



*The*  
**PORTABLE  
MBA**

*The*  
**FAST  
FORWARD  
MBA**

*"Tough ideas made easy"*

**in**

**Investing**

**QUICK TIPS**

**SPEEDY SOLUTIONS**

**CUTTING-EDGE IDEAS**

**JOHN WAGGONER**

# **The Fast Forward MBA in Investing**

JOHN WAGGONER



John Wiley & Sons, Inc.

New York • Chichester • Weinheim • Brisbane • Singapore • Toronto

This book is printed on acid-free paper.☺

Copyright © 1998 by John Waggoner. All rights reserved.

Published by John Wiley & Sons, Inc.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4744. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 605 Third Avenue, New York, NY 10158-0012, (212) 850-6011, fax (212) 850-6008, E-Mail: PERMREQ @ WILEY.COM.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering professional services. If professional advice or other expert assistance is required, the services of a competent professional person should be sought.

**Library of Congress Cataloging-in-Publication Data:**

Waggoner, John M.

The fast forward MBA in investing / John Waggoner.

p. ; cm.—(Fast forward MBA series)

Includes index.

ISBN 0-471-24661-1 (paper : alk. paper)

1. Investments—United States. I. Series.

HG4910.W248 1998

332.6—dc21

98-3803

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

# ABOUT THE AUTHOR

## JOHN WAGGONER

John Waggoner, 42, is *USA Today's* mutual fund columnist. He also covers personal finance, the stock market, and the economy.

Waggoner has been covering mutual funds and personal finance since 1983. Before joining the newspaper in September 1989, Waggoner was senior editor at *The Independent Investor*, an investment advisory newsletter covering stocks, bonds, taxes, and mutual funds. Prior to that, Waggoner was senior editor at The Donoghue Organization, a newsletter publisher specializing in mutual funds. Waggoner is author of *Money Madness: Strange Schemes and Extraordinary Manias On and Off Wall Street* (Irwin). He is also coauthor of *The Parents' Guide to Money*, an interactive CD-ROM published by Vertigo Development, and he has a question and answer column on investing at *USA Today's* online site.

Waggoner has a B.A. and M.A. in English literature from Northeastern University in Boston. He lives with his wife, two children, and a large array of small, furry animals in Virginia.

# ACKNOWLEDGMENTS

Books are the product of many people, and I can never thank those who have helped me enough.

I'd like to thank the kind people at Lipper Analytical Services ([www.lipperweb.com](http://www.lipperweb.com)) for their patience in helping me mine more data than most people see in a lifetime. In particular, Julie Friedlander, Scott White, and Melissa Daly have been essential to me in writing this book. And Michael Lipper has been most generous with his time and considerable expertise.

Similarly, Don Phillips and all the people at Morningstar have been generous with their time and data; I'm most grateful to all of them.

Debra Englander has been a most noble and helpful editor. Patient beyond belief, too. Evan Marshall, my agent, has supplied me generously with advice and support; Jeff Seglin, editor and friend, has kept me going with kindly good humor and praise.

Raymond Goldbacher, my editor at *USA Today*, performs daily feats of magic; his ideas and help and friendship have been an inspiration to me.

My mother, Dorothy Munding, has provided me with good advice, warm support, and great love all my life. Her gifts to me have been far greater than any investment ever could be.

And I'm grateful to my father, Miles Waggoner, for his kindly patience and affection.

Above all, my wife, Yvonne Surette, has endured a book-writing spouse with love and grace, pointing out where I needed to improve the manuscript and praising where I did not. I'd be lost without her. And my two wonderful children, Nathaniel and Hope, prove that there are some things that are absolutely beyond price.

J. W.

# INTRODUCTION

This book was designed to be a primer on investments. That's easy enough: Investments are very specific objects indeed. You can describe them exactly and legally and in exquisite detail. In these days of global trade, very little is left vague about the instruments of finance.

But if you write about investments, you have a certain obligation to talk about investing, too: when certain investments are appropriate, and for whom, and when. So it's important to start with the most simple and familiar investments and work your way to the most complicated.

This book begins with the most familiar investments available: bank CDs, savings bonds, and money market mutual funds. They are the basic building blocks of a portfolio. After all, most people's investment money comes from the safety of the money market. We use money funds and CDs as staging areas for other investments, and for safe havens when other investments seem too risky.

The money market is important for another reason: It's the best barometer of Federal Reserve policy and the current state of the financial markets. Money market rates rise when the Fed thinks the economy is growing too quickly; they fall when the Fed thinks the economy is growing too slowly. Learn to monitor the money market, and you learn to monitor the Fed, too.

Thanks to the bull market in stocks that began in August 1982, money market investments seem quaintly tame and, well, boring. But I began writing about investing when the money market was interesting indeed. You could earn virtually risk-free returns of 12 percent or more. And stocks and bonds were just easing out of a decade-long period of misery. The money market may seem boring now, but it can become extremely interesting at any time.

Bonds, which can make even hardened MBAs roll their eyes and groan, are the subject of the next chapter. But bonds are the workhorse investments for investors with medium-term goals and retirees with the long-term need for income. Bonds are the vehicle that will help your 16-year-old get to college and help your grandmother live comfortably on her investments. They can help shield your stock portfolio from the worst days that Wall Street has to offer.

And like the money market, bonds can tell you volumes about the economy and Wall Street's view of its prospects. Rising bond yields mean the economy is cooking. But when bond yields rise too far, inflation could be in the pipeline. Similarly, falling rates are good news—provided they don't fall too far, too fast. So even if you don't invest in bonds, you need to understand the bond market.

From bonds we move to the current long-term investment of choice, the stock market. A portfolio of blue-chip stocks can boost your investment income; a portfolio of small, rapidly growing companies can boost your net worth and your blood pressure, too.

But many investors don't invest directly in bonds or stocks. Instead, they invest in bonds and stocks through mutual funds. So the next chapter explains what mutual funds are, how they work, and why they are so popular.

The next two chapters show how you can invest in both stocks and bonds through mutual funds. And, because most investors use stock and bond mutual funds in their long-term savings plans, we talk about different mutual fund investment strategies: how to create an income portfolio; how to create a growth portfolio; and how to use cash and bonds to protect your portfolio from meltdowns.

The final chapter is devoted to some of the most speculative investments available: precious metals, options, and futures. These are investments that are available, but come with high-risk premiums attached to them. Nevertheless, there are times when these investments are useful. You should know of them, but you should be wary of them, too.

So the book moves from the simple to the complex. Although it was written with the hope that

you will read it from beginning to end, those of you who have some experience in investing may want to skip the first few chapters. No one will mind. And those of you who have never invested before should dive right in from the beginning. I'd be delighted if you did.



# CONTENTS

Introduction	xvii
--------------	------

<b>CHAPTER 1</b>	<b>SAFE STUFF: THE</b>	
	<b>MONEY MARKET</b>	<b>1</b>

The Money Market Often Gives Better Rates Than a Savings Account	2
Money Market Mutual Funds Keep the Same Share Price Every Day	3
Money Fund Yields Rise with Interest Rates	5
Money Funds Offer Check Writing	5
Money Funds Offer Telephone Switching	5
Choosing a Top-Performing Money Market Mutual Fund	7
Tap the Treasury with Treasury Bills	8
T-Bills Are Sold at a Discount	11
T-Bills Can Help You Defer Taxes to Another Year	13
A Great Deal: Buying T-Bills from the Federal Reserve	13
Use Bank CDs to Tap the Money Market	14
Compounding Counts	15
Shop Around for the Best Rates	15
Federal Deposit Insurance: More Than Enough to Go Around	16
Give Credit to Credit Unions	17
Why Invest in the Money Market?	18
Use the Money Market for Short-Term Savings	22
Use Money Market Investments to Cushion Your Risk	23
Watch the Fed for Short-Term Rates	24
Use CDs to Lock In High Rates	26
Ladder Your CDs if You Don't Want to Predict Rates	27
End Point	29

<b>CHAPTER 2 COUPON CLIPPERS: THE BOND MARKET</b>	<b>33</b>
A Word about Enormous Numbers	34
Bonds, Bit by Bit	35
Interest Rates Determine the Market Value of Bonds	36
Bond Prices Move in the Opposite Direction of Interest Rates	36
Inflation—or the Fear of It—Drives the Bond Market	40
Bond Prices Depend on the Bond Market's Opinion of Inflation Trends	41
Short-Term Bond Prices Are Hurt Less by Rising Interest Rates than Long-Term Bonds	43
The Yield Curve	44
The Inverted Yield Curve	45
Credit Counts: Bond Issuer Credit Ratings	46
The Best Credit: The U.S. Government	48
Savings Bonds for the Timid	48
Beat Inflation with Inflation-Adjusted Bonds	51
Government and Agency Bonds Provide a Slightly Higher Yield	51
Everyone Loves Ginnie Mae	52
Give Credit to Corporate Bonds	53
Do a Credit Check before You Buy	54
Play the Credit Curve	57
Talking Trash	58
Bond Buyer Talk	59
Municipal Bonds: All This and Tax-Free, Too	60
Do the Math to See if Munis Are Right for You	61
Zero-Coupon Bonds Help Lock In a Long-Term Rate	63
Buy Convertible Bonds for Price Appreciation	64
Use Bonds to Increase Your Investment Income	65
Use Bonds to Temper Stock Market Volatility	67
Use Treasury Bonds as Protection against Deflation	68
End Point	68

<b>CHAPTER 3 STOCK ANSWERS: THE STOCK MARKET</b>	<b>69</b>
A Bit of History	70
When You Own Stock, You Own a Piece of the Company	71
Shareholders Have Rights, Too	73
Don't Overlook Dividends	74
Splits Don't Have to Be Good, But They Often Are	74
All Kinds of Stocks	75
Stocks Are Traded by Auction and by Dealer	76
There's a Broker for Everyone	77
Ordering Your Stock	78
What You Can Tell from Newspaper Listings	79
What You Can Tell from Stock Market Averages	80
What You Can—and Can't—Learn from the Indexes	83
PE Ratio of the S&P 500	84
Rate of Change of the S&P 500	85
Be Careful When the Dow Is the Only Rising Index	85
The Efficient Market	86
The Growth School of Investing	86
The Importance of Reading Earnings	87
Pricing a Growth Stock	89
Dividend Achievers	90
Conservative Investors Look for Value	90
The Dogs of the Dow	92
Wall Street According to GAARP	92
Dividend Reinvestment Plans (DRIPs)	93
Margin Can Amplify Gains and Losses	94
Bear Markets Can Claw Holdings	97
May 1946 to May 1947: Down 23.2 Percent	98
December 1961 to May 1962: Down 27 Percent	98
February 1966 to December 1966: Down 25.2 Percent	98
December 1968 to May 1970: Down 35.9 Percent	99
January 1973 to December 1974: Down 45 Percent	99
September 1976 to February 1978: Down 26.9 Percent	99

April 1981 to August 1982: Down 24 Percent	99
August 1987 to October 1987: Down 36 Percent	100
July 1990 to October 1990: Down 21 Percent	100
End Point	100

## **CHAPTER 4 MUTUAL ADVANTAGES 103**

What a Mutual Fund Is	103
Funds Are Well Regulated—for Good Reason	105
How a Mutual Fund Is Organized	106
How a Mutual Fund Works	107
Funds Charge Annual Fees to Pay Costs	109
Buying and Selling Mutual Funds	110
Buying through a Broker	111
No-Loads Help You Save on Commissions	112
You Can Get in for as Little as \$50	113
Know How to Get Out	113
Listen to Facts, Not Myths	114
A Third Route: Mutual Fund Supermarkets	116
You Can Get Funds and Advice from Financial Planners	118
Mutual Fund Taxes	121
Minimize Taxes with Tax-Deferred Savings	122
Variable Annuities Can Reduce Taxes— but Watch Fees	123
Have Your Income and Dividends Reinvested	124
Closed-End versus Open-End Mutual Funds	125
Never Buy a Closed-End Fund at a Premium	126
Unit Investment Trusts (UITs) Offer Diversification, But No Management	127
End Point	129

## **CHAPTER 5 BOND MUTUAL FUNDS 131**

Why Bond Funds?	132
Total Return Tells the Total Story	133
Annualized Returns Can Be Misleading	134
Performance Figures Can Help You Choose a Fund	134
Government Bond Funds Are Great— But Not Guaranteed	135
What the Past Can Tell You about Government Bond Funds	137
The Recent Past Can Be Misleading	137
Look at Three-Month Performance to Check Volatility	138

Buy a Top-Performing Fund	139
Ginnie Mae Funds	140
Don't Buy Treasury Securities Funds	144
Intermediate-Term Government Bond Funds	144
Corporate Bond Funds Range from Class to Trash	149
Junk Funds Offer High Yields, But Trashy Credit	151
Municipal Bond Funds—Tax Free	155
Insured Muni Funds Might Not Be Worth the Cost	158
Don't Overlook State Tax-Free Funds	160
Beware of Novelty Bond Funds	163
Avoid Funds with Above-Average Expenses	164
Beware of Funds with Above-Average Yields	164
Bond Funds Won't Provide Fixed Payments	166
Bond Funds Can Help Smooth Out a Stock Portfolio	166
End Point	167

## **CHAPTER 6 STOCK MUTUAL FUNDS 169**

Stock Funds Let You Leave the Driving to Someone Else	170
Figure Your Asset Allocation	171
Time Is Your First Consideration	173
Keep an Emergency Fund	174
Know Your Risk Tolerance	175
Start with a Core Portfolio	175
Choose Your Core Holdings	176
Index Funds for Low-Cost Core Holdings	177
S&P 500 Index Funds	179
Growth Funds for Growth or Value	181
Growth and Income Funds for a More Conservative Approach	184
Equity-Income Funds for the Most Conservative Core Holdings	186
International Funds—Not the Best Course	191
Global Funds—a Compromise	192
Aggressive Growth Funds Don't Always Grow	194
Small-Company Growth Funds Never Meet Expectations	195
Small Is Always Better for Small-Company Stock Funds	196

Add Sector Funds for Spice	198
Sectors Don't Stay the Same	200
There's a Sector for All Seasons	203
Beware of Fad Funds	204
Social Investment Funds Can Be Good and Do Good	204
You Don't Need 30 Funds	206
Rebalance Only When Necessary	206
End Point	206

## **CHAPTER 7 SCARY STUFF: PRECIOUS METALS, FUTURES, AND OPTIONS 209**

Gold Is the Oldest Form of Money	210
Choose Coins over Bars	211
Buy Rare Coins Only if You Love Them	212
Always Take Physical Possession of Coins and Metals	213
Other Metals Don't Wear as Well as Gold	215
Metals Scams Abound	215
Spot Markets versus Futures Markets	216
Example 1: The Farmer	216
Example 2: The Baker	217
A Futures Contract Is Just That—a Contract	217
Anatomy of a Trade	218
Opposite Trades Cancel	219
Futures Markets Are No Longer Just a Hill of Beans	220
How Futures Are Priced	220
Why Trade Futures?	221
Hedging Can Make Sense	221
Managed Futures Spread the Risk	222
Options: The Right to Buy a Security at a Specific Price	224
Options Increase Your Purchasing Power	224
The Strike Price	225
Time and Sentiment Guide Options Prices	230
Writing Options: Sometimes Prudent	230
Naked Puts and Calls: Terrible Idea	231
Why Invest in Options?	231
Options Aren't for Individual Stocks	234
End Point	235

Notes	237
Index	239

# Safe Stuff: The Money Market

**I**t's Monday morning, and you're contemplating the day in front of you. You've got to drop off the dry cleaning, get to work, and finish that big project. Come lunch time, you have to mail the bills and—that's right! Deposit that check for \$67.24 you got from your dental insurance. You sigh. It's going to be a busy week.

No matter how busy the rest of your week is going to be, you can bet that your money will be just as busy. Once you hand your check to the teller at the bank, your \$67.24 will become part of the money market—the sprawling, worldwide trade in cash among banks and major corporations. It could travel around the globe several times before you spend it.

Let's take a look at what could happen to your \$67.24 over the next few days. The bank will send the check to the Federal Reserve for clearance. In most cases, the check will clear within 24 hours. (The bank can refuse to give you your money for up to 21 business days, depending on its policies and federal regulations, but that's another story.)

At the end of the next day, your bank will total how much it owes to other banks, companies, and individuals. It will figure out how much the Federal Reserve requires it to keep on deposit for emergencies. It will also tally up how much money has come into the bank, through deposits like your

check, as well as through corporate payrolls and loan payments.

On this particular day, the bank has taken in \$1 million more than it must pay out or keep in reserve. Your \$67.24 is part of that \$1 million.

The bank knows that this is just a temporary surplus: It has other obligations coming due in the next few months, such as certificates of deposit and dividend payments to shareholders. So it will need that \$1 million soon.

But it's not about to let that \$1 million collect dust for a month, either.

Now, it so happens that BigBank, the nation's second-largest bank, needs to make a \$2 million short-term loan to BingCo, the nation's largest maker of high-performance ball bearings. It decides to borrow that \$2 million from small banks like yours at a low overnight rate and lend the money to BingCo. The spread between the two loans is BigBank's profit. So your \$67.24 is, at least temporarily, loaned to BingCo.

Just how long your \$67.24 remains loaned to BigBank (and, in turn, to BingCo) is another matter. Your bank may decide it needs its \$1 million back, and use it for its own loan portfolio. Or it may find that another bank is offering a slightly better rate than BigBank. And then your \$67.24 would be off for another journey. By the time you spend it, your money might have been around the world—maybe more than once.



### **THE MONEY MARKET OFTEN GIVES BETTER RATES THAN A SAVINGS ACCOUNT**

The money market is no longer just for the government, banks, and large corporations. A *money market mutual fund* is a registered investment company that is regulated by the U.S. Securities and Exchange Commission. It pools money from small investors and uses it to buy money market securities.

In 1972, the first money market mutual fund, the *Reserve Fund*, opened its doors. It took money from small investors, invested it in commercial paper, Treasury bills and other money market securities, and distributed the proceeds equally.

Now there are some 1,170 money funds with more than \$1 trillion in assets. It's not hard to see



why. The average bank checking account pays no interest. In fact, you will usually be charged an annual fee for your checking account, unless you keep a large balance. The average saving account pays a piddling 2 to 3 percent a year. And most bank money market accounts pay half the current Treasury-bill rate—a standard benchmark for money market interest rates.

After all, banks can pay any interest rate they want. They can even pay different rates to different investors. Money funds must divide their returns equally among their investors. Everyone gets the same return.



### **Money Market Mutual Funds Keep the Same Share Price Every Day**

Most funds add up the value of their holdings every day, subtract their expenses, and divide by the number of shares outstanding to get a share price, or *net asset value*. (This is a bit of an oversimplification, as we will see in Chapter 4, but it will do for now.) Suppose you own 100 shares of Bull Moose Stock Fund. On Monday, the fund's share price is \$41.53. Your account is worth \$4,153. On Tuesday, the fund's share price is \$41.49. Your account is worth \$4,149, and you are \$4 poorer.

Money funds work differently. In most cases, if you put \$10,000 in, you'll get \$10,000 out, plus interest. Let's say you invest \$10,000 in a money market mutual fund. You have 10,000 shares, each valued at \$1. A month later, your account has 10,041.67 shares, each valued at \$1. The additional 41.67 shares is your interest. Why is this a big deal? Money funds are the only type of mutual fund whose structure is designed to keep its share price from rising and falling. In essence, it works much like a bank account or a credit union share account.

Now, there's one big caveat to this: Money funds don't have to stay at \$1 per share all the time. They make heroic efforts to do so. But a money fund isn't guaranteed by the federal government, as a bank deposit is. If your fund's share price falls to \$0.98 cents a share and you sell your shares, you will lose 2 cents a share, or 2 percent.