 0 | 139,877 | 2,000 | 100,316 |
| 27 | 0 | 153,865 | 2,000 | 112,548 |
| 28 | 0 | 169,252 | 2,000 | 126,003 |
| 29 | 0 | 186,177 | 2,000 | 140,803 |
| 30 | 0 | 204,795 | 2,000 | 157,083 |
| 31 | 0 | 225,275 | 2,000 | 174,991 |
| 32 | 0 | 247,803 | 2,000 | 194,690 |
| 33 | 0 | 272,583 | 2,000 | 216,359 |
| 34 | 0 | 299,841 | 2,000 | 240,195 |
| 35 | 0 | 329,825 | 2,000 | 266,415 |
| 36 | 0 | 362,808 | 2,000 | 295,257 |
| 37 | 0 | 399,089 | 2,000 | 326,983 |
| 38 | 0 | 438,998 | 2,000 | 361,881 |
| 39 | 0 | 482,898 | 2,000 | 400,269 |
| 40 | 0 | 531,188 | 2,000 | 442,496 |

*If you invest $2,000 a year for only the first 10 years of a 40-year period with annual compounding at 8%, you will earn more than someone who invests $2,000 a year from years 10 through 40. The latter's total contribution would be 3 times greater, yet would earn 31% less.

replied, "Compound interest; it's the most powerful force on earth." The power of compounding is illustrated in Figure 1-1.

If you put $500 into an account that pays 8 percent a year, compounded annually, and you don't make any further contributions, you would have $2300 at the end of 20 years. Or, consider this example of saving regularly: An investment of $500 a year earning 8 percent will grow to $22,881 in 20 years, compounded annually. You will have invested only $10,000 in that time, but your investment will grow an additional $12,881.

Here's an even more dramatic example: A 21-year-old with a 401(k) who puts in only $800 each year and earns 8 percent annually will contribute a total of $34,400 at the retirement age of 67. The whole investment, however, will have grown to $284,760. If the employer matched contributions, the worker will have $569,520 by the time he or she retires.

## Rule of 72

To find out how long it would take to double your money at different rates, divide 72 by the yield. If you earn 6 percent, for example, it will take 12 years to double your money (72/6 = 12); at 7 percent it will take 10 years; at 8 percent, nine years; and so on. Or, say you borrowed $1000 from a friend who is charging 6 percent interest.

FIGURE 1-2. **Compounding: The Rule of 72**

| Year | Starting $ Amount | Earnings | Ending $ Amount |
|---|---|---|---|
| 1 | 1,000 | 80 | 1,080 |
| 2 | 1,080 | 86 | 1,166 |
| 3 | 1,166 | 93 | 1,259 |
| 4 | 1,259 | 101 | 1,360 |
| 5 | 1,360 | 109 | 1,469 |
| 6 | 1,469 | 117 | 1,586 |
| 7 | 1,586 | 127 | 1,713 |
| 8 | 1,713 | 137 | 1,850 |
| 9 | 1,850 | 148 | 1,998 |

Divide 72 by 6; you get 12, which is the number of years it would take for your debt to double to $2000 if you didn't make any payments. See Figure 1-2 on page 3, for the way the Rule of 72 works using a $1000 investment returning 8 percent annually.

Let's get greedy. To find out how long it takes to triple your money, use the Rule of 115. Divide the rate of return into 115. For example, an investment earning an 8 percent return will triple in 14 years.

The point is, compounding plays a pivotal role in building wealth.

## Save, Save, Save

Even if you're contributing the maximum to a 401(k)—which the IRS calls a defined *contribution* plan—it doesn't mean you're home free. Most companies these days don't have pensions—or defined *benefit* plans—so when you retire, the chances are that you won't be able to rely on a steady stream of income each month, as your parents and grandparents did. Given longer life expectancies, you have no choice but to supplement your Social Security (which one hopes will still be around) and 401(k) with a regular savings plan. And "regular" doesn't mean every quarter or twice a year.

### Individual Retirement Accounts

In fact, we believe that you should set up a weekly or monthly investment plan. To start, open a tax-deferred plan such as a traditional Individual Retirement Account (IRA). If both you and your spouse work and have taxable compensation, each of you can contribute up to $3000 to a separate traditional IRA. Even if one spouse has little or no compensation, up to $3000 can be contributed to each IRA if combined compensation is at least equal to the amount contributed to both IRAs and you file a joint return. If you file a joint return, you can contribute $3000 to a separate IRA for your nonworking spouse.

The maximum traditional IRA contribution in the years 2005-2007 will rise to $4000, and for 2008 and thereafter, it will climb to $5000. For those who have reached the age of 50, the maximum contribution is $3500 annually for the tax years 2002 through 2004; $4500 for 2005; $5000 for 2006 and 2007; and $6000 for 2008 and thereafter.

Under certain circumstances, moreover, your contributions to a traditional IRA may be tax deductible. If you have earned income and are not in an employer-sponsored retirement plan, you can deduct your contributions; or even if you're in an employer-sponsored pension plan, you can take a full deduction if you and your spouse file jointly and your adjusted gross income (AGI) is under $60,000 (for 2003; the amount increases each year, reaching $80,000 in 2005). Single filers may deduct their contributions if their AGI is under $40,000 (for 2003; the amount increases each year, reaching $50,000 in 2005).

## Roth IRAs

For those who qualify, a Roth IRA is a better deal. While contributions are not tax deductible with the Roth, if you're over age 59½ and have been in the Roth for at least five years you don't pay taxes when you withdraw the money.

As with a traditional IRA, you're eligible to make a regular contribution to a Roth IRA even if you participate in an employer retirement plan. These contributions can be as much as $3000 ($3500 if you're 50 or older), which will increase each year, reaching $5000 in 2008 (or $6000 if you are 50 or older). There are just two requirements: You or your spouse must have compensation or alimony income equal to the amount contributed, and your modified adjusted gross income can't exceed certain limits. For the maximum contribution, the limits are $95,000 for single individuals and $150,000 for married individuals filing joint returns. The amount you can contribute is reduced gradually and then completely eliminated when your modified adjusted gross income exceeds $110,000 (single) or $160,000 (married filing jointly).

Many have recognized the value of and the need for IRA accounts. From 1999 to 2002, the number of households with an IRA jumped from 30 to 40 percent. Since 1990, the total assets in IRAs have surged 278 percent, to $2.4 trillion, despite the poor 2000–2002 stock market. These numbers are encouraging, but it's still a fact that only about half of all Americans save.

With traditional pension plans going the way of the dodo, retiree health-care benefits as scarce as a successful hot stock tip, and Social Security on less than firm ground, it's imperative that you set