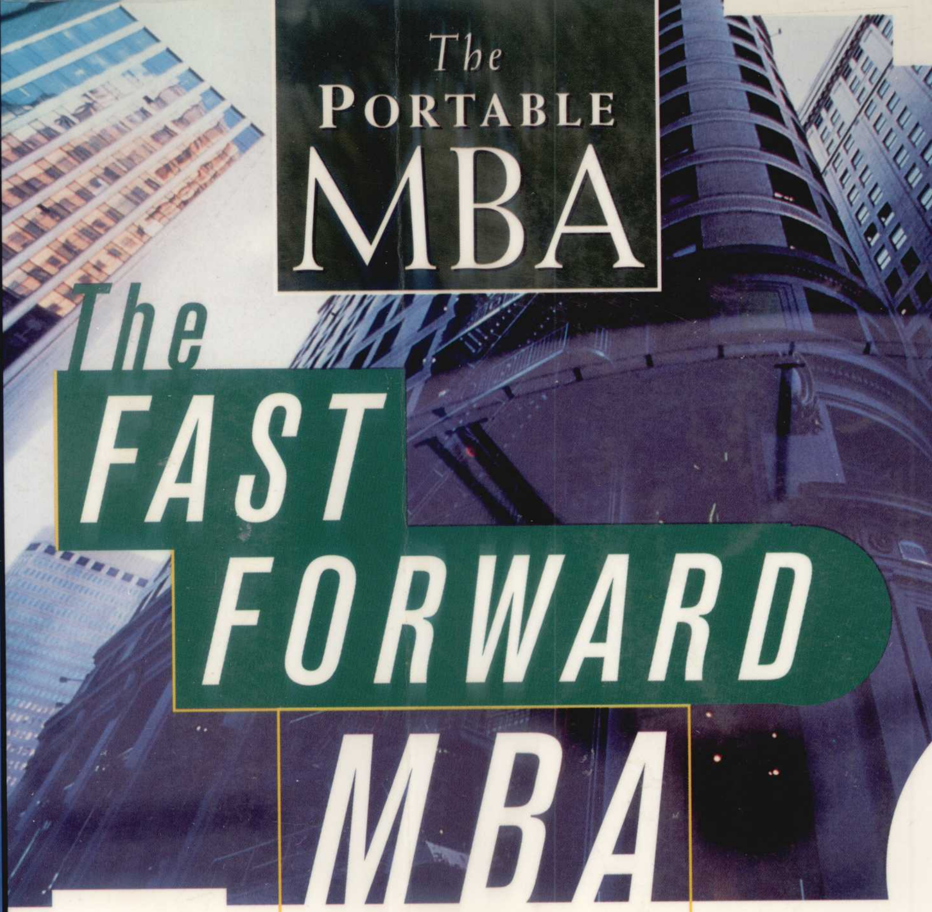

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JOHN WAGGONER

The Fast Forward MBA in Investing

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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.

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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

CHAPTER 1

Safe Stuff: The Money Market

It'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.

KEY CONCEPT

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.

KEY CONCEPT

Money Market Mutual Funds Keep the Same Share Price Every Day

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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.