

**AFSCME's Investor
Education for Working Families**

Presents

Introduction to Successful Investing



Adapted with permission from BetterInvesting

For more information on investing, go
to our website at <http://invested.afscme.org>.

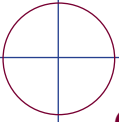


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We have partnered with BetterInvesting to provide this resource, and much material contained in this handbook is adapted from a similar work it produced for its members. Since 1951, BetterInvesting has helped more than 5 million people become better, more informed investors. As the nation's largest non-profit organization dedicated to investment education, it provides investing knowledge and practical investing experience through local investment clubs, local chapters, online courses and an active online community.

In her role as the Jerry Wurf Memorial Fund Fellow, Teresa Ghilarducci helped us think about the

issues that AFSCME's members face and suggested important perspectives for the *Investor Education for Working Families* program. She is the new director of the Schwartz Center for Economic Policy Analysis (SCEPA) and recently was featured in *Money* magazine for her cutting-edge proposal to restructure the United States' retirement income security system. Ghilarducci joined The New School and SCEPA this spring after 25 years as a professor of economics at the University of Notre Dame and 10 years as director of the Higgins Labor Research Center at the university.

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Foreword



AFSCME members make investment decisions every day, often based on the advice of vendors who are watching out only for their own financial interests. That is why I am proud to announce that AFSCME has launched Investor Education for Working Families, a groundbreaking investor education program for our members.

This initiative has been designed to teach AFSCME members basic investing principles, increase their investment literacy and help them secure their retirement by making informed investment choices. We have developed this program with generous support from the Financial Industry Regulatory Authority (FINRA) Foundation. FINRA regulates U.S. securities firms but also supports investor education. It awarded AFSCME one of the largest grants ever given because of our reputation for fighting for the financial well-being of our members. This program will ensure that working families have access to objective investment information.

With retirement security under pressure, we need to ensure that AFSCME members have the investment know-how to achieve their financial goals and retire in comfort and dignity. We are working diligently to preserve traditional defined-benefit (DB) pension plans — Social Security and DB plans are among our members' most important assets. Investor education is an important complement to that work, especially for members with such supplemental benefit programs as deferred compensation and 457 plans. This handbook will help you learn about investing, the third leg of the retirement stool. We hope it will prove valuable as you secure your financial future.

Gerald W. McEntee
International President
AFSCME, AFL-CIO

Introducing AFSCME's Investor Education for Working Families Program

Start your journey here

We've designed this book to be an introduction to investing whether you are investing to buy a house, pay for college or build a retirement nest egg. By the time you're done reading it, you will have learned the basics of investing, including why you should invest, how to get started and where to turn next for more information on your investment journey.

The three-legged retirement stool

It's important to understand that your retirement is affected by decisions you start making your first day of work and how long you stay at your job, when and whether you contribute to a retirement savings plan. These and other things add up fast in your Social Security, your pension and your private savings — the trio of financial supports often called retirement's three-legged stool.

Social Security has been the backbone of Americans' retirement planning for more than 70 years, something workers could rely upon for a modest retirement income. The government now is working to strengthen the fund as baby boomers begin to retire. But Social Security never was intended to provide 100 percent of retirement income. While workers can depend upon it for some of their retirement income, it won't pay all the bills.

Employer pensions, the second leg of the stool, are defined-benefit plans that guarantee a set income upon retirement. Following the lead of the private sector, some public employers are trying to do away with these traditional benefit plans. They'd like to replace them with defined-contribution plans, which require employers and/or workers to contribute a set amount each pay period to personal investment accounts, but do not guarantee payments. Whether called a 401(k), 403(b) or 457, a defined-contribution plan does not promise a set income at the end; workers' retirement income will depend upon when and how wisely they invest within the plan.

Personal investment, the third leg of the stool, is the part of retirement planning you'll hear the most about in this handbook. You can increase most traditional pension benefits by working longer at a higher income. But your opportunities to increase your retirement income through personal savings are far more varied — and so are the pitfalls.

This handbook will examine the last leg of the retirement stool: personal savings and investment. It teaches you how to make your money work for you and how to start moving down the road to securing your financial future. More detailed investment training offered by AFSCME's Investor Education for Working Families Program is available at <http://invested.afscme.org>. AFSCME's Retirees department also publishes many resources to help you understand pensions and Social Security.



Your Financial Foundation

Before you start to invest, you need to take a close look at your entire financial picture and make sure you've taken care of some basic financial needs before you put money into your investment accounts.

Where to begin?

Are you ready to start investing? Get ready, get set, stop right there! As frustrating as it may seem, you need to take care of a few things before you commit a penny toward investing.

1. Prioritize your financial goals

The very first step you should take is to decide why you want to invest in the first place. What do you hope to learn? What will you do with your investment proceeds? How long is your investment timeline? At the end of this chapter, you'll find space to briefly answer these questions. By writing down and thinking through these financial goals, you'll create the beginnings of a plan to help you achieve them.

2. Analyze your current financial situation

Once you've set your financial goals, you'll want to take stock of where you are and how far you need to go. One way to keep track of your financial progress is to calculate your **net worth** at least once a year and maybe even every six months as you get started on your financial journey.

What do you own?

Your net worth is simply a way of measuring your financial health. You can get very detailed and calculate it down to the penny, but you need only a rough idea for

our purposes. First, add up all your **assets** (an accounting term that simply means what you own). These include bank accounts, retirement savings, any investments you own, the market value of your house and any other real estate you own and the resale value of any cars you own. Though you wouldn't be likely to sell your house and car or clean out your retirement accounts in a financial emergency, you should still count these as assets.

Because we're doing just a rough calculation, you'll probably want to leave out items such as household goods and collectible items (unless they're very valuable). If you do want to do a "to the penny" accounting of what you own, go for it, but we're primarily looking for a general idea of where you stand financially.

What do you owe?

Next comes the part you might prefer to avoid — your **liabilities** (a fancier word for debt). Add up your mortgage balance, credit card balances (all of them, including department store or gas cards), car loans, loans against retirement accounts, student loans, outstand-

ing bills and any other money you might owe. Even if it's not a pretty picture, at least you now have a list of everything you owe.

Where do you stand?

Take the amount of your assets and subtract your liabilities to find your rough net worth. Are you surprised by the result? Whether it's a pleasant surprise or a wake-up call, you now know where you stand financially.

If your net worth is negative (and even if it's not), you'll probably want to set up a household budget to track where your money is going. Then you can find ways to ensure your spending stays in balance with your income. If you need help with money management and setting up a realistic budget, look for low-cost classes or support from a local community college or government agency. Many local governments, credit unions and human services agencies offer assistance to people wanting to learn basic financial planning skills. Take advantage of them as you develop your financial plan of action. If you recalculate your net worth every six months, you can chart your progress toward paying off your debts and reaching your financial goals.

If your net worth is positive, you'll still want to recalculate your net worth at least once a year to make sure you're staying on the right financial path. Of course, life events have a way of messing with carefully made plans, so you might see your net worth drop from time to time. As long as you have an updated plan to get it back on track for future growth, you're still headed in the right direction even if your net worth is lower than it was in the past.

3. Pay off credit card and other high-interest debt

This may seem obvious, but remember that if you're paying your credit card company 17 percent interest on your balance every year, you could "earn" yourself a guaranteed 17 percent return by paying that balance off.

So instead of putting extra money into a stock or mutual fund for an unknown return, use that money first to pay off all your credit card and other high-interest debt. This applies to most car loans and department store charge balances, but not your mortgage or home equity loan because those usually carry a much lower interest rate.

Change your thinking about debt

Once you've reduced (or eliminated) your debt, make sure you pay your new credit card balance in full every month so you can avoid interest charges entirely. If you're having a hard time making financial ends meet without carrying a credit card balance, concentrate your energy on resolving that situation before you commit any money to investments.

You can still learn as much as you can about investing in the meantime, but you're probably better served by making sure your financial foundation is solid before you try to siphon money away to invest instead of focusing on paying down high interest debt.

Do you really need to wait?

It may seem contradictory to hold off on investing until the financial basics are taken care of, but there's no sense squeezing your budget to find money to invest when you're better off reducing your debt first. Yes, investing is very important to your long-term financial future, but even more important is developing financial habits that will serve you well for a lifetime. Do you need to have the latest technological wonder in your home, and have it now? Or would you be willing to settle for something not quite as advanced but still functional, or scratch the purchase altogether, and put the money you save toward your future financial security?

We know we're asking you to put off or even give up some things you really want, but as a result of this sacrifice you'll achieve your financial goals more quickly. Only you can decide if the trade-off is worth the effort. If you're not committed to your financial goals, then you're



probably not going to be willing to make the difficult choices required to fulfill them.

The longer you carry high-interest debt, the more money you're throwing at interest payments instead of into your investment account. Clear up your debt and avoid accumulating more by prioritizing your financial goals and living within your means to reach them. We won't pretend that paying off debt is easy. Help yourself by reaching out for support and taking advantage of whatever resources you can to teach you to live without relying on credit cards. (We list some of our favorite financial planning resources at the end of this chapter.) Once you're done making interest payments to your lenders, you can start applying that money toward your own financial dreams.

A few exceptions

Of course you're bound to find exceptions to every rule, though there's no guarantee every exception will be a good one. Here are three we think might be reasonable, but only after you've started a serious debt-repayment plan and are committed to not incurring additional debt. Deferred compensation plans, dividend reinvestment plans (or DRIPs) and some mutual funds offer individuals the opportunity to invest as little as \$50 a month.

Retirement plans

If your employer offers a match on 401(k)-type savings plans (for instance, they put in a certain amount of money for every dollar you contribute,) you may want to consider investing part of your income to take advantage of this "free" money, even if you're still in debt. It's never too early to invest toward your retirement, and establishing the habit as soon as you can is important. But debt-reduction is also important, so you'll have to decide how to balance the two.

Stock mutual funds

A few mutual funds also offer the option of low investments if you commit to making the investment monthly. Again, you'll need to research the mutual fund and investigate management expenses and investment expenses.

You'll learn more about each of these options in this book. These exceptions to the "don't invest until you pay down your debt" rule really should remain exceptions, though. We caution you against putting too much money into investments while you're still paying out a lot in interest.

4. Set aside money for emergencies and planned expenses

You should set aside a financial safety cushion to protect you against turning to credit cards or other debt in times of financial need. Many financial experts say you should have at least three to six months worth of living expenses set aside in an emergency savings account to protect against a rainy day.

One of the biggest reasons for this account is so you won't have to go into debt to pay for unexpected expenses like car repairs, medical bills or anything else that you wouldn't be able to pay off in time to avoid



interest payments. You also can tap these savings to pay your rent or mortgage, food and utilities if you lose your job or can't work for some reason. This financial security blanket will allow you to sleep more soundly at night, and also help you practice the discipline you'll need to save money toward investing. We'll discuss where you should keep these emergency savings.

Keep in mind the difference between saving and investing. Money you put in savings is money you may need quickly. You want to keep it accessible and you want to know that its value will stay roughly the same; this money you can count on to be there in an emergency. Investing is something quite different.

When you invest, you're not only setting aside money, but you're taking measures for it to grow into more than

you started with. You're investing to make a profit, but that often can take years. You shouldn't invest money that you may need immediate access to, only money that you don't anticipate needing for at least three to five years.

This is one reason why it's so important to have enough money in savings before you begin to invest. Investments vary in value from month to month, sometimes up and sometimes down. You don't want to be forced to sell your investments at a loss if you don't have enough money set aside in your savings account and you must dip into your investments during a temporary down time.

5. Purchase life and disability insurance

If you have a family or other people who depend on you financially, life insurance is very important. You can buy a solid, low-cost term life insurance policy from a reputable company to ensure your dependents will be provided for in the event of your death. While any investments you own certainly would help, life insurance is most valuable to a beginning investor (unless you're so wealthy that your dependents would be fine without it).



People often disregard disability insurance, but it's equally important for financial security, whether you have dependents or not. If you're injured and unable to work, disability insurance can provide an essential income until you're healthy enough to bring in an income again. Disability insurance is especially important if you're single or can't depend on anyone else's income if you lose yours because of injury or illness.

There are many types of both life and disability insurance. Be sure to research the different policies before you purchase anything, and choose companies and policies with low expenses and preferably no commissions. **Term life insurance** is usually your best choice. It provides a straightforward insurance policy at the lowest premium because you're not buying protection or services you don't need (such as a cash value that you can access later under certain circumstances).

Above all, don't let anyone confuse you about combining insurance with investing. Insurance salespeople may highlight the benefit of cash value that comes with **whole life** or **universal life** insurance policies. But they're less likely to emphasize that these types of policies also carry hefty commissions and the premiums are much higher than those for a term life policy with the same death benefit. Your best bet is to buy a lower-cost term life insurance policy through a reputable company and invest the difference in premiums yourself. Yes, your goal is to learn to invest, but not through a life insurance policy.

Don't let the differences between life insurance policies confuse you or tempt you to avoid dealing with the whole issue. Insurance is too important to your financial stability to ignore.

6. Investigate brokerage houses and mutual fund families

One of the keys to positive investment returns is keeping expenses low. Two mutual funds may perform equally as well, but if you buy the one with higher management expenses, your returns will be less. As you begin accumulating money to invest, start researching the financial firms you'll entrust that money to.

Many financial magazines and websites do annual brokerage surveys in which they rate the brokers on a variety of criteria. These can be a good place to start looking for ideas. After you've narrowed your choices a bit, do your own homework. (We'll give you some guidelines to use when researching a brokerage firm or mutual fund family later in this manual.) You can find additional information about brokers and brokerage firms at FINRA's BrokerCheck website: www.finra.org/brokercheck.

If you feel comfortable making your own investment decisions, you might choose a **discount brokerage** firm (as opposed to a **full-service broker**), where you'll find lower commissions and fees. With a full-service broker, you'll get advice on which stocks and mutual funds to buy, but you'll also pay much higher trading commissions in exchange for that information.

The same goes with mutual funds. There are quality, low-cost fund families where your investment money will go farther simply because you're paying less in management fees. Even if you're investing in mutual funds through a retirement plan and you don't have many fund families to choose from, you'll still want to analyze the few choices you do have. Part II of this book will guide you through some mutual fund analysis tools and help you learn what to look for in a mutual fund.

7. Consider a consultation with a financial professional

If you're feeling overwhelmed by any of the six steps above, you may want to think about seeking professional guidance, at least on a limited basis. A financial professional can help you calculate your net worth, construct a debt-repayment strategy and analyze your investment needs. A financial professional also can help you decide how much you should be investing toward retirement, and how to combine that objective with paying down any debt you might have.

There is a small array of financial advisers available to help you. Here are some of the major categories of advisers:

- **CFA** — A Chartered Financial Analyst has taken a broad educational program from the CFA Institute of the USA. This professional designation requires about 750 hours of preparation, in addition to three major (daylong) examinations.
- **CFP** — A Certified Financial Planner has taken five college-level courses on personal financial planning, and passed an examination on each course. Sometimes accountants (CPAs) and attorneys are CFPs.
- **ChFC** — A Chartered Financial Consultant has passed exams on finance, investing and insurance, in addition to having at least three years of experience in the financial industry.

- **CLU** — A Chartered Life Underwriter has been trained in life insurance and personal financial planning. Courses and exams cover such topics as taxation, employee benefits, estate planning, investments and insurance.
- A Registered Representative (or stock broker) has passed a test administered by FINRA (the Financial Industry Regulatory Authority).



Looking for a financial planner

Remember, you don't necessarily need to use the services of a financial professional. Many, many successful investors chart their financial plan on their own. There's nothing wrong with a little hand-holding, though, especially as you get started. Even one session with a good adviser can help you prioritize your goals and devise a plan you can follow for years to come as you continue your financial education.

Choosing a financial adviser takes a little effort, though. Don't blindly hire the first person you find; do some research first. The most important factor in your choice should be how the person is compensated. Do they earn commissions or are they a **fee-only financial adviser**?

When "free" doesn't mean free

Some advisers may offer their services to you for free, and if you're working hard to pay down debt or save money toward investing, free financial planning might seem very attractive. You must realize, though, that you will end up paying in other ways if you take the adviser's investment advice.



Advisers that aren't fee-only accept commissions or other payments from the financial services companies whose products they recommend. They may receive a large commission if you purchase a whole life insurance policy, or a payment from a mutual fund family whose funds they suggest you purchase. There's nothing unethical about this practice as long as the adviser is up front about who compensates them and how, but not all advisers are forthcoming with this information unless you ask them directly.

Even if a potential adviser is very open with these details, you're still probably better off with a fee-only financial adviser. When a mutual fund or other financial services company is paying an adviser, you need to be concerned about possible conflicts of interest. It's not uncommon for such an adviser to recommend mutual funds with high management fees or even sales commissions simply because that fund company underwrites the "free" advice your adviser gives you by compensating the adviser in some way. Fee-only professionals don't have this conflict.

Pay your own way

Fee-only financial advisers are paid in only one way — by their clients. While it may seem more expensive to pay a planner up front, you'll know that the planner is not biased toward any financial services, products or companies due to some type of financial arrangement with certain companies. If you specify that you want term life insurance and no-load mutual funds, your fee-only planner can help you decide what's best for your situation based solely on what's in your financial interest.

Finding a financial professional

Ask your friends and family for recommendations, and talk to at least two or three financial advisers before you make a final decision. You can use a financial adviser for a one-time-only consultation to get you started, or you may decide to consult with one every now and then to make sure you're still on track with your financial goals.

Be wary of any professional who pushes you toward investments you're not comfortable with or doesn't seem to listen to what you're saying. The adviser should be offering the guidance you need and are asking for, not pushing his or her own agenda.

Just remember that using a financial adviser isn't a requirement for becoming a successful investor. Trust yourself, reach out for help when you need it, and keep working toward developing the confidence to become a self-dependent investor. The more you learn, the less you'll need to rely on someone else's advice.

Questions to consider as you begin planning

1. Why do you want to learn to invest?
2. What are the most important financial goals you're working toward, and how many years do you have to reach them?
3. What will you need to do before you start putting aside money to invest? Do you have any high-interest debt or other financial obligations to take care of first?

4. Do you have a savings account set up so you won't need to use credit cards to cover unexpected expenses? How much money should you keep in it?
5. Do you have the appropriate types and amounts of insurance to protect yourself and any dependents? If not, when will you start researching your options?
6. Have you asked friends or family for brokerage house or mutual fund family recommendations? Do you have a few prospects to start researching?
7. Will you need to consult with a financial planner, or would you rather get started on your own?

of becoming a successful investor, set some financial goals to work toward. Then plan a strategy to pay off any high-interest debt you may carry and start funding an emergency savings account for short-term or unexpected needs. Investigate and purchase life and disability insurance if you don't already carry them. While you're taking care of all these pre-investing essentials, research brokerage houses and mutual fund companies so you can open accounts as soon as you're ready to start investing. Consult a financial professional if you think you'll need help creating a financial strategy.

Now are you ready?

In this chapter, we've covered the importance of financial goal-setting as well as the basics you should take care of before you even start investing. As you begin the process

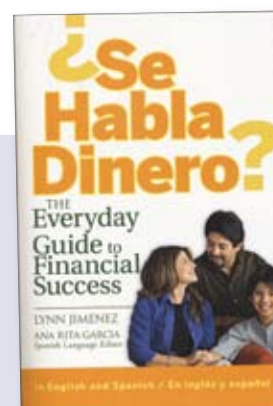
A Few Good Resources

Since the focus of this handbook is to give a digestible overview, we can't go into as much detail as we'd like. If you need a little more information on the basics of financial planning, beginning investing and pension issues, these books are a great place to start your research and find motivation for the journey ahead of you. We also included two websites.

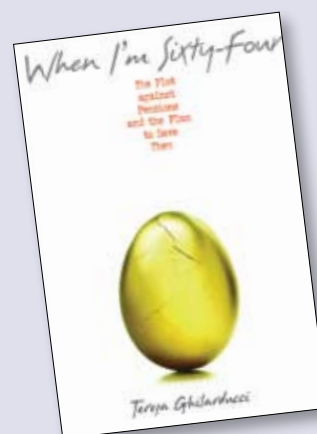
- *The Millionaire Next Door: Surprising Secrets of America's Wealthy* by Thomas J. Stanley and William D. Danko, Pocket Books; 2000 (ISBN: 0743420373).
- AFSCME's Investor Education website is a partnership between the union and the FINRA Investor Education Foundation. It has useful workshops which you can use 24/7. You can stop

and start classes to fit them into your schedule. <http://InvestEd.afscme.org>

- *The Bogleheads' Guide to Investing* by Taylor Larimore, Mel Lindauer, Michael LeBoeuf and John C. Bogle, Wiley Publishers; 2006 (ISBN: 0470067365).
- *A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing 9th Edition* by Burton Malkiel, W.W. Norton; 2007 (ISBN: 978-0393330335).
- *When I'm Sixty-Four: The Plot against Pensions and the Plan to Save Them* by Teresa Ghilarducci, Princeton University Press; 2008 (ISBN: 978-0691114316).
- 360 Degrees of Financial Literacy website has excellent free resources on personal finance issues like taxes, home ownership, budgeting and life insurance. www.360financialliteracy.org



- *¿Se Habla Dinero? The Everyday Guide to Financial Success* by Lynn Jimenez and Ana Rita Garcia, John Wiley & Sons; 2008 (ISBN: 978-0-470-07480-0).



Why Invest?

Ready, Set... Chapter 1 introduced you to the basics of financial planning, including what you should do before you start to invest. Now let's move on to why you should invest.

Savings vs. investing

You save money in the event of a rainy day; you want to be assured the funds will be there when you need them, whether that's tomorrow or next year. You invest money you won't need for a few years, with the expectation it will grow over time. If you research your investments carefully and invest wisely over an extended period of time, investing is a proven and powerful way of increasing your wealth.

Investing can be much riskier than saving, though. Investors are willing to take on more risk in exchange for the possibility of greater financial rewards. Is investing worth the risk to you?

1. Risk vs. reward

Risk and reward go hand and hand. What all investors would like, of course, is a high reward or **return** with very low risk. Unfortunately, as investment risk goes down, so does the potential return. When you save money, you put it in a bank account somewhere where it will be safe. In exchange for this safety, you receive a small amount of interest on your money as your reward.

Investing your money instead of just saving it offers the potential for a much higher return. Not surprisingly, investing carries a greater risk than socking your money away in a bank savings account. If you seek a higher return by investing, you have to be willing to take on a higher

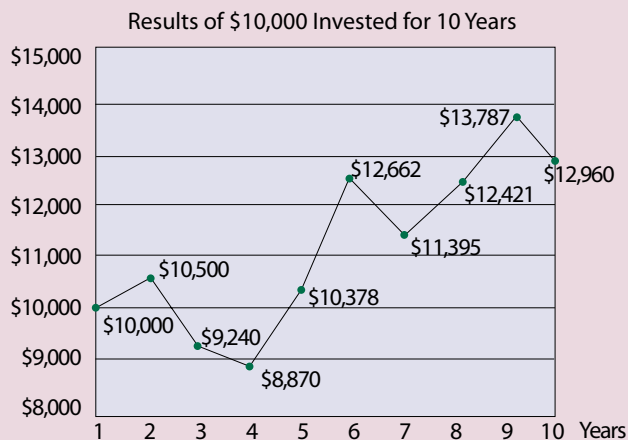
risk that your investment may not perform the way you expect. The value of your investment might go up, but it also might go down. It even might go both up and down in value within a relatively short amount of time.

2. Watching out for volatility

This swing in value is called **volatility**, and volatility is the reason you shouldn't invest any money you'll need access to within three to five years. If you've researched your investments carefully, you're hoping they'll grow in value over time. But you can't plan when the value of your investment will grow to be more than what you started with, or guarantee that it will grow at all. (There's that risk coming into play again.)

Let's use the price chart of a fictional stock in Figure 2.1 to illustrate this point. Imagine you have \$10,000 and you're trying to decide what to do with it. Should you put it into some sort of savings account or invest it

Figure 2.1 Price volatility



instead? Your answer will depend on what you're planning to do with the money, and when.

3. Short-term vs. long-term investing

If you're planning to buy a house in two years, for instance, you wouldn't want to put the money for your down payment into an investment that falls in value right when it's time for you to write that big check. Investments like stocks and stock mutual funds are volatile; they rise and fall in value from month to month and year to year. Over the long term (five years or more in this case), the growth rate will smooth out. If you've chosen a successful investment, your \$10,000 will have grown.

If you're forced to sell your investments after only two years because you need access to that money, however, you'll not only miss out on the future growth, you'll end up with less money than you started out with. If you'll need your money in less than five years, you don't have much tolerance for volatility. You'll need to give up the possibility of a higher rate of return in exchange for the lower risk you'll encounter if you save that \$10,000 in a bank savings account, CD or money market mutual fund instead. You always need to balance reward against risk, especially when you're expecting to use the money within a short period of time.

Don't worry if you're not sure how to make the risk vs. reward decision, or where to put your money whether you're saving or investing. In Chapter 3, we'll explain more about the relationship between risk and reward and your savings and investing options (as well as when — or

when not — to use each type). For now, let's get back to the benefits of investing.

4. Why invest?

Investing is a wonderful way to increase your wealth. Living within your means so that you can save money for your future is very important. Over the long term, that money can grow faster than it would in a savings account if you invest it in shares of quality individual stocks or mutual funds. Investing brings the deeper and lasting rewards of security and economic power that come from the accumulation of wealth.

When you invest, time is on your side. Stock and mutual fund prices are volatile, moving up and down in unpredictable swings. Wall Street goes through periods of growth — **bull markets** — as well as significant downturns — **bear markets**. But over the long haul, the stock market always has gone up, and patient stockholders can profit from that trend. In addition, investors who reinvest their earnings will see their money grow at an ever-increasing rate. (We'll discuss reinvestment further in this chapter).

As Figure 2.2 shows, the stock market has grown at an average annual rate of 10.4 percent during 1926-2003. The bond market, by contrast, has returned 5.9 percent, and Treasury bills have returned only 3.7 percent on average. An aggressive investment goal would be



Figure 2.2 Comparison of total returns of different types of investments

Large Company Stocks Total Return 10.4%

High Grade Corp. Bonds 5.9%

Treasury Bills 3.7%

Inflation Rate 3.0%

1% 2% 3% 4% 5% 6% 7% 8% 9% 10%

This 78-year study (1926-2003) from Ibbotson Associates clearly shows that common stocks have been more profitable than bonds. In addition, common stocks have earned enough to outpace inflation by more than three times.

to double your investment portfolio every seven years. You'll need to achieve on average a 10.3 percent compounded annual growth rate. You won't see this rate of return every year. Some years your return may be much lower than the average and some it may be much higher. But by investing wisely, you should expect to achieve that average over the long term.

Even if your return is lower than 10.3 percent, your financial bottom line still can prosper if you're committed to investing over the long term.

Figure 2.3 shows how your portfolio can grow in value over various spans of time at different rates of return when you regularly invest just a bit less than \$3 a day (\$2.74), which totals \$1,000 a year. An 8 percent return is a conservative objective. If you invested \$1,000 per year over 20 years at 8 percent, your portfolio would be worth \$79,000.

To achieve consistent overall returns, you'll need to invest in quality stocks and mutual funds regularly, through both bull and bear markets. In this way, you'll invest when stocks are undervalued as well as when they're overvalued. This strategy of investing regularly regardless of how the stock market is valued is called **dollar-cost averaging**.

5. Focus on the long term

When you first start investing, you may be nervous about timing. What if you make your first leap into stock ownership and the market takes a nosedive the next day? Are you doomed to lose everything? Time and experience will

help you overcome this common fear. Market booms, recessions, depressions and recoveries are expected parts of the market cycle. Once you recognize the rhythm of these market phases, the volatility no longer will distract you. You'll even come to welcome market dips as an opportunity to invest more at bargain basement prices.

6. The magic of compounding

Investing over a long period of time is profitable in part because your earnings compound, and as a result grow by larger and larger amounts.

Compounding is a simple idea. With compound interest, for example, you earn interest not only on your initial deposit, but on whatever previous interest your deposit has earned. If you deposit \$100 in the bank and earn 6 percent, you'll have

\$106 at the end of the year. But if your account compounds annually, in the second year you'll earn 6 percent on \$106, giving you \$112.36 at the end of the year. At the end of five years, you'll have \$133.82. Figure 2.3 shows the difference between investment totals when dividends are reinvested or paid out.

As you can see in Figure 2.3, the gains created by compounding are modest in the early years; they really start to add up after two or three decades. At the bottom of the table, the numbers generated by each dollar grow at an impressive rate. The earlier you start investing, the greater the effect of compounding will be on your portfolio.



Figure 2.3 Building your portfolio

This table shows what an annual investment of \$1,000 invested at various annual rates of return may yield for an average investor

Years Invested	4%	6%	8%	10%	12%
1	\$1,040	\$1,060	\$1,080	\$1,100	\$1,120
5	\$5,600	\$6,000	\$6,300	\$6,700	\$7,100
10	\$12,500	\$14,000	\$15,600	\$17,500	\$19,700
15	\$20,800	\$24,700	\$29,300	\$35,000	\$41,800
20	\$31,000	\$39,000	\$49,400	\$63,000	\$80,700
25	\$43,300	\$58,200	\$79,000	\$108,200	\$149,300

Use this table to see how much you would save over a period of years at various rates of return if you invested \$1,000 a year.

When you invest in the stock market, you make money in two basic ways — through the dividends companies pay to their stockholders and by increases in the price of the stock you own. When you reinvest the dividends, you're putting even more money to work through compounding.

7. Investing to beat inflation

Investing helps counteract the effects of inflation (the tendency for prices of the things you buy to rise over time). If your wages rise at about the same rate as prices, inflation won't bother you since you're not losing your buying power. Inflation does hurt, however, when you save or invest, because the dollar you get back when you sell won't be worth as much as the dollar you invested.

If you put your money in a bank savings account, for example, and earn 1.5 percent interest but the inflation rate is 3 percent, you're losing money. Intelligent investing produces a higher return on your money than the rate of inflation. In spite of the bite inflation takes out of your money, you still come out ahead.

8. Other reasons to invest

In addition to the prospect of earning greater returns while beating inflation, you might reap other benefits from investing. When you invest in indi-

vidual stocks and stock mutual funds, you become a partial owner of a piece of corporate America. While you may own only a fraction of a company, you're still a shareholder, taking the same risks and hoping for the same rewards as the company itself. The money that shareholders invest when a company sells new shares enables that company to expand its operations, to buy facilities and equipment and to develop ideas into important products and services. If the company performs well and its stock price rises, you as a partial owner can claim your share of the gains.

9. Four investing principles

Now that you know why you should want to invest, it's time to talk about some simple investment principles.

1. Invest a set sum of money regularly over your lifetime

A beginning investor with limited funds can start investing with a little bit of that money every month, either on their own or through an investment club. A seasoned investor with more resources can build a solid financial future by investing regularly as well. Invest something in growth stocks and mutual funds every month and stay on track with your investment savings schedule. It doesn't matter how old or young you are now; investing is a lifetime project and you'll see the greatest results if you start right away.



2. Reinvest earnings, dividends and profits

Put everything you make back into your investments. If a company pays **dividends**, reinvest that money to buy more shares of either that stock or another. When

ment. Along the same lines, don't risk everything on one type of stock or mutual fund. Invest in good companies of varying size and business sectors and in mutual funds from different categories or groups.

Diversification helps reduce risk and decreases your chances of "losing it all" by investing everything in a company or fund that performs much worse than expected. It's true that diversification also can limit your portfolio's upside potential, but diversification is important in order to balance risk and opportunity.

Moving on...

While saving is a vital habit to form, investing is even more important to your future financial success. Investing your money in appropriate places will help that money grow (both in value and through compounding). Over the long term, stocks and stock mutual funds offer higher returns than other investments and help counteract the effects of inflation.



Tools you can use

Investor Education for Working Families

AFSCME recently launched a new website full of investor education resources. There are six online workshops with more coming. Make sure to check back as we add new features.

<http://InvestEd.afscme.org>

you sell a stock, immediately put that money to work in another investment. Even if you start small, reinvesting dividends and earnings will help you build a substantial portfolio over time through the amazing effect of compounding.

3. Consider index mutual funds

Many of us don't have the time necessary to do our own stock analysis and determine which ones we think are likely to increase or decrease in value. An **index fund** is a special type of mutual fund that buys small pieces of lots of companies and holds them. The companies bought are listed in an index (list of stocks), such as the S&P 500, which contains large, U.S.-based companies. Index funds incur low taxes, are diversified across an asset class (we will learn more about this later) and can have the lowest fees of any mutual funds. For people who want to choose a few simple investments, index funds are a smart, low-cost, high-reward option that has produced excellent returns historically.

4. Diversify your investments

Since you can't guarantee which of your investments will be winners and which might not meet your expectations, you don't want to put all your money into just one invest-



Tools you can use

The American Savings Education Council's Ballpark E\$timate is an easy-to-use worksheet that helps you quickly identify approximately how much you need to save to fund a comfortable retirement. The Ballpark E\$timate takes complicated issues like projected Social Security benefits and earnings assumptions on savings, and turns them into language that is easy to understand. It will let you know how much to save each month to put yourself on track to achieve your own financial goals.



www.choosetosave.org/ballpark/

Risky Business

Now that you've set your investing goals and taken care of your basic financial needs, it's finally time to start talking about investing.

How do you know whether you should put your money in stocks or bonds, money market funds or real estate? It all depends on what your goals are and how long you have to reach them. What you invest in also depends on the level of risk you're willing to take. But first you need to learn what your investment alternatives are.

What's the risk?

Let's talk a little more about risk and its relationship with reward. Don't run away in horror; without risk, your chances of a decent investment reward are slim. When you understand how risk and reward work together, you're better prepared to choose appropriate investments.

In Chapter 2, we introduced the idea that the possibility of higher investment returns comes only when you're willing to take on higher risk. Investments with the lowest amount of risk, which are really more savings than investments, offer the lowest return. If you want a higher potential return, you need to be willing to accept more risk.

As we present the following descriptions of potential investments choices, we'll also discuss where each stands on the Risk Pyramid (see Figure 3.1). Follow along with this illustration, and you'll soon recognize the pattern of risk and reward.

Let's briefly run through some of your potential investment options now. There are a lot, but don't let the selections confuse or overwhelm you. Once you start investing, your portfolio most likely will include only a handful of these. Don't expect exhaustive descriptions of these choices because you're not going to find that here. This section is intended only to give you an overview of your possible choices. Use this chapter as a quick reference, and then do more research on the choices that appeal to you.

Later in this book we'll give you guidelines for which types of investments are best suited for your portfolio, depending on your goals and investing timeline.

Level 1 — Lowest risk/lowest return

Government investments

Savings instruments and securities issued by the U.S. government are considered risk free. They are guaranteed by the federal government, which has the power to tax and create money. These types of investments often are referred to as **fixed-income investments**, meaning they earn a fixed rate of return. Investors who need investments with very low risk (such as retirees) often will choose fixed-income investments for their stability, even if this means accepting a lower rate of return.

Figure 3.1 Relative risk and return pyramid — Items at the top of this chart have higher returns and higher risk. As you move down the chart, the risk and returns both diminish. Recognize the level of risk you're willing to accept in exchange for your desired return.



Series EE bonds

These federal government savings bonds are issued in denominations as small as \$50. A \$50 savings bond is sold at a discounted rate of \$25. By the time it reaches maturity, the interest earned plus the \$25 purchase price will equal the \$50 face value. The interest on a Series EE bond is a variable rate based on 85 percent of the average rate on five-year Treasury notes. The tax on the interest is deferred until the bonds are redeemed.

Series HH bonds

Series HH bonds are similar to EE bonds, except they are sold in larger denominations and at face value rather than being discounted. The interest on HH bonds is currently taxable.

Treasury bills

T-bills are short-term government securities sold in \$10,000 to \$1,000,000 denominations. Like EE bonds, T-bills are issued at a discount to their face value. They mature in three to 12 months. The interest paid varies in response to the overall interest rate, and typically is very low.

Treasury notes and Treasury bonds

These securities have longer maturities than T-bills. The notes mature in one to 10 years, the bonds in more than 10 years. Both are issued in minimum denominations of \$1,000. Because of their longer maturities, Treasury notes and bonds normally pay higher interest rates than T-bills.

Federal agency securities

In addition to the federal government, many federal agencies issue debt securities. Three of the best known of these are the Government National Mortgage Association (“Ginnie Mae”), the Federal Home Loan Mortgage Corp. (“Freddie Mac”) and the Federal National Mortgage Association (“Fannie Mae”).

These federal agency securities tend to offer higher interest rates than the Treasury securities, but they still are considered low risk.

Bank savings accounts

Think of savings as the money you set aside for a rainy day. You want it to be there when you need it, so you’re not willing to put it at risk. One of the most popular

places to put this money is in a bank savings account. You won't make much in interest on the money in a savings account, but you will know that it's safe.

Bank savings accounts come with very little risk, especially since the Federal Deposit Insurance Co. (FDIC) insures most commercial banks and savings and loan (S&L) savings accounts up to \$100,000. Remember that in exchange for this low risk, though, you get very little reward.

Level 2 — Low risk/low return

Money market accounts

When we mention **money market accounts**, we're not talking about the money market account your bank may offer (a sort of souped-up savings account that may pay out a little more in dividends than a savings account does in interest but also requires a much bigger minimum balance). These are money market mutual funds offered by mutual fund families and brokerage houses, and usually are composed of such low-risk, relatively short-term securities as Treasury bills, large certificates of deposit and notes issued by large, stable corporations. Money markets are considered safe places to park your short-term money.

Money market funds offer a place to stash the emergency savings we recommended in Chapter 1 that you should start accumulating. Many money market accounts offer free check writing or an ATM card you can use to access your money when you need it. Just be sure to find out if there's a minimum dollar amount before you write a check. Some money market funds won't allow checks for amounts less than \$100 or \$250, for example.

Since the account is for your emergency savings, though, you won't be writing small checks as you would in your personal checking account, and a higher minimum most likely won't matter. Mutual fund companies set this higher minimum to keep their transaction costs lower, and the lower their expenses, the more they'll be able to pay out to you in dividends.

You should look for a money market fund offered by a reputable **mutual fund family** or **brokerage**, and especially one that charges low management fees and no load or **commission**. True money market funds are not risk free. Although they're very safe compared with other places you might put your money, there is a slight risk you might lose some of your principal (the money you start

out with). In exchange for this risk, you'll be rewarded with a higher dividend payout than the interest paid in a bank savings account.

Money market funds typically pay at least 1 percent to 2 percent more than bank savings or money market accounts, but with relatively little increased risk. The biggest drawback to using a money market fund for beginning investors is that the minimum balances sometimes can be more money than you have saved up. If this is the case, start saving in your bank savings account until you accumulate enough to open a money market account.

Certificates of deposit (CDs)

Certificates of deposit (CDs) are slightly longer-term investments ranging from three months to many years. You purchase CDs through a bank or S&L, at either a fixed or variable interest rate over a determined time period. The FDIC also insures CDs for up to \$100,000 per account. Because you are tying up your money for a longer time period, CDs pay more interest than a bank savings account, but still offer relatively low returns.

CDs carry a low risk and a slightly greater reward than a savings account, but aren't appropriate for the money in your emergency savings account. Although you can take your money out of a CD before it matures, you run the risk of losing part or all of any interest earned. Don't put any money into a CD that you might need to use before the CD's term is up. Choose a money market account



for maximum flexibility in this case, even if the dividend payout rate is slightly lower than the interest you might get with a CD.

High-quality corporate bonds/corporate bond mutual funds

By buying corporate bonds or shares in a mutual fund that buys corporate bonds, investors are loaning money to corporations. These loans are riskier than loans to the federal government, but if they are investment-grade bonds, the risk of default still is very low.

High-quality municipal bonds/bond funds

These bonds are similar to high-quality corporate bonds, but with an important difference. They are issued by federal, state and city government entities, and the interest usually is federal and sometimes state tax free. A number of high-quality municipal bonds are insured against default by municipal bond insurers, thus reducing the risk that investors will not get their money back. Municipal bonds only really make sense for investors in a high tax bracket who have the most to gain from the tax redemption. Your tax adviser can tell you whether municipal bonds are a good choice for your portfolio or not.

Level 3 — Relatively low risk

High-quality convertible bonds

A convertible bond is a corporate bond that pays a fixed rate of interest but can be exchanged for a specific number of shares of common stock in the same company. This flexibility has a price. The rate of return (coupon rate) usually is lower than the rate on a “straight” (non-convertible) bond.

High-quality preferred stock

The name is deceptive. **Preferred stock** is really a fixed-income security more like a corporate bond. For most investors, it doesn't make sense to invest in preferred stock, because the yields are very close on similarly rated bonds and because preferred stockholders lack legal power to force dividend payment.

Level 4 — Intermediate risk

Balanced stock and bond mutual funds

A little higher on the risk pyramid are mutual funds that offer an opportunity to invest in a mixed bag of stocks

and bonds. You even can choose your level of risk. A fund with 75 percent of its money in common stock and 25 percent in bonds has a higher risk profile than a fund with 50 percent in each, which in return for this lower risk may have a lower long-term return.

Large-cap stocks

Quality growth stocks are companies that are leaders in their industry and have demonstrated consistent growth rates for both earnings and revenues. These companies usually pay low dividends, but offer opportunities to profit from rising stock prices. Over the long run, quality growth stocks produce returns above the rate of inflation.

Large capitalization (“large cap”) refers to companies in which a lot of money already has been invested and which have a high market value. Market value is calculated by multiplying the number of common stock shares owned by stockholders times the current price per share. For example, a company with one hundred million shares outstanding at \$50 a share has a market value of \$5 billion — considered by many to be the minimum for a large-cap stock.



Real estate

Real estate can mean the home your family lives in or property you buy as an investment, although you probably won't want to consider your primary residence as an investment. Real estate can be residential, commercial or even empty land. Owning real estate carries the same risk as other investments. The market can drop right when you need to sell or you might not be able to find a buyer at all.

There are continuing expenses to consider with rental real estate as well, both in money and in time. You'll need to pay for property taxes, mortgage interest and insurance

every year, find tenants and collect rent, and take care of any maintenance needs. Interest rate fluctuation also can affect the value of your investment.

Real Estate Investment Trusts

If you're interested in investing in rental real estate but would prefer not to deal with the hassles of day-to-day property management, you might consider investing in a Real Estate Investment Trust (REIT). REITs combine the benefits of investing in real estate with the convenience of buying and selling REIT shares like stocks. REITs also offer small investors the opportunity to invest in large commercial real estate they'd otherwise never be able to afford. Buying shares in REITs is similar to buying shares in a mutual fund, because you're purchasing a small portion of a large pool of different investments.

A REIT is a company that owns and often manages income-generating commercial and residential rental real estate. REITs can own shopping malls, apartment complexes, hotels, office buildings, other rental real estate or all of the above. Shares of REITs are traded on stock exchanges, making purchases and sales convenient and fast. A REIT is required by law to pay out at least 90 percent of its taxable income to shareholders each year, which makes REITs attractive to investors looking for income-producing investments.

Because REITs are more liquid and diversified than individual real estate holdings, they provide a way to invest in real estate while assuming less risk than if you went out and purchased a property on your own.

Level 5 — Relatively high risk

Mid-cap stocks

When all the investment in a company are between \$500 Million and \$5 Billion the company is considered to have a Medium **Capitalization**, commonly referred to as a **Mid-cap**. These companies are smaller and less stable than the Large-Caps discussed earlier. Promising Mid-



Caps have demonstrated high growth rates and have room to expand.

Small-cap stocks

When all the investment in a company are less than \$500 Million the company is considered to have a Small **Capitalization**, commonly referred to as a **Small-cap**. Because many of these are small companies with short track records, they represent high risk and relatively high return potential.

While it's possible that small companies such as these might fail completely, it's also possible they may succeed far beyond your expectations.

Therefore, the higher risk of total loss you accept when investing in small-cap stocks is balanced by the potential for a tremendous reward.

Specific industry mutual funds

When you buy shares in a specific industry mutual fund, you are investing in a number of companies in the same industry. For example, you can buy funds specializing in health care, financial services, technology and utilities. If this kind of investment represents a major share of your investment portfolio, you're taking the risk of staking a great deal of your financial future on the developments in one small part of the business world.

Low-quality stocks

The definition of "low quality" is subjective but these are high-risk stocks for a variety of reasons: small revenue and earnings base, erratic past performance, not being leaders in their industry, a concentration on one product or service, a market price of stock under \$5 a share, questionable management and the possibility that the stock is overvalued based on corporate earnings

Low-quality bonds

Because these are non-investment grade bonds, there is a higher likelihood they could default and not pay the interest due and/or the face value of the bond at matu-

ity. At the bottom of this group are the so-called “junk bonds.” But that term is deceptive. Some excellent companies are included in this group and their bonds may very well be upgraded because of improvements in corporate operations. While low-quality bonds carry a high level of risk, they also have produced excellent returns over the past 10 to 15 years.

Level 6 — High risk

Futures

Commodity **futures** are contracts to buy and sell items that will be mined or grown — soybeans, coffee, cattle, crude oil, etc. — at some time in the future. When you buy futures, you’re betting on the future movement of prices, a speculative activity even for those who know the markets well. In addition to commodities, futures contracts also can be based on currency, bonds or stock indexes.

Options

An **option** is a contract to buy or sell a stock at a certain price during a certain specified period of time. Small price swings in the underlying stock will have a large effect on an option’s price. Options often produce large-percentage gains or losses, and primarily are used by short-term traders.

Derivatives

Both futures and options are examples of **derivatives**. Their value is *derived* from the value of the underlying commodity, stock or whatever the contract is based on. Derivatives have no intrinsic value themselves; there’s nothing you can grab on to like a crop of soybeans or a stock certificate. Derivatives also are extremely risky. While your payoff may be huge if you make the right moves, you’re much more likely to lose all the money you’ve put into the derivative.

Hedge funds

Hedge funds are a type of investment fund used by very wealthy investors and institutions willing to take large risks to protect their capital. Hedge fund managers often

use derivatives in an attempt to counter movements in the stock market. Because derivatives are so very risky, traditional mutual funds aren’t allowed to use them. Beginning investors, and even most experienced investors, should ignore derivatives and hedge funds as well. A basic investing rule of thumb to stand by definitely fits derivatives: “If you can’t understand it or explain it to someone else, don’t invest in it!”

Low-priced and “penny” stocks

A low-priced stock sells for under \$5 a share, and a so-called penny stock sells for under \$1 a share. In general, these are shares in small companies with no earnings track record, which makes investing in these stocks a highly speculative move. Although you might be attracted by their prices, low-priced and penny stocks are high risk, and you should avoid the temptation to buy either.

Moving on...

Overwhelmed by all of this? Take a deep breath and relax. You only need to focus on a few of these choices for the near future and potentially for the rest of your investment horizon, depending on your goals.

Most of the rest of this book will focus on investing in individual stocks and stock mutual funds. But there will be times in your investment life where you’ll probably want to put some of your investment money into money market funds (if you’re saving for a house or building up your emergency savings, for example) or bonds (if you’re looking for income in your retirement years, perhaps). Other investments also will make sense for certain people in certain situations.

Also remember that no book can tell you exactly what you should invest in and when. You need to determine your risk tolerance and how that fits together with your financial goals, possibly with the help of an investment professional as we discussed in Chapter 1. Now that you’re familiar with most of your investment options, it’s time to learn how to choose the types of investments most likely to help you reach your financial goals.



Pulling It All Together

You invest hoping to end up with a return on your money that will allow you to meet your financial goals. But what exactly is your return, and what type of return can you reasonably expect from your investments? Your return will depend on the asset classes you choose for your portfolio, as well as the effect of such factors as taxes, expenses and inflation.

Even after you've decided what types

of assets to invest in, you'll need to determine how much of your investment money should go into each asset class to achieve the returns you're hoping for. Determining and following an appropriate asset allocation strategy is an important part of your investment planning. It's also important that you create an investment philosophy, the "big picture" guidelines you'll follow when you make investment decisions.

The importance of returns

You can't come up with a practical asset allocation plan, which we'll talk about a little later, unless you're realistic about your portfolio returns. Your return is the profit you make on an investment. If you invest \$2,000 in a stock, for example, and end up with \$2,200 after a year, your return would be 10 percent (the increase between what you invested and what your investment grew to, including any dividends paid during that time). In other words, \$2,200 (the final investment value) minus (\$2,000) the starting investment value, equals \$200. This \$200 gain (or profit) represents 10 percent of your \$2,000 initial investment.

Of course, as with many financial topics, calculating your return isn't quite that simple. Your return in this example is your nominal return. What you need to focus on is your real return. Keep in mind that investments do go down at times, so your returns won't always be positive, but we'll stick to positive returns as our examples in this chapter.

1. Nominal vs. real returns

Your **nominal return** is the number you arrive at using simple arithmetic, just as we did in the example above. You start with a certain amount of money and end up with (you hope) a larger amount of money. You subtract

the smaller number from the larger and that's your nominal return. But your nominal return isn't your real return on your investment. In order to find that **real return**, you'll need to consider three factors that can negatively affect your initial return.

Commission costs/expenses

Few things in life are free, and unfortunately investing isn't one of them. In order to buy and sell individual stocks, you'll usually need to pay a commission. Before you can calculate your real return, you'll need to add in the cost of doing business with a brokerage house. Using the numbers above, here's how the scenario might work.

We'll use a hypothetical commission of \$19.95 per trade, a typical commission if you're working with a discount broker online.

You'll pay \$19.95 to buy the stock in the first place, then another \$19.95 when you decide to sell. Altogether you've now paid \$39.90 for the privilege of buying and selling your chosen stock, so you'll need to deduct that amount from your gain.

If you're purchasing mutual funds instead of individual stocks, you're still paying expenses, but they're harder to identify. Most mutual fund expenses and fees are deducted from the fund's return. You wouldn't even notice them unless you went looking through the fund's financial reports. We'll cover mutual fund expenses and fees more thoroughly in Part II. You don't need to worry about them for the purposes of our discussion now.

Taxes

If you're lucky enough to see a positive return on your investments in taxable accounts, guess what? You will pay a tax on capital gains. If you have valid reasons for selling the stock, sell with the recognition that, after taxes, you're still ending up with more than you started out with. Of course, there's no reason to pay more in taxes than you need to. Pay attention to short vs. long-term capital gain tax rates, and know the rules of each before you make selling decisions. Be aware of how a tax loss may affect your overall tax situation as well if you're faced with selling a losing rather than winning stock.

Inflation

Although inflation isn't often on the radar screen of many investors, it does have an impact on investment



Figure 4.1 Nominal and real returns

Nominal and Real Total Returns A Hypothetical Example			
Nominal Total Returns	\$2200	Selling Price	
	- 2000	Buying Price	
	= 200	Capital Gain	
	= 200	Nominal Total Return	10% (200/2000)
Real Total Returns	2180	Selling Price	(\$2200 - \$20 Fee)
	- 2020	Buying Price	(\$2000 + \$20 Fee)
	= 160	Capital Gain	
	- 24	Capital Gain Tax @ 15%	
	= 136	Net Return	6.8% (136/2000)
		- 3% Inflation Rate	
		3.8% Real Total Return	

returns. There's nothing you can do to control inflation, but you should make allowances for it in your investment planning. Because inflation will lower the real value of your portfolio over time, you'll want to choose investments with good prospects of delivering inflation-beating returns.

So what's your real return?

After accounting for expenses, taxes and inflation, you'll come up with your real return. The chart above details the process, using the same example of a \$2,000 stock purchase from the previous page, and hypothetical capital gain and inflation rates.

2. Asset allocation

Asset allocation is an important concept to understand as you start to make decisions about what type of investments your portfolio should contain. Your assets are the different types of investments you choose to make. Stocks, bonds, real estate, cash — these are each one of many types of assets. Allocation simply means what percentage of your available investment money you devote to each asset.

Say you have \$25,000 sitting under your mattress. You want to invest it to earn a better return than it's making under there among the dust bunnies, but you aren't sure exactly what to put the money into. You could use an asset allocation strategy to figure out what type of investments and what

percentage of each will help you reach your financial goals within your investment timeline. Ideally, this investment mix will give you the highest return with the lowest level of risk for your particular circumstances.

Managing volatility

Asset allocation is one strategy to control volatility in your investment portfolio. Volatility is the movement of your portfolio's value. With the exception of cash, your portfolio is going to move up and down in value. Stocks typically are more volatile than fixed-income investments, meaning that stock prices (and the value of your holding in that stock) can soar or plummet rapidly at times. You've certainly seen daily news reports that a certain stock went up or down so many dollars. This swing in value is a sign of volatility.

Over the course of a year or many years, this price movement averages out to a steadier curve. When you watch prices in the short term, the volatility can be frightening or exciting, depending on whether the movement is down or up. If you can't sleep at night for worrying about these swings, that's a good indication that you might want to adjust your asset allocation to include less stock and more fixed-income investments.

Managing returns

Some financial experts say that proper asset allocation can account for up to 80 percent of your investment returns over the years, meaning the percentages of stocks vs. bonds vs. cash you hold in your account is more important than the particular investments you choose. Their reasoning is that if you hold most of your money in stocks when stocks are performing well, or most of your money in cash when stocks are on a downturn, you'll end up ahead, regardless of which individual stocks you're invested in.

The problem with this theory is that it's difficult for you as an investor to know when to switch your funds between asset classes to take advantage of these types of market changes. It's just as difficult for seasoned money managers to make the same decisions, so don't feel bad. There's just no proven way to accurately predict market movements well enough to ensure your portfolio is primed for whatever the market is about to do next. Constantly rebalancing your portfolio means higher transaction costs, too, as you buy and sell according to what you think might happen in the market in the future.

A more reasoned approach to managing your investment returns through asset allocation is to research the average historical returns of each asset class before deciding what portion of your portfolio to put in each. You can rebalance the percentages once a year if necessary, and change your asset allocation model as your circumstances change.

3. What are the rules?

Unfortunately, there's no such thing as a standard, one-size-fits-all asset allocation formula. Sure, there's the one that says, "Subtract your age from 100 and invest that percentage in

stocks." Under this advice, a 55-year-old would invest 45 percent of his or her available investment dollars into stocks. But not all 55-year-olds are in the same place financially or have the same goals or risk tolerance.

Take two women, both the same age with the same \$25,000 they've just received as an inheritance. The first woman retired early five years ago and doesn't plan to work anymore, so her current investments will need to last her the rest of her lifetime. She may choose to be more conservative with her investments and invest a higher percentage in an income-generating bond fund instead of in stocks, to provide for her current cash flow needs.

The second woman started investing for her retirement only a year or two ago and will need to work many more years before she can accumulate enough investments to



retire comfortably. She may choose to invest a much higher percentage in stocks than recommended by this simplistic formula, hoping to achieve the better rate of return that stocks traditionally have given compared with bonds.



Why is asset allocation important?

Many financial experts consider asset allocation to be key to your portfolio's performance. Books, academic studies and websites devoted to the topic abound. It's very easy to become confused or overwhelmed by often conflicting asset allocation advice. Ultimately, only you can decide what your ideal asset allocation is, and you should expect that it will change with time as your financial needs and goals change.

Generally, the younger you are and the more years you have to save for retirement, the higher your allocation of stocks and stock mutual funds will be. The closer you get to retirement, when asset preservation becomes more important than asset growth, the higher your allocation of bonds or other income-generating investments most likely will become.

4. Determining your asset allocations

In order to determine the most beneficial asset allocation for your current place in your investment timeline, you'll need to analyze your financial goals, your tolerance for risk and your available assets. We encouraged in Chapter

1 that a fee-only financial professional can help you figure out a financial plan when you're first starting out. A good financial professional also can help you establish your initial asset allocation plan as well as discuss how it may change over the years.

If you don't have a trusted financial planner or choose to make these decisions on your own, here are some questions to consider as you work to determine your asset allocation plan.

Which asset classes will you be putting your investment money into?

As explained earlier, the most common choices for investors are:

- Index funds;
- U.S. stocks/stock mutual funds;
- International stocks/stock mutual funds;
- Fixed income (primarily bonds, bond mutual funds and fixed-income deferred annuities);
- Investment real estate (rental properties, REITs, limited partnerships); and
- Cash (primarily money market funds, CDs — which also can be considered “fixed income” if the term is more than a year — and Treasury bills).

What is your risk tolerance?

Do you have many more years of employment ahead of you, potentially enabling you to take more risk by investing more heavily in stocks? Or are you currently retired and wanting to reduce your investment risk by investing primarily in income-generating asset classes? These questions, and more, need to be considered, but there's no “one size fits all” answer.

How long is your investment horizon?

Is this money you'll be investing for longer than five years, making it more suitable for stocks? Or will you need it in six months or a year, thus making cash a more appropriate choice?

What are your goals for these investment dollars?

If you're investing for retirement in 30 years, you'll probably want to put more of your investment dollars into stocks, which have a higher historical average rate of return (see Figure 2.2, page 16). But if you're thinking of investing money you'll need for a down payment in three years, you'll want to choose someplace less volatile than

the stock market to put your money. The longer you have for your money to work for you, the more aggressive you might choose to be with your investment choices.

Calculating your current asset allocation

Once you have a clear understanding of your answers to these questions, you should calculate what your current asset allocation is. Add up your total investments, and then separate them into the six loose categories above (Index funds, U.S. stocks, international stocks, fixed income, real estate and cash.) Calculate the percentage you currently own in each category, then match those categories up with a general return you might use to estimate potential returns. Using these percentages and your estimates for future returns, are you on track to meet your financial goals? As mentioned earlier, a fee-only financial professional can be instrumental in this process if you find you want more personalized guidance.



Asset allocation vs. diversification

Don't confuse asset allocation with diversification. Although related, they are not the same. Both try to manage your investment returns by managing risk, but while diversification keeps you from investing too much of your money in one particular investment (such as your employer's stock or one single technology mutual fund), asset allocation spreads your investment dollars across



distinctive asset classes in an attempt to achieve the highest returns you can while preserving the money you need to keep safe.

Put another way, diversification spreads your stock and mutual funds across a variety of industries and market caps (large, medium and small) to reduce the risks that come from investing everything in one particular type of stock or mutual fund. Asset allocation offers a way to reduce risk or improve returns by balancing your total portfolio of investments across different asset classes — a certain percentage in stocks vs. fixed income vs. cash investments, depending on your financial goals and timeline.

5. Bringing it all together

Beyond the four investment principles that we introduced previously — invest regularly over the long term, reinvest all earnings, invest in low-cost index funds and diversify your portfolio — here are some other sound investment guidelines to follow regardless of what type of investments you choose:

Define your investment philosophy

Your investment philosophy is your financial mission statement. Before you start investing, you'll want to have a loose set of rules to guide you.

Whatever guidelines you decide to follow, write them down and keep them in mind as you make investment choices over the years. Adjust it to keep it relevant to your circumstances. Above all, try to follow it as closely

as you can to ensure you stay on the investment path geared toward helping you achieve your financial goals as quickly as possible and with the least amount of risk.

See the example of an investment philosophy below. Think a little about your own goals and investment beliefs after you read it. Then take a few minutes to draft your personal investment philosophy.

Stick to one strategy

If your investment philosophy says that you want to follow a long-term buy and hold strategy, selling only for well-defined reasons, follow it. Don't decide one day to start day trading or buying speculative stocks because you think that's the way to goose your portfolio's return. If you really do think this (and here's hoping you don't), then you've undergone a fundamental shift in your investment philosophy and it's time to revamp your entire strategy.

Pick an investment strategy you're comfortable with, one that will help you achieve your financial goals, then stick to it closely as you make your investment decisions. Do whatever research you've decided is necessary, choos-



ing investments that meet your predefined criteria. You'll find that following a set investment strategy frees you from even considering inappropriate investments, saving you time and potentially money.

If you're really itching to experiment outside of your usual investment strategy but you're afraid you'll make costly mistakes with your portfolio, consider an additional option. Some investors allocate a small part of their portfolio, maybe 5 percent or less, as "mad money," money they've decided in advance they'll take more risks with. If you have enough resources to feel comfortable risking the money, then incorporate this idea into your overall investment plan.

Just be sure to acknowledge that while it's possible to hit the jackpot by investing in penny stocks or something else equally risky, you're more likely to watch these speculative investments go to zero. Investing only a tiny percentage of your portfolio helps you work through your speculative urges in a way that won't break your personal bank, allowing you to stay focused on a more reasonable plan for the bulk of your investing dollars.

Keep expenses low

If you're investing in mutual funds, look for **no-load funds** as opposed to funds that carry loads or sales charges. **Index mutual funds** typically charge much lower management fees than actively managed funds. We'll explain these different types of funds in more detail in Part II. The bottom line, though, is that you often can increase your mutual fund returns by choosing funds with low management expenses, no sales charges and low portfolio turnover.

If you're investing in individual stocks, search out brokerage firms with low commissions and fees. Whenever possible, you'll want to keep your investment expenses below 2 percent, and preferably no higher than 1 percent, of the amount you'll be investing. This means that if your brokerage charges \$19.95 to buy a stock,

Sample investment philosophy

My investment objective is to build a diversified portfolio that includes quality growth stocks and mutual funds, balanced according to my personal asset allocation model and focused on achieving my financial goals. I'll create this portfolio based on the results of my detailed research, focusing on investments I intend to hold for the long term.

My investment philosophy



you should be purchasing at least \$1,995 worth of stock to keep your commission expenses at 1 percent. You'll be paying the same commission to sell the stock, of course, doubling your commission expense. If you've chosen a quality stock and hold it for the long term though, the value of the stock should increase, decreasing the commission percentage overall.

Do your own research

Don't trust anyone else's opinions about the investments you're considering for your portfolio, at least not until you do your own research. Brokerage and media analysts sometimes can have conflicts of interest you don't know about that might affect their opinions. You can be sure they don't know the peculiarities of your own portfolio or your investment goals — only you know what types of investments will suit your purposes best.

You'll find plenty of guidance for researching your own investments throughout this book. It's not as hard as you might think to learn what you need to know to make well-informed, reasonable choices for your personal portfolio. Don't trust hot stock tips from some expert you see on TV (or your next-door neighbor) until you do your own homework. If you find that it really is a hot stock tip, then act on it with the clear understanding of where you're investing your money. In the greater likelihood that you find the tip a bust, move on with the knowledge that by doing your own research, you've protected yourself from a shoddy investment.

Hold for the long term

When you do finally invest in stocks and mutual funds after researching them thoroughly, confirming that they fit your investment philosophy and that you've kept your expenses as low as possible, you've most likely chosen high-quality investments with great prospects for future growth. Hold on to them. Don't sell after a few years just because the price hasn't changed much.

If the basic reason for choosing the investment hasn't changed (the earnings still are solid, for example), be patient. No one ever said long-term investing would be exciting. Sometimes you'll need to wait a few years for your investments to start to pay off. If you sell too soon, you'll miss your chance at better returns.

That's not to say you should never sell. If the reasons you bought the stock or mutual fund do change, then it may very well be time to take your gains (or cut your losses) and move on to an investment with a brighter outlook. No matter how good your research is, there always will be corporate developments you never could predict.

Moving on...

When you're contemplating potential returns for your portfolio, don't forget to take into account how investment expenses, taxes and inflation might reduce your real returns. It's better to slightly underestimate the return you think you'll get when you're planning than to think your investments will earn the highest return possible. Wouldn't you rather be pleasantly surprised when your portfolio returns more than you'd planned for, instead of caught in a shortfall because you were overly optimistic?

Appropriate asset allocation can make a noticeable difference in your portfolio's returns. Determining what your best allocations are isn't always simple, though. Take another look at the financial goals you identified to identify your investment timeframe, then choose a mix of investments most likely to meet those goals in the time you have.

Tax-Advantaged Investing

While your investment philosophy will remain the same whether you're investing in a taxable or tax-advantaged account, your investment alternatives might not be the same.

Before you begin investing, you should decide on an allocation strategy to determine what percentage you'll be investing in retirement or college savings accounts and what percentage in taxable accounts. This chapter will explain the basics of the most popular tax-advantaged investment choices as well as some differences you should keep in mind.

Investing in tax-advantaged and other retirement accounts

If you're working, you most likely have access to some type of retirement investment option, whether through your employer's plan or through an IRA you invest in on your own. Investing for your retired years should be one of your top investment priorities.

If you have any choice of investment vehicles (deciding which mutual funds your retirement money will buy, for example), this is the perfect place to start putting your new investment knowledge to work. Chances are you have to make some sort of choice about how your retirement money is invested, so it's in your best interest to learn how to analyze your choices instead of blindly choosing based on a fund's name or what your co-workers invest in.

One reasonable investment policy is to contribute the maximum to your tax-deferred investment alternatives before investing retirement or college savings in taxable accounts. You'll most likely want to invest in taxable accounts for other important financial goals, such as saving for a house, car or other long-term goals. If you've maxed out your tax-deferred retirement and college accounts and still have savings to invest, congratulations! You have plenty of choices, including brokerage and

mutual fund accounts. We'll tackle these subjects later, so let's finish with tax-deferred accounts first.

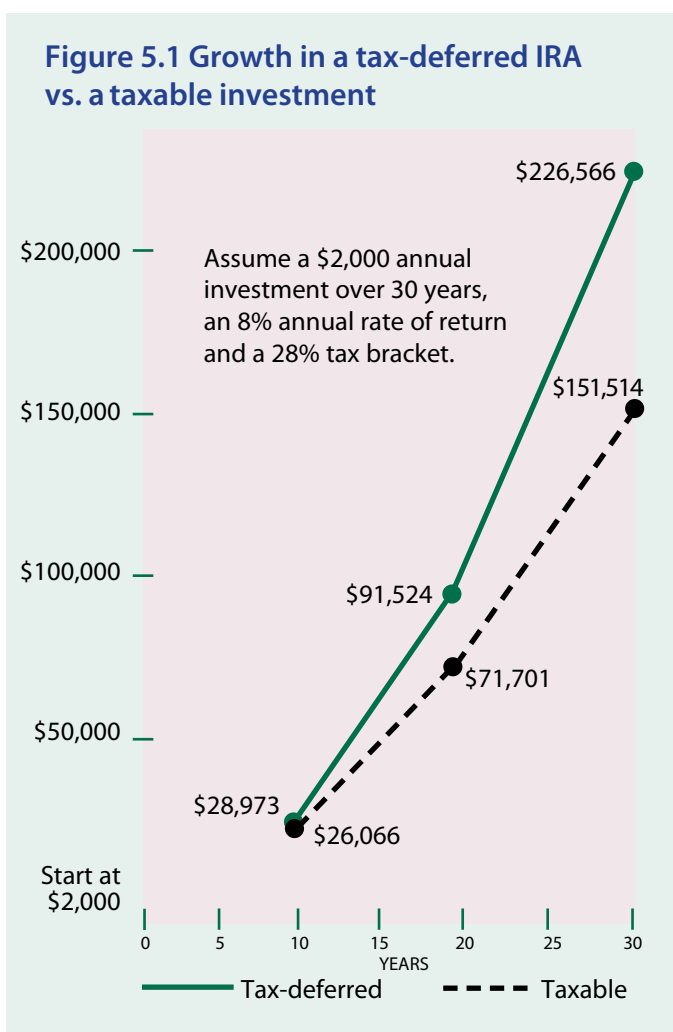
We're only offering a general overview of some of the tax-deferred options you might have available to you. Before making choices about which accounts are best for you or investing any money into them, please do more research on your own or talk to a tax professional. The list of personal finance books and websites at the end of Chapter 1 (see page 13) is a great place to start a deeper investigation. The IRS's website is another valuable source of information.

1. Pre-tax retirement accounts

Many retirement plans are funded through pretax contributions. This means that your taxable income is reduced by the amount you contribute to your 401(k) or traditional (as opposed to Roth) IRA account, for example. If you contribute \$3,000 to a traditional IRA for a specific

year, you do not pay taxes on that amount of income. When you withdraw money from a tax-deferred account, most likely at retirement (otherwise you'll usually pay a penalty), both the contributions and any earnings will be taxed at your regular income tax rate.

By deferring these income tax payments until you withdraw the money from your account, you receive even greater returns through the “magic” of compounding as explained in Chapter 2. The more money you contribute, the more opportunity for those contributions to build on themselves, and the greater chance for your account to grow larger over the years. Figure 5.1 illustrates the benefits of investing long term in a tax-deferred over taxable account.



2. Employee retirement plans

Most public employees have employer-funded **defined-benefit** (DB) pension plans, although these increasingly are rare for employees outside the government and education spheres. Defined-benefit plans guarantee

employees a certain percentage of their salary when they retire, depending on current salary and years of employment. These funds are managed by experts who have the resources and ability to invest in more asset classes than individuals are able to.

Many private-sector employers now offer **defined-contribution** (DC) plans, usually through 401(k)s. Many public employers offer supplemental DC accounts, such as deferred comp plans or 457s. In these types of employer retirement plans, the employer may contribute a “defined” amount of money to an employee’s account, which is controlled by the employee. Also, the employee may contribute dollars to his own account.

3. Defined-contribution plans

401(k), 403(b) and 457 plans are examples of employer-sponsored, tax-deferred retirement plans. A 403(b) plan is similar to a 401(k) plan except that 403(b)s are for employees of such non-profit organizations as schools, hospitals, foundations and religious organizations. 457 plans are similar to 401(k) and 403(b) plans but 457s are mostly for government workers. You can contribute a certain percentage of your earned income to these plans, up to a maximum limit set by the government. You can find out the current contribution limit from your employer or the IRS. These plans offer a significant tax advantage since dividends, interest and capital gains are not taxed until you make withdrawals.

Check with the IRS for the current age at which withdrawals may begin — there can be expensive penalties for withdrawals before you reach this age. You may, however, be allowed to make a penalty-free withdrawal from some plans for college tuition or medical emergencies. Your employer or the IRS can give you more specific details about these options. The rules and penalties vary between the three plan types.

Some employers match part of each employee’s contributions. If your employer offers a 50 percent match, that means for every \$100 you contribute, your employer will contribute another \$50. If you’re lucky enough to have an employer match in your 401(k) or 403(b), make it a priority to contribute at least up to the maximum that your employer will match. This “free” money will probably be the fastest, most risk-free return on an investment you’re ever likely to earn.

Your 401(k) and 403(b) contributions automatically are withheld from your paycheck on a pretax basis,



meaning you don't pay income tax on the amount you're contributing, at least until you withdraw it after you've retired. Your contributions are deposited into the professionally managed investment account that you've designated. You typically have a choice of mutual funds to invest your contributions in, usually stock growth funds, a balanced fund (stocks and bonds), a bond fund and a money market fund. There may be both index and managed mutual funds to choose from.

4. Traditional Individual Retirement Accounts

If you're not covered by an employer-sponsored retirement but you do have earned income, you can contribute to a tax-deductible traditional IRA. You also can make contributions for a non-employed spouse. The annual contribution limit varies depending on your age and income. You can contribute to a traditional IRA even if you are covered under an employer-sponsored investment plan, but your contributions will not be tax deductible.

As with all the other retirement plans, check with the IRS or your tax professional for complete details, including current contribution limits and any income restric-



tions. For traditional IRAs, the income tax deduction is phased out after you reach a certain income level, and you may not contribute more than your earned income. Even if your contributions aren't deductible, your capital gains and dividends still will grow tax deferred until they are withdrawn.

5. Roth (after-tax) IRAs

Technically, Roth IRAs are tax free. Contributions to a Roth IRA are made with money that's already been taxed. No further tax is collected either on your original contributions or on any earnings or capital gains they produce. You even can withdraw your original contributions without penalty after a certain number of years (check the IRS website at www.irs.gov for the most updated Roth IRA regulations).

If you currently have a traditional IRA account, you can convert it to a Roth IRA. You'll have to pay taxes on the converted amount. An IRA conversion may or may not make financial sense depending on your age and other factors, so it's worth talking to your tax professional about it if you're considering such a move.

6. Other tax-advantaged investment alternatives

Besides retirement accounts, you have other options for investing in tax-deferred accounts. Although this may sound repetitive, be sure to check with the IRS or your tax professional for guidance on any contribution or income limits for these choices.

Tax-deferred annuity (TDA) insurance contracts

If you've maxed out your employer-based retirement accounts and IRAs, you do have another option for tax-deferred retirement investing

— annuities. An **annuity** is a type of investment contract used to provide future income. While traditionally offered by insurance companies, you now can purchase annuities from other providers.

Because annuity earnings are tax deferred until distribution, they're useful once you've exhausted all your

other retirement savings options. When you purchase an annuity, you contract with an annuity issuer to make contributions and the insurance company agrees to pay out a certain amount of income distributions over a certain number of years, usually far in the future. These are paid to the beneficiary, which may be you or someone you choose (a spouse or child, for example).

Annuities can charge relatively high management expenses, and there also can be substantial fees (called surrender charges) if you attempt to cash out early. Also, you must use after-tax dollars to fund an annuity, so your contributions are not tax deductible. If you do decide an annuity is right for your situation, be sure to compare choices from a few different companies. Management expenses, other fees and investment options can vary greatly and will affect the return on your investment. You'll also want to completely research the tax treatment of annuity distributions so you won't run into any surprises down the road.

7. College savings plans

Thanks to relatively new college savings plans, parents, grandparents and others can reap tax benefits while saving for a child's higher education needs. One of the accounts even can be used for qualified educational expenses for elementary, middle and high school students.

Section 529 plans

Almost every state offers **Section 529 plans**, with a variety of different contribution limits and investment options. Withdrawals are free from federal income tax if used for qualifying college expenses, and contributions to 529 plans are even tax deductible in some circumstances. If the family member you set up the plan for doesn't use up all the money in the account, funds can be transferred to another family member without tax penalty. Since investors are not limited to their own state's plan, you should research your options carefully

before choosing the best one for your particular circumstances.

Section 529 plans do have some downsides you'll want to investigate. Each state sets its own investment options, maximum account contribution, management expenses and tax benefits, leading to a confusing array of choices for investors trying to compare their options. Even if your state's plan is one with increasing annual management expenses, check to make sure you won't be missing out on a state income tax deduction or state tax-free withdrawals before choosing a different state's plan. See *Tools you can use* at the end of this chapter for a website to help if you're trying to research and choose between different state plans.

Coverdell Education Savings Accounts (ESAs)

Formerly called Education IRAs, **Coverdell Education Savings Accounts** (ESAs) are unique among college saving options in that tax-free withdrawals may be made for elementary, middle and high school as well as college educational expenses. Parents may use ESA funds to pay for private school tuition and uniforms and educational computer equipment, among other expenses. With higher annual contribution limits than in the past and more flexible investment options (as well as often lower management expenses) than Section 529 plans, ESAs



have become an attractive savings vehicle for families within the eligible income range.

While ESA contributions are not tax deductible, withdrawals for qualified educational expenses are tax free. Any money left in an ESA when the student beneficiary turns 30 is subject to tax and penalties, although unused funds can be transferred to another qualified family member under some circumstances. If your state's Section 529 plan doesn't offer any extra state tax benefits or charges high management fees (it may take a little research to track these down), ESAs could offer more of an advantage as long as you're within the income requirements.



Moving on...

Once you've utilized your tax-deferred and other retirement options, you'll probably want to consider investing in taxable accounts as well. If you're saving for a house, your child's education or another non-retirement financial goal, you'll most likely need to invest outside of your retirement account. Whether you open a brokerage account so you can buy individual stocks or buy shares of a mutual fund directly from the fund family, Parts II and III will help you learn to select quality investments to meet your goals.

Your investment portfolio should include tax-deferred, tax-free and taxable accounts. The percentages will vary depending on where you are in your investment timeline, but you should be sure to make good use of such tax-advantaged investment options as your employer's retire-



ment plan or your own IRAs. Tax-advantaged college savings options also can help you increase your higher education savings.

If you've maxed out your retirement plans or are investing for such shorter-term goals as a house down payment, you'll be using taxable accounts in addition to your tax-deferred options. If you are investing in taxable accounts, be sure to keep tax ramifications in mind when you're choosing your investments or making selling decisions.



Tools you can use

Both the FINRA College and the Saving For College websites provide useful tools for cutting through the Section 529 college saving plan jungle. Both help understand fees and expenses. FINRA has more information on tax savings issues, and Saving for College has more information on plan performance.

www.savingforcollege.com

www.finra.org/college

Stock Market Basics

Now that you've got the basics of money management down, it's time to jump straight into the world of investing. We'll focus on the stock market in general in this chapter, then move on to analyzing and buying individual stocks.

What is a stock, and a stock market?

When you buy stock in a certain company, what you're purchasing is an actual piece of ownership in that company. Granted, it may be a very tiny piece and you will not have much say in how the company is run beyond annual shareholder votes, but you're still considered a partial owner even if you own only one share.

1. Private vs. public companies

You can't buy stock in just any company you're interested in, because not every company is publicly traded. Privately held companies don't offer shares to the general public, and they're not required to disclose such financial details as their earnings and revenues.

Shares of publicly traded companies, on the other hand, generally are available through one of the stock exchanges to anyone interested in purchasing them. Publicly traded companies also are required by the Securities and Exchange Commission (SEC) to report their finances regularly, according to established standards. This financial reporting is what provides investors with the information they need to research and analyze a company before deciding whether to purchase shares.

2. Initial public offerings

When a privately held company decides to become publicly traded and offer shares on the open stock market,

this process is called an **initial public offering** (IPO). While you've probably heard plenty of stories of people making huge profits by investing in IPOs, there are many reasons to steer clear of them, at least until you've had a few years of investing experience behind you.

Even then, investing in IPOs can be tricky. You may not have access to at least five years of financial information, making it difficult to properly research the fundamentals. Also, investors rarely have an opportunity to buy shares of the most promising IPOs. These often are informally reserved for the very best customers of the brokerage firms handling the offering. These first investors frequently "flip" their shares, meaning they resell them almost immediately to capture their gains if the share price rises dramatically in the first hours or days of the IPO.

Investors who buy shares of these stocks on the secondary market (meaning when shares are exchanged between investors after they've gone on the public market) can end up paying inflated prices, only to watch

their investment shrink in value after the IPO's stock price retreats to more reasonable levels.

3. Preferred vs. common stock

You may come across the term preferred stock at some point and wonder how it differs from common stock. Preferred stock resembles a bond more than a stock, and preferred stock holders enjoy a little more safety in some ways than common stock holders do. Preferred stock dividends, for example, are paid out before common stock dividends.

Also, if a company were to go bankrupt, preferred stock holders are given precedence over common stock holders when it comes to recovering any money. One drawback to preferred stock is that preferred stock holders generally have no say in how the company is run, whereas common stock holders are eligible to vote in person or by proxy at the annual shareholder meetings.

When we discuss investing in stock throughout this book, we're referring to common, not preferred, stock. Preferred stock holders have priority for dividends and claims on assets, but common stock share prices are where the real action is, especially for growth companies. Preferred stock doesn't offer the same potential for growth as common stock, and is much more suitable for investors looking for income rather than growth in their portfolio.

4. The stock markets

There are two kinds of stock markets — exchanges and the over-the-counter (OTC) market. Exchanges such as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) are auction markets where buy-



ers and sellers come together to do business. The NYSE, sometimes called “the Big Board,” is the most well-known and prestigious of the stock exchanges.

The over-the-counter or NASDAQ (National Association of Securities Dealers Automated Quotation System) market is a dealer marketplace where securities dealers buy or sell from their own accounts. As a rule, smaller and newer firms as well as a number of technology companies are traded on the NASDAQ.

5. Stock market terminology

Navigating the stock market sometimes can be intimidating for beginners. The rest of this chapter covers some terms and concepts you'll probably encounter before too long.

Dividends

Some companies choose to pay out part of the corporate earnings to shareholders quarterly or annually in the form of **dividends**. You can reinvest these dividends in shares of the company if you participate in their dividend reinvestment plan (DRIP) or through a brokerage that offers reinvesting, or you can choose to receive the dividends in cash.

Not every company pays dividends. Some choose to reinvest their earnings right back into the company to finance the company's continued growth. A company may decide to pay dividends after it has become more estab-

lished. Once a company begins paying dividends, it rarely stops or reduces the dividend amount, as that would be an indication of shaky corporate finances. If indeed a company finds itself in financial difficulty, management may decide to suspend the dividend for a period or end it altogether in an attempt to rescue the company from failure.

Stock splits

If a company's share price moves higher and higher (past \$100 is a common measure), management may decide to declare a **stock split** as a way to bring that share price down to a level deemed more popular by investors. In a two-for-one stock split, for example, shareholders end up with a total of two shares for every one share they owned at the time of the split.

These extra shares don't appear out of thin air, of course. When the stock splits, the share price splits as well. So if you owned one share of a \$20 stock before the split, you would own two shares of a \$10 stock after a two-for-one split. It's fun to think that your investment has been doubled, but nothing has really changed. Think of it as a pizza cut into eight slices instead of four. You may have twice as many slices, but they're only half the size of the original slices. The size of the pizza doesn't change, just the number of slices it's divided into.

Reverse stock splits

There are times when a company's fortunes head in the opposite direction. An especially low stock price can be just as discouraging to investors as a tremendously high price. When a stock price dips too low, the company also runs the risk of being delisted by the stock exchange it's traded on, meaning that its shares no longer can be bought easily and sold by investors or bought and sold easily. That's why a company facing this future may choose to do a **reverse stock split**.

In a reverse stock split, the shareholder ends up with *fewer* shares than they started with. A one-for-five stock split, for example, leaves an investor who previously

owned five shares with only one. The share price goes up in a corresponding manner as well, so the investor



with five \$1 shares now holds one \$5 share. Shareholders owning less than five shares in this example would be cashed out completely, since they don't own enough of the old shares to convert into one of the new shares.

6. The Securities and Exchange Commission (SEC)

The Securities and Exchange Commission is a federal agency responsible for establishing and enforcing regulations that protect investors from unfair practices in the securities market. Companies issuing new stocks and bonds to the public are required to file registration information with the SEC, including data on the company, its industry, competitors and management, among other topics.



The SEC requires publicly traded companies to report information regularly about earnings, sales and other financial data. These companies also must have their annual financial statements prepared by an outside accounting firm in accordance with generally accepted accounting principles (GAAP).

The SEC also regulates proxy statements and financial disclosures linked to a corporation's annual meetings. Shareholders have a responsibility as owners to vote their proxies on such issues as director elections, executive compensation and issues submitted by other shareholders.

7. Active ownership

Corporate governance

If you buy stock in a company, you own a piece of the corporation and get some say over how it is governed. Corporate governance is the interaction among the board, the executive management and the shareholders for the purposes of strategic planning, determining the corporate structure and monitoring the management of the corporation. Corporate governance allows shareholders to influence issues significant to the company, such as election to the board of directors, board structure, company capitalization, mergers/acquisitions and certain executive compensation issues. In addition, an important aspect of ownership is the ability of shareholders to submit resolutions at annual meetings dealing with a broad range of issues so long as they are consistent with SEC requirements.

Proxy voting

If you own shares of a company, you will be eligible to vote your proxy annually. Issues ranging from whom should sit on the board to whether executive compensation should be changed come up. Proxy voting can influence the long-term performance of public companies by improving corporate governance practices. Proxy voting is the fundamental action taken by shareholders to ensure an effective system of corporate

governance, because they can take part in important decisions without attending their company's annual meeting.



Tools you can use

AFSCME's Issue Guide to Pension Security describes the union's active ownership shareholder program. You can see how the AFSCME Employees Pension Plan voted its own prox-

ies as well as descriptions of the shareholder proposals filed by the union's pension plan.



<http://afscme.org/issues/75.cfm>

Those shareholders who use proxy voting to influence corporate behavior engage in what we call "active ownership." They actively use their ownership power as a way to improve their companies' long term value. For example, shareholders can use the proxy vote to throw out entrenched managers who are mishandling the company, to seek greater director accountability through annual elections, to demand CEOs get paid on the basis of performance or to prevent ill-advised mergers. The AFSCME pension fund is very active in corporate governance and proxies voting, as are many public pension funds. Responsible investors make sure to use their voice in corporate elections and do so by voting their proxies.



Buying and Selling Stocks

Ready to make your jump into stocks? You'll need a way to buy them first. Your most obvious option is a brokerage account, but you do have some other alternatives. This chapter will take you through the basics of researching your options, as well as some very general guidelines to get you thinking about why you might want to buy or sell a stock.

How to invest in stocks

When it comes time to actually buy or sell a stock, you have a few choices. Most investors choose to open a brokerage account, but there are other options. You'll need to research your choices and decide which one (or more than one) is best for your needs. Here are the most popular options open to you, and the basics you should consider before making a choice.

1. Full-service brokerage

It used to be that the only type of broker an individual could work with was one employed by a full-service brokerage. Full-service brokerages employ analysts who make investment recommendations based on their research. Investors pay higher commissions than they would at a discount brokerage, but usually receive more personalized attention in addition to purchase recommendations from their particular broker. Only you can decide if this type of extra attention is worth the higher expenses.

Several full-service brokerages have come under fire due to the potential conflicts of interest between their stock analyst and investment banking divisions. If you choose to use a full-service broker, be sure to ask your broker how he or she is compensated. If they come to you with stock recommendations, you should ask why they're recommending that particular stock and whether

they receive any special compensation or other reward if their clients buy it.

Most brokers aren't paid based on how well your portfolio performs, but rather on how many transactions they complete for your account, among other criteria. For this reason, a full-service broker is more a salesperson than a financial planner in most cases. You're in the process of learning to make your own stock selection judgments, so there's not much reason to pay a broker to do what you can do yourself if you have the time and desire to do so.

2. Discount/online brokerage

Most discount brokerages also are considered online brokerages, so we'll consider them the same entity in this book. Using an online brokerage doesn't mean you'll be day trading or frequently buying and selling stocks with your home computer. It just means you're able to conduct all of your brokerage business online in addition to



over the phone or potentially in person if the brokerage has an office in your area.

Discount brokerages offer commissions much lower than those traditionally offered by full-service brokerages. In return for these lower commissions and expenses, you'll be on your own when it comes to investment recommendations. Discount brokerages generally don't offer any guidance as to which stock you should buy or even what percentage of your portfolio should be made up of stocks. That shouldn't be too big of a problem if your goal is to learn to research and choose your own investments anyway. Many full-service brokerages have their own discount brokerage arms, which you may want to investigate if you're already a full-service account holder.

The level of services offered and expenses charged can vary greatly from one discount brokerage to another. You'll want to compare features and expenses before deciding which brokerage best suits your needs. Some of the services offered include free check writing and automatic dividend reinvestment. You should shop around until you find the firm that offers most of the features you're looking for.

3. Dividend reinvestment and direct share purchase plans

A dividend reinvestment plan (often referred to as a DRIP) is a way for you to purchase more shares of a stock you already own by directly reinvesting any dividends you receive from the stock. Many, though not all,

dividend-paying companies offer DRIPs, and fees can vary widely from plan to plan. Most plans require that investors already own a minimum number of shares in the company (typically one to five shares).

If you're considering enrolling in a particular DRIP, be sure to request and fully read the plan's prospectus so you're aware of any charges for purchases and sales, as well as for issuing or transferring stock certificates. Many brokerage accounts will allow you to reinvest dividends for free, so look into that option as well before you enroll in a DRIP plan that charges purchase or reinvestment fees. Those brokerage accounts that allow dividend reinvestment do not have the optional cash investment feature that DRIPs offer. When you add to holdings with an additional cash investment, regular brokerage commissions are charged.

Another way to buy stock is directly from the company, through a direct stock purchase (DSP) plan. Such plans are similar to DRIPs but they allow investors to buy their initial shares through the company rather than using a brokerage firm as a middleman. DSPs may require a minimum initial investment and may charge commissions on each purchase (though these typically are much lower than you'd pay if you invested through a brokerage). DSPs usually allow investors to reinvest dividends automatically as well.

4. Choosing a broker

One of your first steps as a beginning investor is to open an account with a brokerage firm. With so many brokerages out there, how do you know where to start? Below we've listed some of the most important qualities to look for in a broker.



What to look for in a broker

Website: If you plan to make transactions online (a great way to reduce commission costs at many brokerages), test drive a few brokerage sites first to make sure they're fast as well as easy to use.

Customer service: Even if you intend to use the brokerage's website for all your transactions, you're sure to have some reason to call customer service at some point. Try calling to request new account information, paying attention to how long you have to wait for your call to be answered and how well the customer service representative answers your questions. Also check to see whether there's an office near you, if that's something you find important.

Research resources: Investigate the types of online or other types of research tools the brokerage offers to see whether they meet your needs.

Documentation: Although you may not be able to see them until you're a customer, try to check out the brokerage's account statements to make sure they're easily understandable and give you all the information you're interested in.

Access to recent and historic statements online: Check to see whether you can view or download current or past account statements and tax information online.

Commissions and other expenses: While you don't want to choose a brokerage simply based on commission

costs, you do want to ensure they're not overly high. The same goes with account expenses. Make sure you won't be nickel-and-dimed by charges for account inactivity, closing or transferring the account, dividend reinvestment and mailing trade confirmations, for instance. You often can find a complete commission and fee schedule at a brokerage's website. If you can't locate it on your own, call customer service and request a written copy.

Minimum initial deposit: Some brokerages allow you to open an account with no minimum deposit, while others require thousands of dollars be deposited at opening. Choose a brokerage that fits your initial deposit capabilities.

5. Placing an order

Once you've chosen a brokerage firm and have opened and funded your account, you're all set up to actually buy a stock once you identify a quality prospect. Placing the order isn't quite as simple as picking up the phone or going online to place your order. You also need to know what type of order you want to place, and how order pricing works.

Bid vs. ask price

The **bid** is an indication of the price you can sell at, and the **ask** is the price you can purchase at. The difference between these two prices is called the **spread**. Stocks that are very popular or heavily traded commonly have a very narrow spread (meaning that the buying and selling prices are almost identical). Thinly traded stocks (i.e. very low volume of trading) may have a very wide spread, meaning the buying and selling prices may be dollars apart. Each transaction has the possibility of changing the bid and ask prices.



Market order

If you want to buy or sell stock at the best price currently available, place a **market order**. If the market is open, your order will be sent to the market and executed (completed) immediately at the current price.

You may want to be careful about placing a market order when the market is closed, however. Such an order will be executed as soon as the market opens. If bad or good news is announced between the time you place your order and the time the order is executed, you could find yourself buying at a price much higher than the last closing price or selling at a price far below what you expected.

It's best to place a market order when the market is open, and after you've checked the current bid or ask price to ensure it's in a range you're comfortable with.

Limit order

If you want to specify the price at which you'll buy or sell shares (especially if you're placing your order when

the market is closed), place a **limit order**. This will reduce the risk that you'll pay more than you wanted on purchases or receive less than you expected on sales.

Be aware that many brokerages charge a higher commission for limit orders than for market orders. Also, it's possible to miss out on a stock you want to buy completely by using a limit instead of market order. The stock price may come to within pennies of your limit order price without meeting it, then move up, leaving your order unfilled even though the price was so close to your limit.

Day vs. good-till-canceled (GTC) order

If you're considering selling a stock, but only if it reaches \$60 a share on the day you place your order, place a **day order** with this limit. If the stock price doesn't reach the specified price that day, the order automatically will expire at the market close.

To keep the order to stay standing for days, weeks or months until the stock either reaches that specific share price or until you reach the brokerage's order expiration date (typically 60 days), place a limit order that's **good till canceled** (GTC). The order will stay on the books until it's either filled or canceled by the brokerage.

If you do place a GTC order, be sure you check the stock price and status of your order from time to time so you're not caught by surprise if an order you placed a month ago and then forgot about is executed.



Cash vs. margin accounts

When it comes time to buy stocks, you have two choices for your purchases. You can open a **cash account**, meaning you'll either have money already in your account or that you'll deposit money to cover your transactions within three days of the trade date (called T+3 after the SEC requirement regulating this type of transaction).

Another option is to borrow the money to pay for your stock purchases by opening a **margin account** with your brokerage. The brokerage will allow you to buy stocks on margin, which means that the brokerage is giving you a loan to pay for the stocks you buy.

You should steer clear of buying on margin for a variety of reasons. Not only will you be paying interest to your broker for this loan, but if the value of the stock you purchased on margin drops a certain percentage below the purchase price, you could be subject to a **margin call**. In this case, you would be required to immediately pay back the entire amount you owe to the brokerage. Many investors have incurred deep losses after they've unexpectedly received margin calls and found the only way they can pay back their loan is to sell off the stock at a loss.

6. A little something about selling

Knowing when to sell is equally as important as knowing when or how to buy. With buying, once you're confident you've found a quality company and that the



price is attractive, all you need to do is decide to go ahead with the purchase.

You need the money

If you need cash, obviously your decision isn't so much to sell as it is what to sell.

Fundamentals are declining

You may have bought a particular stock in part because both earnings and sales were increasing year after year. Once you own the stock, you'll continue to regularly follow these financial details as part of your portfolio management routine. If you notice declining fundamentals, you'll want to do more research into the cause of the decline. If you don't like the reasons you discover for the downturn, it's probably time to sell.

Fraud or scandal

There are times when you'll decide to sell a stock on bad news even if that means taking a huge loss. This is a personal decision and one you should deliberate over carefully. If strong evidence of fraud or scandal concerning a company you own comes to light, you may decide to wash your hands of the whole thing before the news gets even worse. Some investors have little patience for corporate misbehavior. They'd rather sell immediately and then invest in another company whose management they can trust.

While we all hope the companies we invest in are run by ethical people according to sound business practices, there's no way to ever be protected completely from the potential for fraud. It's a good idea to think through your possible reactions to bad news concerning one of the companies in your portfolio, so that in the unlikely event you're faced with this terrible situation someday, you'll already know if you're going to hang on in hopes of better news or bail out right away to cut your losses.

Portfolio rebalancing

Sometimes a stock performs so far beyond your expectations it becomes a much greater percentage of your portfolio than you're comfortable holding. While there

are certainly worse problems in life than a highly profitable stock, this is one of those times you'll need to make an important portfolio management decision.

When one stock makes up a larger percentage of your portfolio than others, you run the risk of greater than average losses if that stock's price takes a sudden tumble. Even if you think the price will continue to rise, it may be prudent to sell part of the holding and invest the proceeds in another stock to bring your portfolio

holdings back into a more healthy balance. You'll want to ask yourself if the stock is likely to continue to appreciate so that you reach your individual company and portfolio total return, or whether another stock might be a better value now.

Selling a winning stock may leave you conflicted; no one likes the prospect of leaving money on the table. But you don't need to sell the entire position, unless you judge that the stock is highly overvalued and you'd rather switch to another stock with greater growth potential.



Checking on a broker

FINRA's BrokerCheck is a free online tool to help investors check the background of financial professionals. Using BrokerCheck is a great way to learn whether a broker or brokerage firm has had criminal issues, dealt with lawsuits, or experiences a lot of turnover.



www.finra.org/brokercheck/

Mutual Fundamentals

Mutual funds offer a convenient way to invest in a portfolio of stocks, bonds, money market funds and even real estate. This convenience doesn't mean you can overlook the importance of researching potential mutual funds before you buy, though. In this chapter you'll learn about different types of mutual funds and the reasons you might want to invest in funds.

What is a mutual fund?

In the simplest of definitions, a mutual fund pools the money of many investors into one fund whose management then purchases investments according to the mutual fund's *investment philosophy*. Each shareholder owns a proportionate share of the fund equal to the money they have invested.

Mutual funds can be made up of stocks, bonds, cash (money market funds) or a variety of other investment vehicles. Funds also can be a combination of these assets, such as balanced funds that invest in a specific proportion of stocks and bonds or other fixed-income investments.

1. A history of mutual funds

But before we get to all that, a little background. The first **open-end** mutual fund, Massachusetts Investors Trust (MIT), was created in 1924. MIT allowed investors to buy and sell fund shares at will, and with far lower expenses than the typical investment trusts investors had access to at that time. Expenses dropped even lower in 1928, when Boston money management firm Scudder Stevens & Clark opened the first **no-load** (meaning no sales charge) mutual fund.

The Securities Act of 1933 required that mutual funds make a **prospectus** available to potential shareholders.

The 1950s brought further growth to the increasingly popular mutual fund industry as investing giants John Templeton and T. Rowe Price opened funds. The year 1975 saw the introduction of both 401(k) plans and the **discount brokerage** industry, such as Charles Schwab. A year later, Vanguard revolutionized mutual funds with the introduction of the first **index fund**. More changes came to the mutual fund industry with the introduction of Individual Retirement Accounts (IRAs) in 1981.

Today, there are more than 8,000 mutual funds in the United States, with about \$12 trillion invested in them. You can't open a financial magazine without seeing page after page of fund advertisements. Mutual funds are a way of life for millions of investors now.

2. Mutual fund structure

A mutual fund is made up of a pool of money contributed by all of the fund's shareholders, invested in what-

ever assets the fund's investment philosophy dictates. Legally, funds are structured as corporations or business trusts. As a shareholder, you own a proportionate share of the fund in the same way that you own a proportionate share of a company whose individual stock you invested in.

Mutual funds can be actively managed, meaning a manager — or more frequently these days, a management team — chooses the investments, or passively managed, like index funds where the investment decisions are automated based on the index the fund is attempting to imitate.

Unlike owning individual stocks, when you own a mutual fund you don't usually get to vote on matters the way you would by proxy or at the annual shareholder meetings. You trust the fund's management to make these decisions for you. Mutual fund owners can't tell the management of actively managed funds which investments to buy, for example, though there are times when shareholders are given an opportunity to vote on leadership issues. Shareholders still can voice concerns to management, of course, but can't be guaranteed their opinion will be acted on.

Just as holders of individual stocks do, mutual fund shareholders also receive regular statements containing earnings reports, listings of fund holdings and fund management's outlook for the future.

3. A mutual fund vocabulary lesson

While all mutual funds calculate their **net asset value** the same way and share the same basic legal structure, there often are more differences than similarities when it comes to other comparisons. These are some of the most important mutual fund terms you should know.

Net asset value (NAV)

Stocks prices fluctuate throughout the trading day based on supply and demand. Most mutual funds, on the other hand, are valued only once a trading day, after the market has

closed. This valuation is based on the fund's **net asset value**, or NAV.

The chart below shows how the NAV is derived, but really it's a very simple process. The NAV is the current market value of all of the mutual fund's holdings (investments plus any cash) minus its liabilities, then divided by the total number of outstanding shares in the fund. Sound similar to how you calculated your own net worth? It is, except that the total net worth then

NAV formula

The net asset value is the current total market value of the portfolio holdings plus cash holdings ... minus its liabilities ... divided by the number of shares outstanding.

Shown as an equation:

Portfolio Assets – Liabilities/Total of Shares = NAV

Say the total of all Growth Fund XYZ's holdings are worth \$10 million at close of trading today. The fund's liabilities total \$100,000 (1 percent) and there are 1 million shares outstanding.

\$10,000,000 – \$100,000 / 1,000,000 = \$9.90 NAV

is divided into tiny pieces representing the value of each share in the fund.

In the example above, that day's NAV is \$9.90, which is the amount per share you would receive if you'd sold any shares that day. The NAV isn't always the price you pay to buy a fund, however, because there also might be sales charges added on to the cost.

Investment objective

Like your own personal investment philosophy, a mutual fund's **investment objective** (found in the fund prospectus, which you should analyze before investing) explains the basis for the fund manager's investment decisions. Is the fund aggressively seeking a high return by investing in high-risk technology stocks, or does it follow a more conservative route





by seeking to replicate a large market index? It's important for you to know the fund's stated investment objective so you can decide if it's the right type of fund to help you meet your own financial objectives.

Investment style

There are three major mutual fund investment styles: growth, value and core or blend style. You'll find these terms used by such mutual fund data sources as Morningstar. Managers of growth-style funds seek out companies with above-average sales and earnings growth. Value-oriented managers buy companies that appear undervalued based on certain measurements. Managers of blend style funds mix the two styles, following a growth approach combined with the addition of undervalued companies.

Fees and expenses

Mutual funds can charge a variety of fees in addition to regular operating expenses. You should fully identify all fees and expenses charged by a fund you're considering investing in.

No-load funds

Many mutual funds carry an upfront sales charge, also called a **front-end load**. While there are several different types of loads, all loads compensate brokers, financial planners or insurance agents for providing investment advice. There isn't any-

thing wrong with getting investment advice, but as with many other services, it comes at a cost.

Paying a front-end load when you purchase a mutual fund means your investment dollars are reduced by the same percentage as the sales charge. If you invest \$10,000 in a fund that charges a 6 percent load, for example, \$600 of your money goes to those involved in the marketing (sales) of the shares instead of into your investment account. By investing in a no-load fund, all \$10,000 goes to work for you. Put another way, if you invest in a fund with a 6 percent sales charge, that fund has to earn 6.38 percent more than a

no-load fund just to bring your investment value back up to where it started.

In addition to front-end loads, mutual funds also can charge **back-end loads**, where you pay a certain percentage when you withdraw funds within a specified period of time after you invest. **Level load** funds charge an on-going load — usually about 1 percent — for the entire period of time an investor owns shares in the fund.

12b-1 fees (see next page) also can eat away at your investment dollars.

Studies have shown that loaded funds don't outperform no-load funds. With thousands of no-load funds available, chances are very good you can find a superior no-load fund that will meet your investing needs.

Management fees and operating expenses

All mutual funds incur management fees and operating expenses, which are passed along to the shareholders. These fees — collectively known as the expense ratio — are paid to the fund company for management of the portfolio and for such other services as maintaining fund records and publishing statements and regular fund reports.



In plain terms, the expense ratio expresses the percentage of assets that you as a fund investor pay for fund management and operating expenses. The expense ratio is deducted from your assets. For example, if you invested \$10,000 in a fund with a 1 percent expense ratio, you would pay the fund company \$100 out of your investment assets each and every year you owned fund shares. If the value of your fund shares rose to \$20,000, you would pay \$200 in expense ratio costs.

Annual charges average from less than 0.25 percent to 1.5 percent of the fund's total asset value, but can be as high as 3 percent for some funds. Many index funds carry lower expense ratios than actively managed funds.

12b-1 fees and other expenses

Named for the SEC rule that allows it, a 12b-1 fee is simply a marketing fee that includes expenses for advertising and sales literature. A fund with annual 12b-1 fees in excess of 0.25 percent cannot be considered *no-load*. Other expenses a fund can charge include telephone service, costs of a dividend reinvestment plan, postage expenses and more.

Expense ratio

If you find yourself choosing between two mutual funds that otherwise are similar in performance and return, you may decide to let the funds' expense ratios influence your final decision. The expense ratio is a way of describing the relationship between a fund's expenses and the fund's net assets. The expense ratio does not include such account-based expenses as brokerage commissions, sales loads, account maintenance fees, redemption fees and exchange fees.

The SEC requires that mutual funds provide a three-, five- and 10-year expense projection to shareholders as well as to prospective investors. This projection includes all expenses and gives investors a way to accurately compare load and no-load funds as well as funds of differing sizes. This kind of information is very important to prospective investors because every extra dollar of expenses a fund pays out reduces the fund's overall return.



Of course, you can't choose a mutual fund simply based on its expense ratio. Expenses are only one piece of the picture you need to consider, along with the fund's investment style, risk, performance and how well the fund's investment objective matches your own financial goals.

Redemption fees

Purchasing a mutual fund with redemption fees means that you may be charged a fee if you sell (redeem) any of your fund shares. Redemption fees typically last only for a short, specific period of time (often 30, 180 or 365 days). Some redemption fees can last up to five years. Redemption fees also can be charged if you exchange funds within a fund family. These fees are put back into the fund's assets — they aren't paid to the management company as a back-end load.

Mutual fund managers also may use redemption fees as a way to discourage market timers, investors who hop in and out of mutual funds trying to capture a quick gain. Excessive investment movements by market timers can be disruptive to a mutual fund. Since these types of investors also can cause a fund's operating expenses to increase due to higher transaction costs, fund managers of vulnerable funds may use redemption fees as a protective measure.

Brokerage commissions

In the same way that you pay brokerage commissions when you buy and sell individual stocks, mutual funds also must pay these expenses. You can find out how much a fund has paid out in brokerage commissions by

reading the fund's annual report. Brokerage fees aren't included in a fund's expense ratio. They are charged to shareholders on top of other fees and expenses in the fund expense ratio.

4. Fund management styles

Actively managed funds

An actively managed mutual fund is one in which actual people, a fund manager or management team, make the investment decisions. You can research the fund managers, including their past investment results, using information you can get from the mutual fund company or in the fund's prospectus. Many investors look for a record of long-term management success before they'll choose a particular mutual fund.

Index funds

Index funds are mutual funds that attempt to reproduce the holdings and performance of a specific market index. For example, there are index funds that aim to replicate the investments in the Standard & Poor's 500 (S&P 500), an index of 500 large-cap companies. You can buy index funds for virtually every major stock market, as well as bond market, index.

In most cases, any new money that an index fund receives from investors on a particular day is invested proportionately into the portfolio holdings of whichever index the fund is tracking. For example, if a fund tracking the S&P 500 received 1 million in new investments in a certain trading day, a computer program automatically would allocate shares of that money into each of the stocks represented in the index.

However, there are some index funds that invest in very broad market indexes, such as an index representing the entire stock market, that don't actually purchase all the companies in the index because to do so would be prohibitively expensive. Instead, they employ a sampling technique whereby some, but not all, of the smallest companies in the index are representatively included in the fund. If stocks are removed or added to a particular index (an infrequent but still potential event), the fund



would sell all shares of the stock being dropped or buy shares of the new addition.

Because index funds are *passively* managed and investment decisions are largely automated, they tend to incur much lower operating expenses than actively managed funds. This often can make an important difference when calculating a fund's total return. The large majority of actively managed mutual funds don't beat the broad market indexes each year, so there's no reason to pay the higher expenses of these funds only to receive lower returns in the end.

Open-end vs. closed-end funds

Most investment funds are open ended, which means there is no set number of shares outstanding. This type of fund is also called a "mutual fund." Any investor can invest at any time and in unlimited quantities, as long as the fund is open to new investment dollars and any minimum initial investment is met.

Closed-end funds are similar to individual stocks in that there is a set number of shares that can be bought or sold. Shares of these funds trade like a stock.

Due to differences in supply and demand, the price you pay for a share of a closed-end fund often can be higher or lower than the fund's net asset value. If the market is weak, shares in a closed-end fund may sell at a discount. When the market is strong, shares may sell at a premium. In order to buy a share in a closed-end fund, there has to be a shareholder willing to sell his shares to you.

This can lead to one problem with closed-end funds — the potential for a lack of liquidity. If shareholders don't want to sell their shares, new investors might not

be able to buy in except by paying a very high premium compared with the fund's NAV. Conversely, if the fund is not doing well, shareholders may have a hard time finding any buyer at all for their shares.

Closed mutual funds

Not to be confused with closed-end funds, a closed mutual fund is one that's no longer accepting new money from investors (or in some circumstances, only accepting investments from current shareholders). Mutual fund managers will close funds for different reasons, but usually funds close to new investors when they become too large to manage efficiently. If a fund grows too large, it can be difficult for fund management to pursue the fund's stated objectives. A mutual fund manager may choose to close a fund to new money for a period of months or years to prevent the fund from becoming unwieldy.

5. Four principles of mutual fund investing

1. Invest regularly, and for the long term

Mutual funds make it easy for shareholders to invest regularly. Most fund families offer investors an opportunity to set up automatic investment plans that regularly deduct funds from your checking or savings account to invest in your choice of mutual funds. You also can set up plans to deduct investment money automatically from your paycheck.

Investing regularly, through up markets and down, is one of the keys to successful long-term investing (as long as you're researching your investment choices carefully first, of course). As we mentioned earlier, *dollar cost averaging* allows you to accumulate more shares in your chosen investment because you buy more shares when the fund's NAV is low and less when it's high. When you choose quality no-load mutual funds that invest in growth stocks and then hold these funds for the long term, you're giving yourself the best possible chance to create a strong, healthy portfolio.



2. Reinvest earnings, dividends and profits

Reinvesting your mutual fund dividends and capital gains couldn't be easier. Simply request that all fund distributions (such as dividends and capital gains) be reinvested and your money will continue to work for you after being reinvested in your chosen mutual funds. If you want to reinvest earnings and dividends in other funds or into a money market fund, you can have them automatically transferred elsewhere as well.

By reinvesting your dividends and other fund distributions, you allow them to compound. As we illustrated in Chapter 2, compounding can increase your investment return greatly over time.

3. Diversify your investments

Diversification is an attempt to minimize risk. As we explained earlier, diversification means making sure all your eggs aren't in one basket. Mutual funds allow you to diversify by investing in a wider range of stocks than you can easily (or affordably) replicate in your own portfolio of individual stocks. You also can diversify your mutual funds even if you're trying to invest primarily in index funds by choosing funds that focus on large-, mid- or small-cap stocks.

4. Invest In low-cost index funds

No-load index funds consistently exceed the returns of actively managed funds when fees, commissions and loads are considered. Though many investors wish to invest some money in stocks they have chosen or actively managed mutual funds, low-cost index funds are a great investment for the core of your portfolio. You can diversify by investing in index funds that invest in stocks of big companies, stocks of small companies, bonds of different sorts and both stocks and bonds from the global economy.

Finding a Place for Funds

Mutual funds offer another way to invest, whether you use them instead of or in addition to individual stocks.

The key to investing in mutual funds is knowing how to select the best fund for your situation out of the options you have available. In the meantime, here are a few of the more common reasons for investing in mutual funds.

Advantages of mutual funds

One of the most common reasons investors choose mutual funds is simply because they don't have any other choice. If you have a retirement plan through your employer, mutual funds may be the only investment option your employer provides. The same is true with Section 529 college savings plans as well as other investment accounts.

Investing in mutual funds requires research and planning similar to what you do when investing in individual stocks. Depending on your situation, you most likely have at least a few funds to choose from, so you do have some freedom to select the funds that best meet your investment requirements. With a little research into your choices, you can select the funds with the best chances for helping you reach your financial goals.

1. Diversification

Another reason for investing in mutual funds is instant diversification (see Chapter 2, page 18 for more on diversification). Buying shares in a single stock mutual fund can give you exposure to potentially thousands of different stocks, depending on the type of fund you invest in. A \$50 monthly contribution, for example, can allow you to invest in dozens of different stocks at once, something

that might take years to accomplish if you were investing solely in individual stocks.

2. Sector exposure

Mutual funds also offer easy exposure to sectors of the stock market that can be difficult for beginning investors to analyze. If you're interested in the energy sector or banking industry within the financial sector, for example, you might find them a little harder to research or analyze than companies in other sectors of the stock market. By purchasing shares of a mutual fund (after doing the appropriate research to select such a fund, of course) that purchases only stocks in that sector, you can bring these types of stocks into your portfolio while letting the fund's managers do the actual individual stock analysis for you.

Sector funds also provide a convenient way for individuals and possibly even investment clubs to add foreign investments to their portfolio. It can be difficult

for investors to analyze individual international stocks because not every country requires companies to disclose as much information as U.S. companies do. By choosing a reputable international mutual fund, you can let the fund's management do the financial detective work for you while still adding an additional type of diversification to your portfolio.

Keep in mind that sector funds can be extremely volatile, flourishing when their particular sector is in favor in the market, and plunging when it's not. If you lack a strong stomach for volatility, it might be better to stick with a more broadly based fund that invests in a number of market sectors.

3. Small investment amounts

If you don't have much money to invest each month, buying small amounts of individual stocks can at times become very expensive if brokerage commissions eat away a large percentage of your total investment dollars. Many no-load mutual funds allow you to invest as little as \$50 a month, and if you don't pay a sales charge, every dollar of your investment goes right to work for you.

You also can set up automatic investments with many mutual fund companies without making a large initial investment. This makes investing automatic because you can arrange for your monthly investment amount to be transferred directly from your paycheck or bank account into your mutual fund account. It's hard to match that convenience, as long as you've researched your chosen fund before investing in it.

4. Professional management

Actively managed mutual funds are operated by a manager or management team who devote their talent to managing the fund's portfolio to achieve the fund's stated goal. The theory is that investors buy actively managed funds because the fund managers have more expertise and more time to make the actual investment decisions than investors do.

Of course mutual fund managers are only human, and some are much more successful than others. That's why it's important for investors to research a fund manager's track record before making an initial investment (remembering the often-repeated warning that past returns are no guarantee of future results).

5. An "easier" choice?

Along the same line of thinking, investors often will choose mutual funds over stocks because the choice, at least on the surface, seems to take much less effort. Of course it's just as easy to pick a bad mutual fund as it is to pick a bad stock when relying on tips from friends or ads in a magazine. Potential mutual fund investors must be just as diligent as stock investors when researching their investment choices before purchasing anything.



Disadvantages of mutual funds

1. Style drift

Key to a fund's prospectus (see Chapter 10, page 59 for more information) is the management's description of the fund's *style*. Style is simply another term for the fund's investment philosophy, the same type of philosophy you decided for yourself.

What you need to know now is that regardless of what a mutual fund's stated style is, there are times when that style might drift and all of a sudden the fund you thought was investing in small-cap stocks has turned into a mid- or large-cap fund.

2. Management changes

If you choose a mutual fund in part because of stellar management, there's no guarantee that manager or management team still will be making the investment decisions next year or even next month. Management changes are a fact of life for many mutual funds, so even if you do all the appropriate research and find a successful fund manager, they could be replaced with little or no notice to shareholders.

Read all semi-annual and annual reports you receive from your mutual funds, and if you notice a management change you don't agree with, it's time for you to decide whether you're comfortable remaining invested in that fund.

3. Taxable events

One major disadvantage of mutual funds over individual stocks is that you have little control over some taxable events. Even index funds, which buy and sell stocks with much less frequency than most actively managed funds, are forced to sell portfolio holdings if the index they track drops a stock or if there's not enough being held in the fund's cash reserves to cover fund redemptions (sales by shareholders).

Broadly based index funds tend to be more tax efficient than narrowly based index funds. For example, there is little turnover in an index built to replicate the entire stock or bond market. There will be more turnover in a fund seeking to duplicate the performance of a certain segment of the market, such as large or small-cap stocks.

Funds with high portfolio turnover (buying and selling lots of stocks throughout the years) are likely to generate more capital gains for shareholders. Fund managers buy and sell individual stocks without shareholder permission or prior knowledge, and a profitable sale means taxable capital gains. Lots of profitable sales during the year can mean a large capital gains distribution to each shareholder, and a large tax liability if you hold the fund in a taxable account.

A large capital gains distribution combined with a taxable account means you would pay taxes even if you didn't sell even one share of your mutual fund investment that year. Mutual fund investors may find themselves facing large tax bills from their taxable mutual fund accounts even though their funds have declined in value overall, simply due to fund management selling off profitable positions in an attempt to lock in gains.

Unless your mutual funds are invested in a Roth IRA, they eventually will be taxed. In a tax-deferred account, tax payments are held off only until the funds are withdrawn. But in the years the payments are deferred, you can take comfort in the knowledge that those tax-deferred dollars will be hard at work increasing your worth through compounding.

To avoid an undesirable tax payment in your non-deferred accounts, you may want to look for **tax-advantaged mutual funds**. This is just a fancy way of saying that fund management tries to keep portfolio turnover as low as possible while still pursuing a positive return. **Tax-adjusted returns** give you another way to compare returns on funds

you hold in a taxable account. These return figures will make it clear as to which funds you might want to hold in tax-deferred rather than taxable accounts.

The more taxable distributions specific mutual funds (such as income-producing bond funds) make, the better suited they are to be held in a tax-deferred or tax-exempt account.

4. Fund expenses and sales charges

Mutual funds aren't always less expensive to invest in than individual stocks. If you don't choose your funds carefully, you might find yourself paying a 6 percent initial sales charge right off the top of your investment, as well as annual management fees in excess of 2 percent or 3 percent a year. These kinds of fees can rapidly decrease your investment dollars, another reason you may want to select no-load mutual funds whenever possible.

Some mutual fund companies will waive certain fees once your combined accounts reach a certain dollar amount, though this might not be done unless you call to have them removed. It's worth asking if this sort of rule applies at a fund family you're considering.

Before you make an investment in any fund, be sure you're aware of any upfront sales charges (or loads), back-end or exit (redemption) fees and ongoing operating expenses. Remember that all of these fees and expenses reduce your potential annual return, one reason why low-expense, no-load index funds often reap a higher return than actively managed funds.



Mutual Fund Expense Analyzer

FINRA's Mutual Fund Expense Analyzer is an excellent tool for comparing the fees and expenses of different mutual funds (and Exchange Traded Funds). All

you have to do is input the name and it will find the fees and compare them for you.

www.finra.org/FundAnalyzer



Types of Mutual Funds

Mutual funds come in such a wide range of options that you might be confused about which type to choose. Being familiar with the most common choices before you decide can help make your selection process easier.

Risk and reward

Remember all the discussion of investment risk and reward in Chapter 3? The same holds true for mutual funds. If you want to increase your chances for a higher return, you'll need to choose investments carrying a greater risk.

Review the major categories of investments in Chapter 3 (see page 19). You can find mutual funds offering portfolios of most of those types of investment if you decide to invest through a fund rather than directly. Also, see Figure 10.1 on the next page.

Remember not to judge a mutual fund's investment style based on the fund's name alone. You still need to read the fund's prospectus carefully to make sure the fund meets your investment needs. Regardless of the type of fund you ultimately select, your aim should be to obtain the best possible performance at the lowest after-tax cost and at a risk level acceptable to you.

Here's a recap of the major fund categories you're most likely to invest in. You can review the reasons you might choose to invest in each type in Chapter 3, pages 19-24 if you need a refresher.

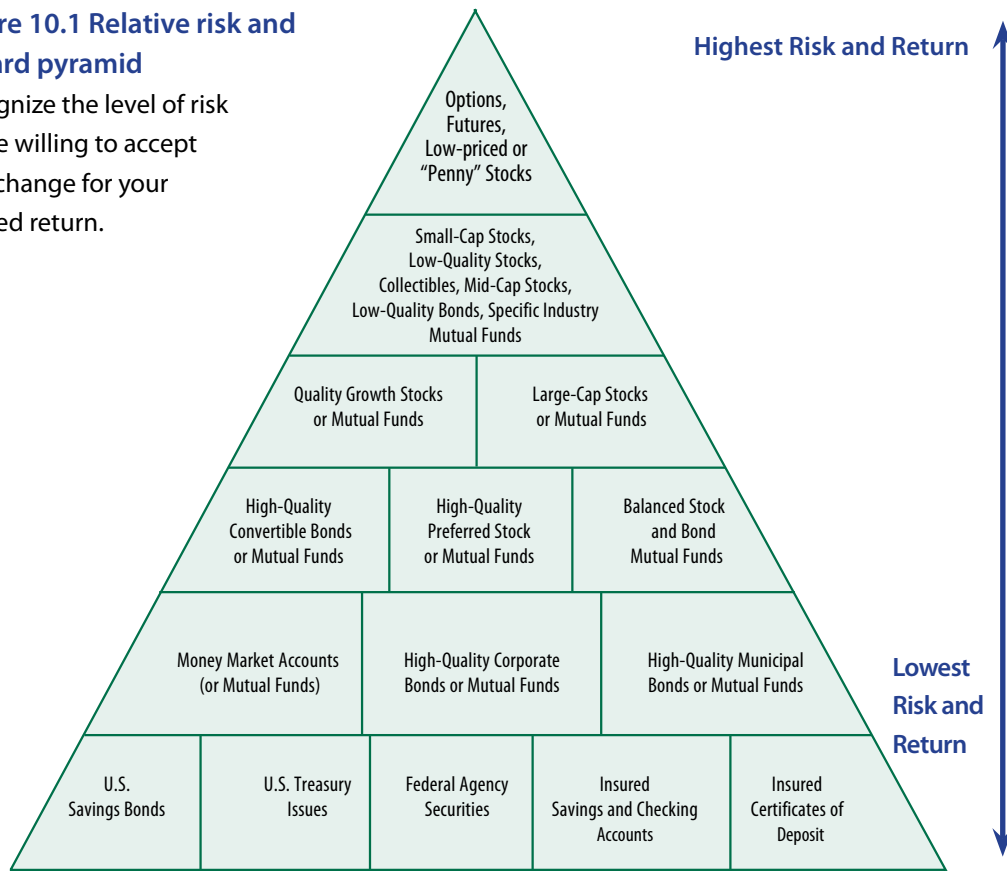
1. Money market funds

A share in a money market fund represents ownership in a pool of short-term securities that pay interest. Money market funds are available in taxable and tax-exempt versions. Many money market funds offer the convenience of free check writing, though they may require a minimum check amount and limit the number of checks you can write each month.

Carefully research the expenses a mutual fund charges before choosing a particular fund. There's usually not a large difference in returns between money market funds, but the lower the fund expenses, the higher your return should be, because you're paying less to the fund for management fees and other expenses. Even a difference as small as 0.25 percent can add up over time.

Figure 10.1 Relative risk and reward pyramid

Recognize the level of risk you're willing to accept in exchange for your desired return.



2. Stock funds

These are mutual funds that invest primarily in the stocks of publicly held companies. Stock funds also can invest in cash and bonds depending on the fund, so it's in your best interest to read the mutual fund prospectus carefully to make sure the stock fund you're considering really is investing primarily in stocks. (See Chapter 11, page 59, for more on reading a mutual fund prospectus.)

Stock funds make money the same way individual stocks do, through share price increases and through dividend payouts. Stock funds can focus on investing in specific types of companies, such as only large-cap or small-cap companies. When you research stock mutual funds for potential purchase, be sure you're comparing funds with the same investment objective and that invest in companies with similar characteristics.

3. Bond funds

Bond mutual funds invest in bonds. Types of bond funds range from those investing in high-quality government bonds to those investing in high-risk corporate

bonds (sometimes called junk bonds) plus every type of bond in between.

4. Balanced funds

Balanced funds offer an opportunity to invest in a mixed bag of stocks and bonds, usually with a set proportion of 60 percent in stock and 40 percent in bonds. The actual proportion and investment mix varies from fund to fund and can be found in the fund's prospectus.

5. Growth funds

Growth funds invest in stocks with potential for capital appreciation (another name for an increase in share price). Growth fund managers look for companies with increasing sales and earnings, the same characteristics investors look for when investing in stocks.

Aggressive growth funds

These funds aim for maximum gains by taking larger risks than regular growth funds. Aggressive growth fund managers seek these gains by investing in stocks with potential, rather than actual, earnings growth. These

often are smaller companies in a currently popular industry.

Aggressive funds tend to have very high portfolio turnover rates, meaning the fund managers buy and sell portfolio holdings frequently. While it's possible this type of trading may lead to higher returns, it's almost a certainty that active trading will lead to higher brokerage commissions and capital gain taxes for shareholders (important to know if you hold the fund in a taxable account).

Stock income funds

Stock income funds invest in stocks that pay high dividends. This type of fund is attractive to investors who want some exposure to stocks and are willing to give up higher growth potential for higher income.

Growth and income funds

These funds hold both growth and income stocks and sometimes bonds as well.

International funds

International funds invest in stocks, and sometimes bonds, from countries outside of the United States. Investors often choose international funds to provide economic, geographic and currency-related diversification. If the U.S. economy is experiencing a down period, for example, international fund investors hope that other economies around the world are more robust.

Global funds

Global funds invest anywhere in the world, including the United States. Fund management usually sets a maximum percentage of foreign vs. domestic investments.

Real Estate Investment Trust (REIT) funds

REIT funds give investors a way to invest in a variety of real estate positions, from residential to office to retail.

Sector funds

Sector funds focus on specific parts of the stock market, either an industry (such as technology) or even smaller, more specific segments of a larger industry (such as computer chip makers).

Exchange traded funds (ETFs)

Exchange traded funds (ETFs) are not mutual funds, but rather are more similar to stocks. ETFs offer investors the opportunity to buy and sell index fund-type investments, but in real time throughout the trading day rather than only at the close of the market day as with index funds. Investors also can manage taxable events better with ETFs by choosing when (or if) to sell. ETF trades incur brokerage commissions, potentially leading to higher expenses in exchange for this flexibility.

Index funds

As we learned last chapter, index funds are a special kind of mutual fund that aims to match the performance of a specific set of investments, like the U.S. large-cap companies, municipal bonds or global small-cap companies. Index funds tend to have the lowest fees and have built-in diversity. Like many other mutual fund types, a diverse portfolio would have bond-based index funds as well as stock-based funds.

Lifecycle funds

Lifecycle funds often have a year in the name, such as ACME 2050. This means the fund is designed for people who anticipate retiring in 2050. These funds adjust their asset allocations over the life of the fund. Since 2050 is far away, ACME would have mostly stocks in the fund now and eventually shift to more conservative investments as 2050 approaches. It is important to make sure you purchase funds with low fees; these funds can have attractive fees but also can have loads, so be careful. We all have our own tolerance for risk, so it may be worthwhile to do your own thinking about your best asset allocation.

If you'd prefer to avoid the work of targeting your asset allocation and rebalancing your portfolio over time, this may be a good option for you.



Mutual Fund Mechanics

While there are many different types of mutual funds to choose from, they all have some key elements in common. In this chapter we'll introduce some of these basics, including important fund documentation as well as how to buy shares in a mutual fund.

Mutual fund families

One part of choosing a mutual fund is knowing a little about its fund family. The companies that administer a set of mutual funds are called mutual fund families. Investors have hundreds of fund families to choose from. Some people prefer to choose funds from only one or two fund families to keep recordkeeping more streamlined and simplified.

It's also often easier and less costly to transfer money from one fund to another when they're within the same fund family. If you choose a well-respected fund family with a wide variety of funds, keeping all your fund holdings within the same family is certainly a valid option.

Some brokerage and mutual fund accounts allow their customers to buy mutual funds from a wide variety of fund families. For example, if you have an IRA account at "The Generic Mutual Fund Company," you can invest not only in Generic Company funds, but also in funds offered by other mutual fund families. The brokerage/fund family may charge a transaction fee for investing in such "outside" funds, so be sure you investigate this possibility before making your choices.

Keep in mind you may not have much of a choice in fund families if you're investing through your employer's

supplemental or deferred compensation plan. Some employers offer a wide range of fund options, while others might restrict the choices to just a few funds within one fund family. If you're unhappy with the fund options in your employer's plan, be sure to let your benefits office know. It's possible your opinion will influence your employer to offer better choices in the future.

1. Important fund documents

Just as you read over an individual stock's most recent quarterly and annual report (along with other documentation) before investing, it's important that you familiarize yourself with a mutual fund's documentation as well. Be sure to request and read these documents as part of your research before making any investment decisions.

Prospectus

The mutual fund prospectus functions as an owner's manual of sorts for prospective and current shareholders of that fund. At the very minimum, a prospectus clearly states the fund's goals, strategies, fees, past performance and expenses. Many of the details discussed in the prospectus are fund features introduced in Chapter 8.

The Securities and Exchange Commission (SEC) requires every fund to provide investors with a copy of the fund prospectus either before the first investment or along with the statement confirming an investor's first contribution.

Some of the items you'll find in a mutual fund prospectus

- Investment objective and style;
- Sales charges (front- or back-end loads);
- Management fees;
- Operating expenses;
- Historical performance;
- Total return;
- Specifics of buying and selling shares; and
- Management details.

The fund prospectus may come with an application for purchasing shares if you decide to invest in the fund. The application will give you options for dealing with any fund distributions, such as reinvesting all dividends and capital gains, receiving them in cash, or *sweeping* (transferring) them into a money market fund in the same fund family. The application also will give you an opportunity to set up an automatic investment plan.

Statement of additional information

The **Statement of Additional Information** (SAI) offers just what its name promises: more information about the mutual fund's corporate aspects, its advisers, its board of directors and other financial details. But don't worry about the SAI as you're first learning about mutual funds. What's important for you to know at this stage is that the SAI exists and that you can learn more about the fund from it when you're ready. If the SAI doesn't automatically come with the prospectus and you'd like

to see it, the prospectus will give you instructions for obtaining it.

Shareholder report

After you've purchased shares in a mutual fund, you'll start receiving regular shareholder reports. If you'd prefer not to receive a paper copy, many funds will give you the option of reading these reports online or through e-mail.

Annual and semiannual reports detail the fund's most recent financial information, as well as performance numbers and the fund's latest reported portfolio holdings. You'll also find a letter from the fund manager or management team discussing the fund's results, most likely in relation to the overall market's performance and future prospects.

The shareholder report should contain graphs plotting the fund's investment returns over a certain period of time, often comparing the fund's performance to that of the S&P 500 or another appropriate market index. These graphs track the value of a hypothetical \$10,000 investment (after fund expenses). You can also find the fund's one-, five- and 10-year total return figures, again with a comparison to one or more market indexes.

2. Buying and selling mutual funds

You'll find specific information about buying (and selling) mutual fund shares directly from the fund family in a fund's prospectus. You usually have other options for making fund transactions as well.

Mutual fund investment options

- Directly from the fund family;
- Through your retirement account;
- Through your brokerage account;
- Through a financial planner; and
- Through another fund family.

Be aware that purchasing a mutual fund in any way other than directly through the mutual fund family itself may result in an additional fee. For example, you may be able to buy a wide variety of mutual funds through your brokerage account but be charged a fee for each transaction. If this is the case for a fund you still would like to

invest in, you may want to consider buying it directly from the fund family to avoid the extra transaction fees.

3. Initial investments

Some mutual funds require a much higher initial investment than others. (You can find out the exact amount in the fund's prospectus.) One reason for high initial investments is to reduce fund expenses due to investors who buy only a small amount of shares or who make small investments in lots of different funds. The cost of servicing these small investors (by sending out account statements and shareholder reports, for example) is proportionately higher than for investors with larger accounts.

An investor who buys \$500 worth of a mutual fund and never adds to that initial investment, for example, is more a liability than an asset to a mutual fund. The fund still incurs expenses in servicing this small account, and higher expenses in turn affect the fund's total return.

If you've chosen a fund to invest in over the long term but the initial investment is more than you currently have saved, check the fund prospectus to see if the fund allows a lower initial investment when you sign up for their automatic investment plan. Some funds even offer investors the chance to invest without any initial investment, as long as you commit to a minimum regular monthly investment. Plans like this can help you get started investing in quality mutual funds even if you have only \$50 or \$100 a month to start out with.

4. Tax implications

It's important to reiterate just a few things about taxes and mutual funds at this point. When you own a mutual fund, you won't have as much control over taxable events as you do with individual stocks. By law, mutual funds must distribute any year-end gains to shareholders.

You'll owe taxes on these distributions each year (unless you hold the shares in a tax-deferred account), even if you've had the distributions themselves automati-

cally reinvested and you haven't sold any of your shares. When you own individual stocks, you'll have to pay taxes on dividends, but you're usually able to control the timing of any capital gains.

Both of these types of mutual fund distributions, income and capital gains, will be reported on the form 1099-DIV sent to you by the fund after the end of each year. **Ordinary income** includes the dividends, interest and other income earned by the fund each year. This income is divided among the shareholders after expenses are deducted. Profit from any sales is distributed as a **capital gain**. Remember that even if your fund has a losing year overall, you still may owe capital gains taxes.

5. Recordkeeping

This is a good time for a reminder about keeping accurate records. At the very least, be sure to keep your annual summary statement reflecting your mutual fund transactions for the year, as well as any Form 1099Bs from the years when you sell fund shares held in taxable accounts. You'll need to know how much you've paid for your fund shares and how long you've held them for tax purposes. Sales charges, redemption charges and taxes paid on reinvested distributions will affect your tax liability when you sell shares, so you'll want to have records of those amounts available when you need them.



Responsible Investing

It's not enough to just be an investor. You also must take your role as an investor seriously and be deliberate about keeping on top of paperwork, continuing research and tracking your portfolio to ensure it's meeting your goals.

Portfolio management

You shouldn't set up a 401(k) or automatic mutual fund investment only to ignore it until it's tax time or you need the money. Portfolio management is just as important as portfolio building. You must do at least a minimum of regular portfolio management, but there's no reason this should be an overwhelming task.

1. Schedule your tasks

Becoming a responsible investor doesn't take much work. You can make the process much easier by breaking down your most important investment-related tasks into a schedule. The tasks that follow are meant as a general guideline. Some of them may not apply to your situation, or you may have other items to take care of that we don't list here.

The basic concept remains the same regardless of the specific tasks, however. Identify what you need to do and how often it needs to be done, then schedule appropriately, in tandem with the other items on your monthly, quarterly and annual "to do" lists. Here are some ideas of where to start.

Monthly

1. Enter all investment transactions into your investment recordkeeping software or accounting notebook.

2. Read through any financial statements sent to you by mail or online.
3. Reconcile all brokerage, mutual fund and relevant bank statements against your accounting records.

Quarterly

1. Read any quarterly updates you receive from your investments, looking to see whether earnings have increased or decreased.
2. Update stock selection guides for any individual stocks you own with the company's latest financial data (such as earnings).

Annually

1. Complete your own annual report for your portfolio, including annual returns for all investments and for your portfolio as a whole.

2. Compare your portfolio returns to your financial goals for the year, determining whether any changes (in investments or goals) need to be made.
3. Set financial and investment goals for the year ahead, including a plan for how you anticipate meeting those goals. Is there a certain amount of money you'd like to invest over the coming year? Are you working toward a specific financial goal?
4. Read annual reports for your portfolio holdings, both individual stocks and mutual funds, either online or in paper form. If you're especially motivated, read the footnotes as well and learn to interpret their at-times-confusing contents.
5. Attend annual stockholder meetings for all individual stocks you own whenever possible, or vote the proxy that is mailed to you before each annual meeting.
6. Prepare for tax season by either creating the appropriate reports or by gathering the appropriate broker/mutual fund statements and compiling a list of your financial transactions for the year.
7. Archive the previous year's financial statements after tax preparation. Remove them from your current files but keep them someplace accessible in case you need to check something. Some investors keep a back-up copy of their year-end financial reports, either on paper or in electronic form, and store it at an off-site location (such as a safe deposit box) in the event their original records are lost or destroyed.



2. Which records to keep, and for how long

How long you should keep old utility bills and credit card receipts is a question you can answer with any decent personal finance book. The answer can be complicated depending on your financial situation and personal preferences, so we won't dive into it at this point. But we can give a brief overview of how you might want to handle your investment-related paperwork.

Remember to be conscious of your privacy when discarding any financial paperwork. Never just throw away account statements and bank records or anything

else with an account, credit card or your Social Security Number on it. Buy a paper shredder (you can find decent, inexpensive ones at an office supply store) and use it to destroy any document containing financially sensitive information before you recycle or throw it away.

While the chances may be low, it's possible that anyone coming across intact financial records after you've put them in the trash may use that information for unscrupulous purposes. Better to spend an extra few minutes to shred anything even slightly financial in nature than to deal with the potential for identity theft or other similar crimes.

Transaction and dividend reports

Keep all buy and sell transactions for stocks, mutual funds and other investments indefinitely. This is one of those "better safe than sorry" situations. Even if you hold these investments in a tax-deferred account and won't have to worry about calculating the cost basis or capital gains, you still should hang on to these transaction records and dividend statements, just in case.

You also want to keep anything that shows fees you paid when buying or selling (such as brokerage fees or

mutual fund loads). You may need these amounts to calculate the cost basis (the purchase price minus any expenses or dividends on which taxes already have been paid) of your investments for tax purposes.

This doesn't mean you have to clutter up the files you use day to day with these or any old records, though. Put them out of the

way in a safe place, and then put them out of your mind. Some people package all the documents they might need to back up their tax returns, along with annual statements and other financial end-of-year records, and file them away in a manila envelope or banker's box with the year clearly written on the outside. This collection then can be stashed out of sight in a closet or attic somewhere, while still remaining within easy grasp if the need for access arises.

Monthly statements

As soon as you receive a quarterly or annual statement containing the same information, you can safely discard your monthly statements (shredding them first to maintain privacy, of course).

Annual statements

Annual statements from brokerages, mutual fund companies and other investment entities should be kept indefinitely (archived as we describe above so you don't clutter your files). Double check your monthly or quarterly ending balances against those in the annual statement to ensure everything reconciles. You may need these annual statements for tax preparation, so keep them close at hand once you receive them in January until after your taxes have been filed and any payment made or refund received.

Quarterly and annual reports

Unless they contain crucial information you know you'll want to review in the future, you can discard past quarterly and annual reports from your stock and mutual fund holdings after you've read them and voted on any pending shareholder issues. Many investors keep the most current annual and quarterly reports for reference, replacing them as newer reports are released.

If you find you need an old report in the future, chances are excellent you can access any of the company or fund's recent filings at their website. There's little reason to hang on to all those glossy reports and pages of financial reports in tiny type on tissue-thin paper when you shouldn't have much trouble getting the information in other forms if you really need it at some future date.

3. Tracking your portfolio

Portfolio management is another hallmark trait of the responsible investor. You should regularly review your portfolio to ensure you're following your own chosen investment philosophy and that you're on track to reach your financial goals. Of course your investments may not always perform as well as you'd hope in the short term, but it's important to try to determine whether that's because of a depressed overall market condition or because you've chosen substandard investments.

Good portfolio management means tracking your stocks and mutual funds on an annual (at minimum) or quarterly (best option when possible) basis. Check to



make sure a stock's earnings and sales are in line with your projections. You'll also want to know if a mutual fund's investment choices have veered away from its stated strategy, or if there's been a change in fund management.

4. Key traits of a responsible investor

As a responsible investor, you should:

- Ask questions until the answers make sense to you;
- Thoroughly research stocks and mutual funds (including reading the annual report and fund prospectus) before investing;
- Maintain and regularly update accurate records;
- Understand your investments so that you know what you're investing in;
- Vote your proxies (stock and mutual fund);
- Attend shareholder meetings whenever possible (even if only just once);
- File taxes accurately and on time;
- Invest regularly according to your investment philosophy and financial goals;
- Analyze your portfolio regularly; and
- Sell when necessary, according to your investment philosophy.

Glossary



Accelerated Depreciation

The amount of expense charged against earnings by a company to write off the cost of a plant or machine over its useful life, giving consideration to wear and tear, obsolescence and salvage value.

Account Maintenance Fees

A fee an investor pays to a fund company or broker in return for account services.

Accrued Wages, Interest and Other Expenses

Current liabilities. Money owed by a company to its employees, other businesses (i.e., banks) and miscellaneous expenses.

Acquisitions

The purchase of one company by another for the purpose of gaining access to different, new or complementary products or technologies.

Active Portfolio Strategy

Uses strategies and information to achieve better performance than a mutual fund portfolio that passively manages a broadly diversified portfolio, i.e., an index fund.

Actively Managed Mutual Fund

A mutual fund with a manager who uses strategies and information to achieve better performance than a particular market index.

Adviser

The company that manages a fund's portfolio. The adviser makes the portfolio buy and sell decisions in an effort to carry out the fund's investment objective. The investment adviser also is known as the management company. See also Investment Adviser.

After-Tax Return

The return an investor receives on an investment after applicable taxes are paid.

Aggressive Growth Fund

A fund that seeks maximum capital appreciation by purchasing stocks thought to offer potential for rapid growth. These funds also can invest in smaller emerging companies that may not have a proven track record of increasing sales and earnings.

American Depository Receipts (ADRs)

Stock representing specific shares in a foreign corporation.

Amortization

Reduction of debt through periodic payments consisting of interest and part of the principal.

Analyst

An employee of a mutual fund adviser who analyzes companies for possible fund purchase.

Annual Report

A report issued by a mutual fund detailing a fund's performance, expenses and holdings during a particular year.

Annuity

An insurance product in the form of a contract that provides a series of income payments made at

regular intervals during a set period (such as retirement) in return for a premium (or premiums) paid. An annuity usually offers tax-deferral benefits.

Asked Price

The price demanded by a willing seller.

Asset

Property or items of value owned by a company, or the economic resources of a business.

Asset Allocation

The practice of dividing personal assets among different investing vehicles.

Asset Allocation Fund

A fund that spreads its portfolio among a range of different investments. These can include U.S. and overseas stocks, bonds, real estate and gold.

Authorized Stock

The total number of shares that a corporation, as indicated in its charter, is authorized to sell.

Automatic Reinvestment Plan (Dividend Reinvestment)

A fund service that provides shareholders with the option to invest their income dividends and capital gain distributions automatically, also known as a dividend reinvestment plan (DRIP).

Average Credit Quality

Assesses the overall credit quality of a bond fund's portfolio. To calculate this number, Morningstar averages the credit rating of each bond in the portfolio.

Average P/E Ratio

As defined by Morningstar, a fund's weighted P/E average, which is calculated by using current stock prices divided by the company's projected earnings.

Averages

Selected lists of stock or bonds whose price action is considered representative of the market as a whole. The best-known averages are the Dow Jones and Standard & Poor's.

Back-end Load Fund

A mutual fund that charges shareholders a fee (commission) to sell shares. This charge decreases the longer the investor holds the shares, eventually zeroing out.

Balance Sheet

A financial statement detailing, as of a certain point in time, a company's assets, liabilities and capital.

Balanced Fund

A fund that maintains a portfolio that is divided into a certain percentage of stocks and a certain percentage of bonds.

Basis

The price an investor pays for a security plus any commissions, sales charges or other out-of-pocket expenses.

Bear

An investor who anticipates a market decline.

Bear Market

A market in which stock prices have declined 20 percent from a recent high.

Benchmark

The performance of a group of securities used for comparison purposes. Through such a comparison, you can determine whether your fund outperforms the index over the long term.

Beta

A coefficient that measures volatility relative to the total market, usually as represented by the S&P 500.

Bid Price

The price offered by a willing buyer.

Blend Style of Investing

This investing style combines elements of the growth and value styles of investing.

Blue Chip

The common stock of a well-known company that has a long record of growth and a reputation for quality management.

Board of Directors

The body that oversees a fund's activities and contracts with the management company, distributor, custodian and transfer agent to run the fund.

Bond

A debt instrument. When a company issues bonds, it agrees to pay bondholders a stated rate of interest until the principal is repaid on a specified date.

Bond Fund

A fund with a portfolio consisting primarily of corporate, municipal or U.S. government bonds. These funds focus on income potential rather than growth.

Bond Index Fund

A bond fund based on a bond index. Managers of such funds invest their assets according to the particular index followed by the fund.

Bond Ratings

An assessment of the solvency of a particular company in terms of its ability to pay interest and repay principle to bond holders.

Bond Ratio

That portion of a company's capital structure consisting of bonds, found by dividing the face value of bonds by the total value of bonds, preferred stock, common stock, capital surplus and retained earnings.

Bondholder

A creditor.

Book Value (Common Stock)

The value of common stock of a company, found by adding the par value of the common stock, retained earnings and surplus reserves.

Broker

A firm or individual that arranges a transfer of securities between a buyer and a seller, charging a fee for the service.

Brokerage Commission

A sales fee charged in return for investment advice and/or the buying and selling of fund shares.

Brokerage House

A firm whose employees (brokers) arrange the transfer of securities between a buyer and a seller, charging a fee for the service.

Bull Market

A period of generally rising market prices.

Business Cycle

The phases of transition in a free economy, consisting of prosperity, recession, depression and recovery.

Buy and Hold Philosophy

A philosophy that can be adopted by individual investors or fund managers that involves purchasing stocks and retaining them for the long term.

Capital Appreciation

An investment gain from the price appreciation of a security.

Capital Gain or Capital Loss

Profit or loss from the sale of a capital asset, such as a security.

Capital Gains Distribution

Shareholders receive these distributions when a fund manager sells stock held in the portfolio at a profit.

Capital Structure

The total of bonds, preferred stock, common stock and retained earnings.

Capitalization

The total value, as stated in a company's books, of bonds, preferred and common stock and retained earnings.

Cash

This includes actual cash held by a fund and cash equivalents. Cash equivalents include money market or other fixed-income securities with maturities of less than one year.

Cash Dividend

A portion of the net earnings or retained earnings of a corporation directed by the board to be paid to the stockholders in cash.

Cash Flow

The net income of a company, with the addition of any such non-cash deductions from income as depreciation and depletion.

Cash-Flow Statement

A report showing a company's cash flow over selected periods of time.

Cash Reserves

Cash or short-term securities held by a mutual fund.

Cheap Stock

Not necessarily a low-priced stock, but one that is selling at a lower price/earnings ratio than would appear justified by corporate results.

Chief Executive Officer (CEO)

The head of a company's business operations.

Class A Shares

Investors who purchase these shares are assessed a sales charge (commission) taken off the top of their initial investment. Also known as a front-end load.

Class B Shares

A mutual fund that charges investors a fee (commission) to sell shares. Class B shares have a bank-end load charge that also is known as a contingent deferred sales charge.

Class C Shares

These funds charge a sales fee (commission) annually and also are known as Class C shares. Such shares cannot be converted to another share class.

Commission

A sales fee charged in return for investment advice and/or the buying and selling of stock.

Commission Free Brokerage Trades

A brokerage trade that is executed without a commission or fee.

Common Stock

A representation of ownership in a corporation.

Common Stock Ratio

That portion of a company's capital structure consisting of common stock.

Compounded Annual Return

The yearly rate of return that is earned or paid and that usually is compounded daily, monthly or yearly.

Compounding

Earnings that are generated from the return on an investment.

Consolidated Statement

A statement that includes figures for a company and all of its subsidiaries.

Contingent Deferred Sales Charge

A commission or back-end load that may be imposed on fund shares sold within a certain period of time. Also known as a back-end load or Class B shares.

Corporate Bonds

Bonds issued by U.S. and foreign corporations.

Corporate High-Yield Bonds

Bonds issued by corporations with below investment grade credit ratings.

Corporation

An entity created by law with perpetual life and limited liability of shareholders.

Cost Basis

The price an investor pays for a security plus any commissions, sales charges or other out-of-pocket expenses.

Country-Specific Fund

A mutual fund that invests its assets in the stocks of one particular foreign country.

Coverdell Education Savings Account (ESA)

Formerly known as Education IRAs, these are individually established college savings plans.

Creditor

An individual or entity that lends money to a company, e.g., a bondholder, buyer of commercial paper or extender of trade credit.

Current Asset

An asset that can be converted into cash within a year.

Current Liability

A liability of a company that must be paid within one year.

Current Ratio

A firm's current assets divided by its current liabilities.

Current Yield

The annual income yielded by a security, divided by its current price. For stock investors, the current yield also is known as the dividend yield.

Cyclical

A trend or process that moves in a cycle. The stock market follows a cyclical pattern from a bull market to a bear market and back to a bull market.

Cyclical Growth Stock

A stock that is very dependent on the business cycle, and reaches new highs in sales and earnings in each succeeding period of prosperity.

Cyclical Industry

An industry that follows a boom-bust pattern in a regular market cycle.

Debenture

A bond not secured by any specific property but backed only by the general credit of the issuing company.

Defined-Benefit Pension

A retirement plan that promises to pay a certain amount, usually based on the number of years employed and salary level.

Defined-Contribution Pension

A retirement plan with a fixed contribution rate, in which benefits employees receive after retirement depend to some extent upon the contributions and their earnings.

Depreciation

The amount of expense charged against earnings by a company to write off the cost of a plant or machine over its useful life, giving consideration to wear and tear, obsolescence and salvage value.

Derivatives

A financial security whose value is determined in part by the value and characteristics of another underlying security.

Dilution

The effect on earnings and book value per share when the number of shares issued by a company increases disproportionately to growth in company earnings or assets.

Direct Stock Purchase Plans (DSPs)

An investment plan similar to a dividend reinvestment plan but by which investors are able to purchase initial shares of a company directly through the company or its agent rather than through an outside broker.

Discount Broker

A broker who provides services at a price discounted from that of a full-service broker.

Discount Brokerage

A brokerage firm that provides services at a price discounted from that of a full-service brokerage.

Diversification

The practice of spreading investments among a range of different securities to reduce risk.

Diversified Portfolio

A portfolio that invests in many companies in an effort to reduce risk.

Dividend

A payment a company makes, in cash or stock, to its shareholders.

Dividend Per Share

The total dividend paid divided by the number of shares of common stock outstanding.

Dividend Reinvestment Plan (DRIP)

A fund service that provides shareholders with the option to automatically invest their income dividends and capital gain distributions.

Dividend Yield

Found by dividing the cash dividend per share by market price per share. Lower yields are associated with growth companies and higher yields with more mature companies.

Dollar Cost Averaging

Buying a set dollar amount of a security at stated intervals.

Dow Jones Industrial Average

An index of 30 blue-chip U.S. stocks, maintained by the editors of *The Wall Street Journal*.

Earnings

A company's profit after taxes.

Earnings Per Share (EPS)

A company's net income divided by the number of shares of common stock outstanding.

Earnings Report

A financial statement (also called income statement or profit and loss statement) that shows a company's operating results over a period of time and gives evidence of the company's profitability.

Equity

An ownership interest held by shareholders in a corporation. See Stock (Common).

Exchange

A meeting place for the representatives of buyers and sellers of securities.

Exchange Fee

A fee some mutual fund families charge for investors to exchange their shares in one mutual fund for another fund in the same family.

Exchange Traded Funds (ETFs)

An index-based mutual fund that trades like a stock on a stock exchange throughout the day. Unlike traditional mutual funds that are valued at the end of each trading day, the share price of ETFs fluctuates.

Expenses

Any of the sum of fees imposed by a mutual fund on its shareholders.

Expense Ratio

The ratio of investor expenses to net assets of the fund. The expense ratio does not include brokerage costs or loads.

Family of Funds

A group of mutual funds managed by the same company.

Fee-Only Financial Planner

A professional financial planner who charges a flat fee rather than a commission based on investments sold.

Financial Planner (FP)

A professional who provides investing information and advice. FPs and Certified Financial Planners (CFPs) will either charge a flat fee for their advice or will receive a sales commission in return for placing investors' money in particular mutual funds.

Financial Risk

One of the important types of risk confronting investors, it acknowledges that companies may suffer adversity that would affect their ability to make payments to investors and/or creditors.

Financial Statement

A report depicting a corporation's or fund company's financial condition as of a given date or financial results for a given period. The most common financial statements are the balance sheet, income statement and cash-flow statement.

Fiscal Period

A span of time selected as an accounting period.

Fixed Asset

Tangible property owned by a company that is utilized in the production of net income, but is not expected to be consumed or converted into cash.

Fixed Cost

A business expense that continues even if production ceases.

Fixed-Income Investments

Those investments, including bonds and (usually) preferred stock, for which the company is committed to paying a specific amount of return to investors.

401(k) Plan

An employer-sponsored retirement plan. Such plans allow employees to make tax-deferred contributions into the plan, which in some cases are matched by the employer.

403(b) Plan

An employer-sponsored retirement plan available to employees of educational institutions and non-profit organizations. Similar to 401(k) and 457 plans plan.

457 Plan

A type of tax-advantaged defined-contribution retirement plan available for governmental and certain non-governmental employers in the United States. The employer provides the plan and the employee defers compensation into it on a pre-tax

basis. 457 plans are similar to 401(k) and 403(b) plans. The key difference is that unlike a 401(k) plan, there is no 10 percent penalty for withdrawal before the age of 59½ (although the withdrawal is subject to ordinary income taxation).

Foreign Currencies

The money issued by foreign countries.

Foreign Stocks

Companies based outside the United States.

Forms 10-K and 10-Q

A mutual fund's annual and quarterly reports, filing requirements of the Securities and Exchange Commission.

Front-End Load

A sales charge that is assessed when a fund investment is made.

Front-End Load Mutual Fund

A mutual fund that assesses a sales charge when a fund investment is made.

Full-Service Broker

A broker that charges a higher commission than a discount broker in return for a higher level of service.

Fund Asset Size

The amount of assets in a mutual fund.

Fund Exchanges

Many fund families allow investors to exchange their shares in one fund within a family for another fund within the same family.

Funding

The refinancing of debt, prior to maturity (same as refunding).

Fund Share Classes

Many fund companies sell different classes of the same fund shares. For individual investors, these classes are Class A, which carry a front-end load, Class B, which carry a back-end load, and Class C, which carry a level load.

Fund Shares Outstanding

The number of shares issued by the fund company to fund shareholders.

Fund Manager's Letter

This is the part of the shareholder report in which the fund manager comments on the fund's recent performance and strategy as well as the general economic outlook.

Fund Statements

Fund companies issue statements regularly to all shareholders. These inform shareholders about their fund holdings, performance, net asset value and the overall value of their funds.

Fund Transfers

Sending money electronically from one account to another.

Futures

Contracts to buy and sell commodities (items that will be mined or grown). This market can be highly volatile and difficult to accurately evaluate.

Global Bond Funds

Bond funds that invest their assets in any country around the world.

Global Fund

A mutual fund that invests in both U.S. and foreign securities.

Government Bond

U.S. government debt, offering what experts consider the lowest possible financial risk.

Government Bond Fund General

A bond fund with a portfolio invested in Treasuries, mortgage-backed securities and governmental agency securities.

Government Bond Fund Treasury

A bond fund with a portfolio solely made up of Treasury bonds, bills and notes.

Government Securities

U.S. government obligations (bills, notes and bonds).

Governmental Agency Securities

A bond, bill or note issued by an agency of the federal government.

Gross Domestic Product

The new statistic offered by the U.S. government to supplant Gross National Product.

Gross Profit

Net sales minus cost of goods sold.

Gross Profit Margin

Gross profit divided by net sales, also called gross margin.

Gross Sales

Sales before deductions for returns and allowances.

Growth Fund

A fund with an objective of long-term growth of capital. Managers of such funds invest in common stocks with significant growth potential.

Growth and Income Fund

A fund that has a portfolio that holds companies with both growth potential and dividend income.

Growth Manager

A fund manager who invests in companies that demonstrate higher than average sales and earnings growth.

Growth Stock

Companies that show higher than average growth in sales and earnings. Growth is fueled by a number of different elements, including superior management, new products, expanding markets or the discovery of new resources.

Growth Style of Investing

Managers who follow this style of investing seek companies with consistent, above-average sales and earnings growth in an effort to produce long-term growth of capital.

Goodwill

An intangible asset that arises from business combinations accounted for under the purchase method and represents the cost to a purchaser in excess of

the fair value of net tangible assets (equity) of an acquired business.

Hedge Fund

A mutual fund that hedges its market commitments by holding securities it thinks are likely to increase in value while short-selling securities it thinks are likely to decrease in value.

High-Yield Bond Fund

A bond fund with a portfolio of non-investment grade bonds that pays a high interest rate compared with other bond funds. High-yield bond funds also are known as junk bond funds.

Income

An amount of money received in return for making an investment or doing a job.

Income Fund

A fund that seeks income by investing in stocks and bonds that pay high dividends and interest.

Income Return

The portion of a fund's total return that derives from interest distributions.

Income Statement

A financial statement, also called a profit and loss statement, that reports income, costs, expenses and profits (losses) over a period, usually one full year.

Income Stock

A stock offering an above-average cash dividend yield.

Index Fund

A fund with the goal of replicating the performance of a particular market index. Index funds are not actively managed. Their performance usually lags their respective index by the fund's expense ratio. Even so, they typically outperform individual investors and actively managed mutual funds due to their low fees.

Individual Retirement Account (IRA)

A personal, tax-deferred retirement account. Taxes on capital are deferred until you withdraw money, usually at retirement.

Inflation

An increase in the cost of consumer goods, which leads to a decline in the purchasing power of the dollar.

Initial Public Offering (IPO)

The first time a stock or closed-end mutual fund is offered to the investing public.

Institutional Funds

Mutual funds designed for wealthy investors or managers of large organizations who have large sums of money to invest. Minimum investment requirements for institutional funds can be in the tens of thousands or hundreds of thousands of dollars.

Institutional Investors

Wealthy investors or managers of large institutions such as pension funds that have large sums of money to invest in the markets.

International Bond Funds

Bond funds that invest their assets outside of the United States.

Interest

A payment made to a creditor by a borrower for the use of money.

Interest Rate

A percentage rate at which money can be lent or borrowed. In the United States, the Federal Reserve sets interest rates.

Interest Rate Risk

One of the important types of risk confronting investors, resulting from a rise in interest rates.

Intermediate-Term Bond Fund

A bond fund that concentrates its portfolio in intermediate-term bonds. According to Morningstar, such funds focus on bonds with maturities between four and 10 years.

International Fund

A fund that invests in securities markets outside the United States.

Inventory

The raw materials, work in progress and finished goods of a company.

Inventory Turnover

A measurement of efficiency, found by dividing the cost of goods sold for a period by average inventory at cost for the same period.

Investment Adviser

The company that manages a fund's portfolio, making the portfolio buy and sell decisions in an effort to carry out the fund's investment objective. The investment adviser also is known as the management company.

Investment Advisory Fee

The fee charged by the investment adviser or management company for managing a fund's investments.

Investment Club

A group of investors who work together, either as a formal legal partnership or as a more informal study group, to research, select and potentially purchase investments.

Investment Grade Bond

Bonds that are judged likely to maintain interest and principal payments to investors.

Investment Objective

The financial goal pursued by an investor or mutual fund manager.

Investment Philosophy

A set of values or guidelines an investor or investment club strives to follow when selecting investments.

Investment Style

The direction a fund manager pursues to achieve a fund's investment goals.

Investment Sub-adviser

A management company hired by the fund's investment adviser to manage the fund.

Junk Bonds

A bond considered by a credit-rating agency to be less likely to repay investors' principal or to pay interest than investment-grade bonds.

Junk Bond Fund

A bond fund with a portfolio of non-investment grade bonds that pays a high interest rate compared with other bond funds. High-yield bond funds also are known as junk bond funds.

Large Cap

With market capitalization measured by a company's sales revenue, large-cap companies are those with market capitalization greater than \$5 billion.

Large-Cap Mutual Fund

A mutual fund that has a portfolio primarily composed of large-cap companies.

Lehman Brothers Aggregate Bond Index

Morningstar's benchmark for all bond funds, this index attempts to replicate the performance of the entire U.S. investment grade bond market.

Level Load

A sales fee charged to shareholders annually.

Level Load Mutual Fund

A mutual fund that charges a sales fee to shareholders annually.

Leverage

The use of debt capital in the hope of increasing the return on equity for shareholders.

Liabilities

The sum that a company or mutual fund owes its creditors.

Life Cycle Fund

A fund that invests its assets in other mutual funds that are built around a particular date, such as college education or retirement.

Limited Liability

Restriction of liability to the amount invested.

Liquid Assets

Current assets that can be converted quickly into cash.

Liquidity

The ease with which a company's assets can be converted into cash.

Listed Security

A security that has met the requirements for trading on one or more of the nation's stock exchanges.

Load

A sales charge or commission assessed by some mutual funds.

Load Mutual Fund

A mutual fund that assesses a sales charge or commission.

Long-Term Capital Gains or Losses

Realized gains or losses on securities held for more than one year.

Long-Term Debt

On the balance sheet, borrowed funds that are due for payment after one year, usually over several years.

Long-Term Liabilities

Obligations that fall due after one year, including long-term debt, deferred income taxes and deferred credits.

Low-Cost Investment Plan

A service from National Association of Investment Companies (NAIC) through which investors may purchase, for a minimal fee, the initial shares of stock necessary to enroll in a Dividend Reinvestment Plan (DRIP).

Low-Credit Quality

Securities issued by a government or corporation that may not repay interest or principal to bond investors.

Management Fee

The amount that a mutual fund pays to the management company or investment adviser. It is expressed as a percentage of a fund's assets.

Management Team

A number of managers that run a mutual fund, using a team management approach.

Market Capitalization

A measure of a company's size, based on its level of annual revenue.

Market Crash

An abrupt steep decline in a well-known market benchmark that affects many of the stocks in an exchange.

Market Expansion

Expanding the markets for a company's products by increasing sales in regions of the United States other than where the company is located, or even overseas.

Market Price

The price at which transactions in a security take place.

Market Sector

A particular area or portion of the stock market. Fund portfolios are analyzed by sector by both Value Line and Morningstar. Each fund-tracker divides the market into 10 nearly identical sectors.

Market Timing

A strategy used by an investor, fund manager or market speculator who hopes to buy low and sell high by darting in and out of the market.

Market Value

The sale price of an asset on the open market.

Maturities

The point in time when a bond issuer will return the money investors used to purchase a bond. Bonds are classified depending on their maturity as short, intermediate or long-term bonds.

Mid Cap

With market capitalization measured by a company's sales revenue, mid-cap companies are those with

market capitalization between \$500 million and \$5 billion.

Mid-Cap Mutual Fund

A mutual fund that has a portfolio primarily composed of mid-cap companies. According to Morningstar, a mid-cap fund has a portfolio with a weighted median market capitalization of between 80 percent to 95 percent of the 5,000 largest U.S. stocks. A mid-cap fund holds companies with a market capitalization between \$500 million and \$5 billion.

Minimum Purchase Amounts

The lowest investment a mutual fund requires for an investor to open an account.

Money Market Account

A type of mutual fund that invests in cash equivalents and whose net asset value is almost always \$1.

Money Market Fund

These funds invest in safe, highly liquid, short-term securities with maturities of 90 days or less. They pay interest on their investments to shareholders.

Money Market Instruments

Money market instruments are short-term securities with maturities of 90 days or less. These instruments are held by money market funds.

Morgan Stanley European, Australian & Far East Index (EAFE)

An index created and managed by Morgan Stanley Dean Whitter that is composed of companies in Europe, Australia and the Far East.

Morningstar

An investment education company that issues data reports on mutual funds. Morningstar reports are widely available in public libraries.

Mortgage

A loan to finance the purchase of real estate, one form of long-term debt on the balance sheet.

Mortgage-Backed Securities

A security that represents ownership of an interest in a group of mortgages.

Municipal Bond

A bond issued by a state, city local government or local governmental agency. The interest payable by these bonds is not subject to federal taxes. Some municipal bonds are free of state and local taxes as well.

Municipal Bond Fund

A bond fund that holds municipal bonds.

Mutual Fund

An open-end investment company that buys back or redeems its shares on command at their current net asset value.

Mutual Fund Company

These companies are structured as corporations or businesses trusts and supervised by a board of directors. Mutual fund companies generally outsource their various functions to investment advisers, distributors, custodians and transfer agents.

NASDAQ 100

An index of the largest and most actively traded non-financial companies listed in the NASDAQ National Market, heavily weighted toward technology and telecommunications companies.

New Fund

A mutual fund with no history, newly offered to the investing community.

Net Asset Value

The market value of a fund's assets, less any liabilities and fund expenses, divided by the number of shares outstanding.

Net Income Before Taxes (Pre-Tax Profit)

Earnings or income before taxes.

Net Income After Taxes (Profit or Earnings)

Profit or earnings after taxes.

Net Sales

Gross sales minus returns and allowances.

Net Working Capital

The difference between current assets and current liabilities.

Net Worth

All assets minus all liabilities of a corporation. Net worth is equivalent to stock, paid-in capital and retained earnings.

New York Stock Exchange

The largest auction market securities exchange in the nation.

No-Load Mutual Fund

A commission-free mutual fund.

Nominal Return

The actual rate of return not adjusted for inflation, contrasted with real returns.

Non-Investment-Grade Bond

A bond considered by a credit rating agency to be less likely to pay interest or repay principal to bond investors than an investment-grade bond. Standard & Poor's considers bonds rated BBB or below to be non-investment grade; Moody's considers bonds rated Baa or below to be non-investment grade.

Non-Operating Income and Expense

Income and expense of a corporation not connected with the principal business. Sale of property is an example of non-operating income; payment of interest to bondholders is an example of non-operating expense.

Notes Payable

A current liability on the balance sheet for money owed, usually to a bank by a company, as evidenced by promissory notes.

Online Broker

A broker that does business primarily on the Internet.

Open-End Fund

A fund that will redeem shares for cash or issue new shares.

Operating Expenses

Generally defined as selling, general and administrative expense.

Operating Profit

Gross profit minus operating expenses.

Options

Contracts that give the buyer the right, but not the obligation, to buy or sell a futures contract or a specified quantity of a commodity, security, currency or index at a specific price within a specified period of time, regardless of the current market price of the underlying item.

Ordinary Income Rate

The rate at which the federal government taxes a particular level of earned income.

Other (Non-Operating) Expense

Expense of a corporation not connected with the principal business. Payment of interest to bondholders is an example of non-operating expense.

Other (Non-Operating) Income

Income of a corporation not connected with the principal business. Sale of property is an example of non-operating income.

Outstanding Stock

Stock issued and in the hands of owners.

Overhead

Similar to fixed costs.

Over-the-Counter Market (OTC)

Marketplace for securities that, because the issuing companies cannot qualify or do not care to do so, are not listed on any securities exchange.

P/E Ratio

The price/earnings ratio (P/E) is determined by dividing a stock's market price by its earnings per share. For a mutual fund, the fund's average P/E ratio is the average P/E ratio of all the companies held in the portfolio. The P/E ratio is used to determine whether a stock represents value at a given price. The market generally accords higher P/E ratios to companies growing at higher-than-average rates.

Passive Investment Management

Management that relies on diversification to represent a broad-based market index, without using special strategies or information to attempt to achieve better results than the market index.

Performance

The total return of a mutual fund during a particular period of time.

Portfolio

All of the securities held by a mutual fund. Also used for all investments held by an individual investor.

Portfolio Earnings Growth Rate

A measure of the annualized earnings growth rate of a stock fund's portfolio over a certain period of time. Morningstar provides this for the most recent three years, while Value Line provides this figure for the most recent five years.

Portfolio Management

The maintenance, buying and selling decisions an investor makes regarding his or her investments.

Portfolio Manager

The individual or individuals responsible for the management of a mutual fund — that is, for the holding, buying and selling of securities in a fund portfolio.

Preferred Stock

An equity security that pays shareholders a dividend at a specified rate.

Pre-Tax Profit

Earnings or income before taxes.

Pre-Tax Profit Margin

Profit before taxes divided by sales.

Price Appreciation

The advance in price of a security.

Price/Earnings (P/E) Ratio

The market price of a security divided by the earnings per share. Used to determine whether a stock represents value at a given price. Higher than average P/E ratios mean that investors judge the stock will perform well in the future and are willing to pay a higher price than usual to own the stock. Stocks with a lower than average P/E ratio may represent a better value than usual if the stock's earnings and revenues still are strong.

Principal

The original sum of money invested as capital.

Privately Held

A company that is owned privately. Privately held companies do not issue stock on the stock exchanges, thus are not available as investing vehicles for individual or institutional investors.

Profit

The positive gain from an investment or business. Same as earnings or income.

Prospectus

A written document offering to sell securities, which provides information required by the Securities and Exchange Commission. The prospectus describes the fund's objectives, strategies, risks, fees and expenses. It also describes the fund's policies regarding buying, redeeming, reinvesting and exchanging fund shares.

Proxy

A document seeking shareholder approval for some fund action or activity.

Publicly Held

A company that has stock available for sale on a stock exchange. Individual and institutional investors can invest in publicly held corporations.

Quality

A rating given to bonds and stocks by a recognized rating service.

Quality Company (Stock)

A company that has had five to 10 years of consistent increases in sales and earnings, and also consistently has maintained superior pre-tax profit margins and earnings on invested capital.

Quarterly Report

A report issued by a mutual fund detailing a fund's performance, expenses and holdings during a particular three months. The quarterly report also

contains the fund manager's letter regarding the fund's performance during the past three months as well as overall economic conditions.

REIT (Real Estate Investment Trust)

A company that buys and manages real estate investments and whose shares sell on the stock market.

Real Return

The rate of return of an investment adjusted for inflation.

Redemption Fee

A fee charged by some funds for selling fund shares before a certain period of time.

Refunding

Replacing one bond issue with another of a lower rate when it is to the financial advantage of the corporation to do so.

Registrar

The agent, usually a bank or trust company, responsible for issuing and distributing shares of stocks and bonds.

Regular Trading Day

The markets are regularly open from 9:30 a.m. to 4 p.m., Monday through Friday (Eastern time), except for federal holidays.

Reinvest

To put back a sum of money into a particular investment that an investor has obtained, such as a stock or mutual fund dividend or capital gains distribution.

Researcher

A mutual fund adviser employee who researches companies for possible purchase.

Return

A measure of performance usually based on the profit per dollar invested.

Revenues (Sales)

Synonymous with sales and receipts.

Reverse Split

A decrease in a company's shares outstanding. Investors in the company end up with more stock, worth more per share, but their stock doesn't actually increase or decrease in value.

Reward

A satisfying return or result. A profit.

Risk

The possibility of suffering a financial loss on an investment.

Roth IRA

A tax-deferred individual retirement account in which an investor makes a taxable contribution and the money is not taxed when withdrawn after retirement.

Russell 2000

An index of small company stocks created and managed by Russell. Fund managers who manage small-cap mutual funds use the Russell 2000 index as a benchmark to measure their fund's performance.

Russell 3000

An index that measures the 3,000 most actively traded U.S. companies by market capitalization. It is a measure of total stock market performance. This index is a reflection of broad stock market performance and can be used as a benchmark for U.S. growth stock funds.

S&P 500 Index

A measure of the performance of 400 industrial stocks, 20 transportation stocks, 40 financial stocks and 40 public utilities in the United States, selected by a committee at Standard & Poor's. Commonly used as a performance benchmark by mutual funds.

Sales (Revenues)

The amount received by a company from the selling of its products and services.

Sales Charges

A load or commission assessed by some mutual funds.

Sales Commission

A fee paid by investors in return for financial advice. Brokers and financial planners receive a sales commission in return for selling their clients mutual funds.

Sales Growth

The rate of increase in a company's sales growth during the past four years.

Section 529 Plan

State-sponsored college savings plan.

Sector Fund

A fund that concentrates its portfolio on a specialized industry sector.

Securities

Stocks, bonds or other instruments that investors can own and trade on financial markets.

Securities and Exchange Commission (SEC)

The federal agency that regulates the securities business and protects the interests of the investing public.

Semi-Annual Report

A report issued by a mutual fund detailing a fund's performance, expenses and holdings during a particular six months. The semi-annual report also contains the fund manager's letter regarding the fund's performance during the six months as well as overall economic conditions.

Share Classes

Many fund companies offer funds in different share classes. These most often are funds with different types of loads, or funds with varying investment minimums.

Shareholder

Synonymous with stockholder or shareowner, the owner of one or more shares of a corporation or mutual fund. When you become a shareholder of a corporation or mutual fund, you own a portion of the companies in the fund's portfolio.

Shares Outstanding

The number of shares issued by a company available to the investing public.

Shareholder Report

A periodic report issued by a mutual fund company about a fund containing the fund manager's update, fund performance statistics and a list of portfolio holdings.

Short-Term Bonds

Bonds with maturity dates between one and four years according to fund tracker Morningstar, and less than three years according to Value Line. Short-term bonds and short-term bond funds are less subject to interest rate swings and are somewhat less volatile than long-term bonds and bond funds.

Short-Term Bond Fund

A fund that invests primarily in bonds with maturity dates between one and four years, as defined by Morningstar.

Short-Term Capital Gains or Losses

Realized gains or losses on securities held one year or less.

Short-Term Securities

Bonds that mature in three-and-a-half years or less.

Single State Municipal Bond Funds

Funds that have portfolios composed of municipal bonds issued by governments or governmental agencies within a single state.

Sliding Scale

A fee or charge that is reduced gradually depending on certain factors, such as time or income.

Small Cap

With market capitalization measured by a company's sales revenue, small-cap companies are those with market capitalization less than \$500 million.

Small-Cap Mutual Fund

A mutual fund that has a portfolio primarily composed of small-cap companies.

Socially Responsible Investor

An investor whose investment strategy includes choices based on social or political beliefs.

Spread

The difference between a security's bid and asked prices.

Stock (Common)

A unit of ownership of a public corporation.

Stock Dividend

Distribution of stock to shareholders as a dividend on shares held.

Stock Exchanges

A physical place or electronic platform where stocks are traded. Major U.S. exchanges include the New York Stock Exchange, NASDAQ and the American Stock Exchange.

Stock Fund

A mutual fund that has a portfolio primarily composed of stock. Also known as an equity fund.

Stock Index Futures

An agreement from an investor to buy or sell a set amount of a stock index at a certain price by a certain date.

Stock Split

An increase or decrease in a company's outstanding shares. In a traditional split, a company increases its shares outstanding and the value of its stock is reduced accordingly. In a reverse split, the shares outstanding are reduced, increasing the value of the stock.

Stockholder

Synonymous with shareholder, the owner of one or more shares of a corporation.

Street Name

Refers to securities held in the name of the broker rather than the customer.

Sub-Adviser

A management company hired by a fund's investment adviser to manage a fund.

Sub-Adviser Fees

The fee charged by the investment sub-adviser for managing a fund's investments.

Sub-Sector Fund

A fund that specializes in a sub-category of a particular market sector. For example, a telecommunications fund is a technology sub-sector fund.

Systematic Withdrawal Plans

Programs offered by some mutual funds that allow shareholders to receive regular payments from their investments.

Tax-Adjusted Return

A fund's annualized after-tax total return for a certain time period.

Tax Deferred

A characteristic of certain investment accounts that allows contributions and earnings to be made and accumulate tax free.

Tax-Deferred Retirement Plans

Plans that allow contributions and earnings to be made and accumulate tax-free.

Tax Efficiency

A measure of a mutual fund's history in regard to fund distributions.

Tax Exempt

Securities exempt from federal, state or local taxes.

Tax Liability

Taxes owed by an individual or corporation to local, state or federal governments.

Taxable Account

Money held in such an account is subject to taxation by local, state and/or federal governments.

Taxable Bond Fund

A bond fund that invests in taxable bonds.

Thin Market

A market in which there are few offers to buy or sell a security, characteristic of stocks with a small number of shares outstanding.

Term Life Insurance

Life insurance protection that lasts a limited number of years and expires without value if the insured survives the stated period.

Total Assets

The total of the entire fund's shares at the end of the most recently reported month.

Total Return

The performance of an investment, including dividends, interest, capital gains distributions and changes in net asset value. The total return is the change in value of an investment during a given period of time.

Trader

An individual who does a good deal of buying and selling in the hope of realizing short-term profits.

Traditional IRA

A tax-deferred individual retirement account in which an investor makes a tax-deductible contribution and the money is taxed when withdrawn after retirement.

Treasury Bill

A U.S. government obligation that matures within a year of issuance.

Treasury Bond

A U.S. government obligation that matures more than five years from the date of issuance.

Treasury Note

A U.S. government obligation that matures from one to five years from the date of issuance.

Turnover

The volume of trading in a particular security or in the market as a whole.

Turnover Rate

A rough measure of how much buying and selling a fund manager does in a mutual fund portfolio.

12b-1 Fee

An annual charge deducted from a shareholder's assets to pay for a fund's distribution and marketing costs.

U.S. Bond Funds

Bond funds that invest their assets in bonds issued in the United States.

U.S. Stock Funds

Stock funds that invest their assets in U.S. companies.

Unrealized Gain or Loss

A gain or loss not transacted yet (i.e., a "paper gain" or "paper loss").

Value Line

An investment education company that issues mutual fund reports and provides electronic fund information.

Value Manager

A mutual fund manager whose investment strategy is to buy shares of companies with earnings growth potential that are selling at a discount.

Value Style of Investing

Managers who follow this style buy companies that appear to be undervalued based on such defined measurements as the P/E ratio or price-to-book ratio.

Volatility

A measurement of the change in price of a security over a given period.

Wilshire 4500

An index of mid- and small-cap companies, which contains all publicly traded companies except those in the S&P 500.

Wilshire 5000

A value-weighted index of the most active stocks in the U.S. market. This index is a performance measure of total U.S. stock market activity.

Yield

The per-share cash dividend divided by the per-share market price of a stock or fund. Also called dividend yield.