2nd edition

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Paul J. Lim

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Investing

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About the Author

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Lim is a graduate of Princeton University, where he earned his bachelor's degree in politics in 1992, and the University of Pennsylvania, where he earned his master's degree in 1994 from the Fels Center of Government.

Introduction

If the last decade has taught us anything, it's the importance of getting back to the basics when it comes to our understanding of investing.

In the late 1990s, in what now seems like a bygone era—before Wall Street's numerous bubbles burst—many investors thought trading stocks was a simple road to riches. Well, as it turned out, that road was full of unexpected twists and turns, and potholes and detours that have taken many households off the path of being able to meet their long-term financial goals. Indeed, after returning nearly 20 percent a year throughout the 1990s, equities actually lost ground between 2000 and the start of 2010. This period of time was so difficult for investors that it got its own name: "The Lost Decade."

Of course, as soon as the stock market soured, investors moved onto other investments, such as the real estate market in 2000 and 2001. And sure enough, throughout the early part of the 2000s, our homes had supplanted stocks as the preferred alternative route to riches. And just as "day traders" thought they could make it rich trading stocks in a fast-and-furious fashion in the late 1990s, home flippers thought they could get into and out of residential real estate—at a tidy profit. Of course, a problem arose: the epic collapse in the mortgage market that sent home prices sinking and millions of homes into foreclosure.

You can blame timing for some of this. If you look back at history, the essential asset classes that make up one's investment portfolio—stocks, bonds, cash, real estate and commodities—all go through cycles of ups and downs. And as it just so happened, stocks and real estate (and to a lesser extent, commodities) all went up and down at just about the same time. This made it next to impossible for investors to hide out from market troubles in recent years.

But investors themselves weren't blameless either. In the late 1990s and again in the early 2000s, many investors thought that the powerful gains they were enjoying in the stock and housing markets changed the rules of investing. For instance, many investors thought that investment gains could take the place of good old-fashioned savings. As it turned out, they were wrong. And many incorrectly assumed that powerful bull markets in stocks and houses made concepts like moderation and diversification outmoded. They were wrong as well.

The enduring lesson of the Lost Decade for investors isn't that investing is pointless—everyone must learn how to invest for their financial security, as we'll explain later on. Rather, the enduring lesson of this roller-coaster ride of a decade is that the essential rules of investing never change—no matter how much we want them to.

For every reward you might receive in your investment portfolio, you have to accept a commensurate level of risk. And sometimes, risk means losing more money than you're willing (or capable) of losing.

That's why now more than ever, it's vital that you truly understand what it takes to invest in a safe and sound manner to make it possible to achieve all of your financial goals.

How to Use this Book

This book is geared for all those investors and would-be investors out there who know the importance of managing their money for the future but who aren't entirely certain how to go about it. That's probably the majority of the general population. Public opinion polls tell us that today more Americans think and worry about money—and how to invest it—than any generation in this country's history. Part of this worry, as I'll explain, is due to the fact that more of us are responsible for our own financial futures than ever before. Yet fewer than 20 percent of us feel that we're doing very well at this incredibly important task, which explains why baby boomers and members of Generation X worry more about their financial well-being than their own mortality.

This book is also geared for those of you who aren't entirely interested in investing but who realize its importance. Again, that's probably the majority of you. But who can blame you? After a series of bear markets and roller coaster rides in a variety of investment vehicles between 2000 and 2010, the once-unshakable faith that investors had in stocks, real estate, and even commodities has been tested thoroughly. Yet at the end of the day, investors in this modern age, when the security of government and corporate pensions is under threat, realize that learning to invest on their own—and to secure their own financial security—is as unavoidable today as paying taxes.

Finally, this book will be particularly useful for those of you who are just getting started in your careers or who are still in school. Why? It boils down to the basic laws of compound interest. The so-called time value of money tells us that the younger you start saving and investing for your future, the easier it will be to meet your long-term goals. Consider this simple but ubiquitous example: If you want to have $1 million saved up for your golden years and you start putting away a portion of your income starting at age 20, all you would need to set aside annually would be around $3,500 (assuming your investments returned around 7 percent annually). However, if you were to wait until you turned 35, you would have to sock away nearly $11,000 a year to reach that same goal—just because of the later start you got.

It just goes to show how easy, in theory, it can be to make your investments work for you. Unfortunately, even though investing has become a daily part of our lives—and a daily part of our national conversation—the language of investing and some basic investing concepts are still foreign to many of us.

The sad reality is, no one really teaches us how to become investors. Few high schools these days even offer economics courses, let alone lessons in personal finance or investing. And unless your parents were investors themselves and taught you the ins and outs of the stock and bond markets, you were probably left to figure it out on your own.

What happens if you don't pick it up? Chances are, you'll be thrown head first into the markets—with little clue about how to stay afloat—the minute you start a new job and enroll in your employer's 401(k) retirement plan. Those enrollment papers not only ask you if you want to participate but what investments you want to put money into and how much money you want to invest in each. Terms like "small-cap growth funds" and "long-term government bonds" and "annual expense ratios" will be thrown at you as if you somehow intuitively understand what it all means. Yet in this day and age, you have to know what these things mean to take control of your financial futures.

Hopefully, this book will answer some of your basic questions and take some of the mystery out of investing. When you boil it down, learning to invest is really a four-step process. First, you have to figure out who you are and what kind of investor you plan to be. Then, you have to become familiar with the assets that serve as the building blocks to an investment portfolio.

Then you have to figure out how to research and select those assets.

And finally, you have to learn how to mix and organize those assets into a comprehensive and diversified portfolio that will serve your specific set of needs.

I'll outline how I hope to address these topics in the coming chapters.

Getting Ready

In Part I, "Getting Ready," I want to familiarize you not only with the basic concepts of investing—like risk and returns—but also investing jargon. I begin in Chapter 1 with a discussion on "Why We Invest." That's followed in Chapter 2 with laying the groundwork. Here, I address all the things you have to consider "Before You Get Started." In Chapter 3 the focus is on "Demystifying the Language of

Investing," in order to expedite our conversation about key investing terms and concepts. And then, in Chapter 4, "What Kind of Investor Are You?" I discuss what strategies may work well with your sensibilities as a saver and investor.

Some investors find success by investing directly in the stock market by buying shares of individual companies. Others prefer to go through professionally managed mutual funds. Some have built nice nest eggs by buying and holding a diversified basket of stocks and funds. Others have done well by concentrating their bets on only their best ideas. Some make money by focusing on those investments that offer the greatest growth. Still others focus not on the best investments but the best-priced investments. In other words, they go bargain hunting. History has shown that money can be made in all sorts of ways, and I'll outline some of those different schools of investing for you.

Your Assets

In Part II, "Your Assets," I turn the attention to the building blocks of investing. You can make money, as was just discussed, in stocks and bonds, just as you can in real estate and gold. So I'll discuss the basic types of investments you can choose from, outlining their risks and rewards. In Chapter 5, I'll focus on "Demystifying Stocks." In Chapters 6 and 7, I'll turn the focus on "Demystifying Bonds" and "Demystifying Cash." And in Chapters 8 and 9, I'll spend time with perhaps the most popular investment for most households, mutual funds, in "Demystifying Mutual Funds I and II." Then, in Chapter 10, I'll turn our attention to "Demystifying Other Assets," including real estate, commodities, and a new class of fund-like investments we call "unmutual funds."

Selecting Your Assets

In Part III, I focus on "Selecting Your Assets." Here, I'll outline some basic ways investors can research and sort through the thousands of choices before them, starting with stocks and bonds. Then, I'll cover the most popular investment vehicles, mutual funds. I'll cover those topics in Chapters 11 through 13.

Organizing Your Assets

In Part IV, I address issues surrounding "Organizing Your Assets." In Chapter 14, "Demystifying Asset Allocation," I'll discuss the importance of creating an asset allocation strategy and talk about ways to determine what the right mix of stocks, bonds, and cash is for you. And finally, in Chapter 15, "Demystifying Asset Location," I'll go into the different types of asset accounts in which you can hold your stocks and bonds, and the strategies you might employ.

Again, just as there is no single investment that's right for everyone, there is no single investment account that's best for all investors. Some may find it more appropriate to invest primarily in a Roth IRA. Others will find traditional IRAs better. Still others may decide that it's beneficial to invest some money in a regular, taxable brokerage account.

By the end of this book, no matter who you are or what kind of investments you choose, I hope you will feel more comfortable as an investor—and I hope you will start to invest in a manner that is both appropriate for your circumstances and suitable to your sensibilities.

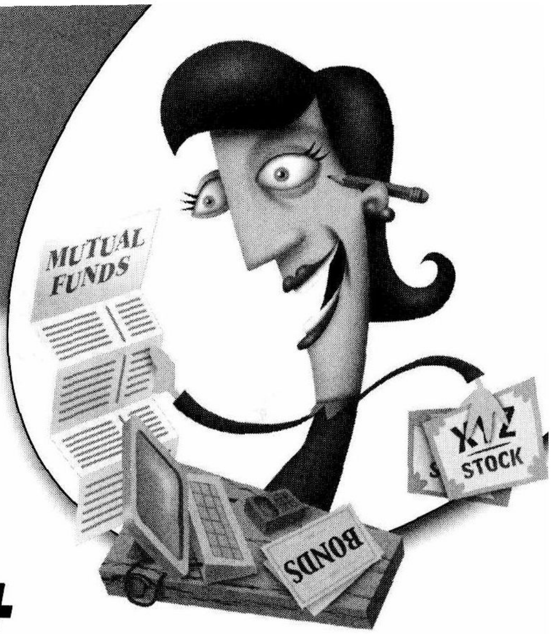
Contents

Part I

Getting Ready

chapter 1

Why We Invest



CHAPTER OBJECTIVES

In this chapter, you will learn the following:

- Why a majority of Americans invest
- How the shift from pensions to 401(k) plans is driving this trend
- Why you need to plan for at least a 30-year retirement
- The difference between investing and saving

In this age of Roth IRAs, 401(k)s, 403(b)s, 457s, and 529 savings plans, all of us are investors—or at least we're bound to be. Yet this wasn't always the case.

Not so long ago, Americans could be classified into two distinct groups. On the one hand, there were workers. On the other, there were investors. The difference being: The working class worked long hours and often earned little pay, while the investor class worked few hours but earned great sums. The advantage the investor class had, of course, was access to *capital*. In other words, they had money. And that money worked on their behalf so they didn't have to. Of course, back then, investors didn't invest because they had to. They invested because they wanted to—and because they could.