PART I

INTRODUCING THE *BUCKETS*

CHAPTER 1

Everybody's Got an Investment Idea—But Is It a *Good* Idea?

If there's anything we've got plenty of in our Information Age, it's advice about how to make a bundle. Money gurus promise wealth without risk. Financial magazines trumpet the latest trends. The Internet virtually bristles with offers. Our neighbors or co-workers eagerly share their astounding stock market secrets. The daily mail overflows with wealth-building tips.

As a result, many of us are surrounded by opportunities, flooded with information—*much of it wrong*—and are often totally confused about how to build a nest egg so we can enjoy a decent retirement. Actually, what most people want to know is simply:

- How can I retire in reasonable comfort?
- How can I know my retirement funds will keep pace with inflation and taxes?

- How can I protect myself from the short-term swings in the stock and bond markets?

Those are increasingly urgent questions for an astounding number of people. Here's a startling statistic: The number of Americans 65 and older will grow almost five times faster over the next 40 years than those in the 20-to-64 age group. What that means is that tens of millions of workers—far more than in any other era in our history—will soon reach the end of their working lives. So "How can I retire successfully?" is a question that's quickly moving to the top of the agenda for many of us.

The answer needn't be complicated. But like all things worth doing, becoming investment savvy requires some study and some perseverance. I'm going to try to cut through the fog. I'm going to talk straight about why and how you should be thinking about your money and your future.

I'm not out to prove I'm smarter than you are or that I have all the answers. In fact, I know I don't have all the answers, and I may not be smarter. But I'm smart enough to know you shouldn't need a fancy financial vocabulary or a degree in finance to do some common-sense planning for your future.

My Bias

Right up front, here's my bias: *I like facts.* I like proven principles, not just accepted wisdom or broad generalizations. I agree with Oliver Wendell Holmes, who once said, "I never heard a generalization worth a damn, including this one." So I'm going to emphasize what is provable and scientific and show you the fallacy of so much of what is generally believed. I'm going to tell you, based on more than a quarter-century of helping people with their money, what really works and what doesn't. Further, I'm going to promulgate *Lucia's Laws*—many of which may be the direct opposite of the investment axioms you've heard for years. And with any kind of luck, you will not only learn some things but also have a few grins along the way.

Why All the Concern about Retirement, Anyway?

Americans are living longer, a lot longer. A century ago, life expectancy was 47.3 years. Now it's 76.5 years on average, and in a few decades it will be 82.6. Millions upon millions—quite possibly you among them—will live to be more than 100. (The future Willard Scotts will be very, very busy.) In fact, already the number of people 65 or older has grown by 56 percent since the 1970s. For the first time in history, there are more seniors than teenagers!

Meanwhile, workers are retiring earlier, voluntarily or otherwise. Although your parents and grandparents may have died on the job or within a few years after retiring, many of your generation will live 20, 25, or 30 years after quitting work. All this is good news for those of us in our middle or later years, right? Sure—*if* you plan for it. But consider:

- There's enormous uncertainty about life spans. One study showed that even if you toss out extreme cases—where both spouses died quickly or lived to be very old—among those who remain, the second spouse to die might live to be 83 or last to age 97. If you're in that big middle group, you may need to fund an 18-year retirement, *or* one that lasts 32 years. That's an enormous range.
- Seventy percent of all couples 65 or older will have one or the other spouse in a nursing home. The average stay in a nursing home is 2.7 years at approximately $52,000 a year, or about

$140,000, almost none of which is covered by Medicare. And the costs are accelerating at a rate that far exceeds inflation.

- Despite these demographics, the median savings among adults in their late fifties—just the age when we start thinking seriously about retirement—are less than $10,000.

Even if you're lucky enough to stay out of a nursing home and avoid a big nonreimbursable medical expense, living longer is likely to erode your resources as inflation eats up more and more of your savings. Although you may plan to leave money to your kids or favorite charity, you might end up needing every penny saved—and then some.

I'm not trying to scare you with these statistics. But I am trying to make you aware that the reality of retirement is that—unless you plan ahead and act on those plans—you can very easily run out of money before you run out of years. And that's not so good. It's not good for you, for your children, or for society. And what's more, it's in many cases a preventable problem. That's what this book is all about: helping you become self-sufficient in retirement. Which leads us to . . .

LUCIA'S LAW 1

The government isn't going to take care of you.

I'm sorry. I wish it were otherwise. But even if its much-discussed problem of too many beneficiaries being supported by too few workers is fixed, Social Security just isn't going to be enough. Social Security was intended to be a financial side dish, not the main course. Don't assume you're going to be pleased with what's on your plate if Uncle Sam is the only cook you're counting on.

Meanwhile, the number of active workers covered by company pensions is fast declining. The reasons are numerous. Employees now are less likely to stay at one firm for a long time. Pension plans are costly to run. Pensions at some firms have taken a back seat to stock options and other benefits. Thus . . .

LUCIA'S LAW 2

Don't count on your employer to take care of you, either.

Company pensions are being dismantled in favor of plans like the 401(k), the 403(b), Simple IRAs, and others that shift the burden of saving and investing from employers to employees. These plans can be confusing. But they also give the retiree lots of opportunities.

So the bad news is that it's up to you to make plans. But the good news is that for most people, that's doable. With a bit of smarts and some time, we ought to be able to do this. And we *can.*

The Twin Demons—Inflation and Taxes

In addition to greater longevity, inflation and taxes are two other factors to keep in mind as you begin to think about your retirement nest egg. You're probably old enough to remember the late 1970s and early 1980s—leisure suits, *Mork and Mindy,* and double-digit inflation. Rates on CDs (certificates of deposit) got up to 15 percent or more. A great time to be an investor, right? *Wrong*. Returns after taxes and inflation often were in negative territory, meaning that although you received higher interest payments, your purchasing power—your "real" rate of return—actually declined. (Figuring your real rate of return is easy. Take the yield on your fixed investment, subtract the percentage you'll pay in taxes, and then subtract the rate of inflation.) When interest rates were 15 percent, inflation was also in double digits. And the real rate of return on fixed investments was under water.

Compared to then, inflation right now is relatively tame. Still, inflation is always present and over time will rob you. Even with inflation at 3 percent, the purchasing power of a dollar is cut in half in a little more than 23 years. That means in two decades you'll need twice as much money to buy what you do now.

Similarly, taxes can take away much of what you make. So we need to think about tax-managing our money. One example I often use in my seminars illustrates the effect of such taxes. Let's say Christopher Columbus, when he sailed across the ocean blue in 1492, put $1 in a savings and loan and let it earn interest. What do you think that'd be worth today?

Well, 500 years is a long time (longer than *my* investment horizon). But at simple interest, Chris would now have amassed only $26—that's $25 in simple interest, plus his original investment of one buck. Aha, you say, what if the interest were compounded? If the interest was compounded but earnings were taxed annually, Columbus would now have $6.9 million. Interest on interest is a *beautiful* thing!

But here's the kicker: If the interest was compounded but the taxes were deferred, the good captain would now have $39 *billion*, with a "*B*." So you see just how important compounding in a tax-controlled environment can be. Keep that in mind. We'll come back to that.

And Your Point Is . . . ?

My point is that in any investment strategy you choose, you not only want to make your money grow, you also need to take inflation and taxes into account. Which leads to . . .

LUCIA'S LAW 3

It's not what you make . . . but what you* keep *that counts.

It's that "real" rate of return that will be so important. By real rate, I mean your after-tax, after-inflation rate of return.

What You've Heard about Stocks Is True, Sort of

For years now you've probably heard that the stock market is the place to be. Its growth averages more than 10 percent a year. Can any CD or money market fund match that? No, it can't. With savings accounts paying 2 percent or 3 percent, stocks look pretty good. Yes, indeed.

Further, you've doubtless heard that some people—maybe those you know at work or on the golf course—hit it big with Qualcomm, AmericaOnline, or Somethingorother.dot-com—and made an incredible bundle. Possible? Yes.

In fact, I believe I can safely say . . .

LUCIA'S LAW 4

If you don't invest in stocks, you won't be financially prepared for retirement.

Figure 1.1 shows the return from stocks, bonds, and cash before and after inflation. Stocks, as you can see, have a decided edge in terms of real return. So if that's the case, why not just put your money in the stock market, sit back in your chaise lounge, and

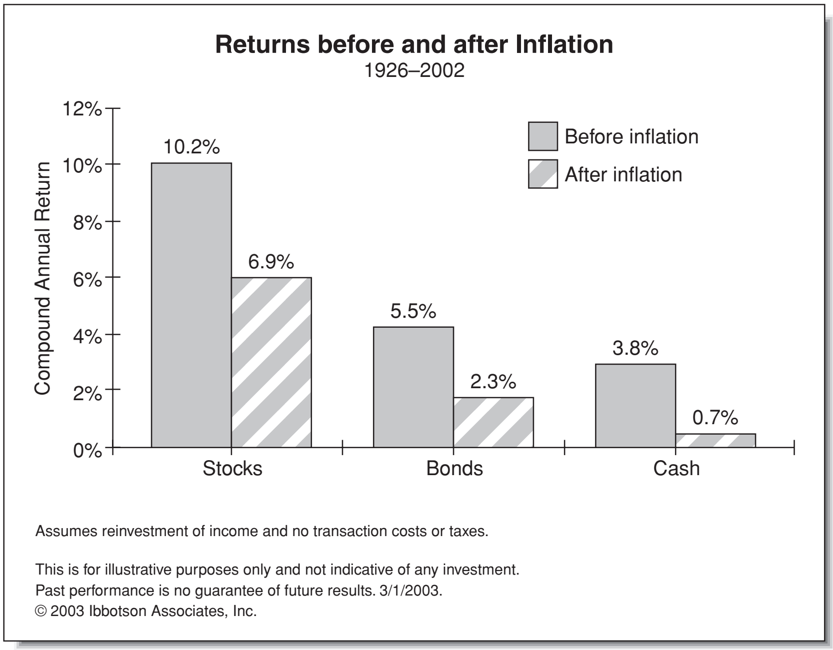

Figure 1.1

reflect on your soon-to-be luxury yacht and million-dollar villa? Well, it's not that simple, and Figure 1.2 shows why.

Figure 1.2 is my EKG. No, just joking! Actually Figure 1.2 shows the *wide* fluctuations in the Standard & Poor's (S&P) 500 index over the years (. . . but my EKG probably does look like that during periods of market turbulence). The stock market is a real roller coaster because, for starters, there are some 20,000 stocks, and they're not all winners—and even the winners don't win year in, year out. And the overall market doesn't perform consistently. That 10 percent-plus average growth figure you've heard about is just that—an *average*. It may be up 30 percent one year and down 20 percent the next. (Be wary of averages. The average American family, for example, consists of 2.6 persons—but how many have you seen like that?)

No doubt about it, stocks are risky—at least in the short term. In fact, stockbrokers and mutual fund managers are so fond of one phrase that they put it in almost all their literature: "Past performance is not necessarily an indicator of future results." That means, "We don't have any idea what's going to happen." And it's true, they don't. *No one* does.

So that unpredictability is a problem for those who are trying to plan for retirement. Because what do you want when you retire? You want to be able to count on a certain level of income, right? Sure. You also want that income to grow to cover inflation. If stocks and the equity markets are the places to be, but stock prices bounce every which way, how are you going to get that kind of certainty? Good question. I'm glad you asked that. Because that's what this book is all about.

However, before we get into the details of the *Buckets of Money* principle, let's look at why the usual methods of investing in the stock market don't work. You may recognize some of these money-making methods, maybe even some that you're so fond of that you use them yourself. But keep an open mind, and I predict

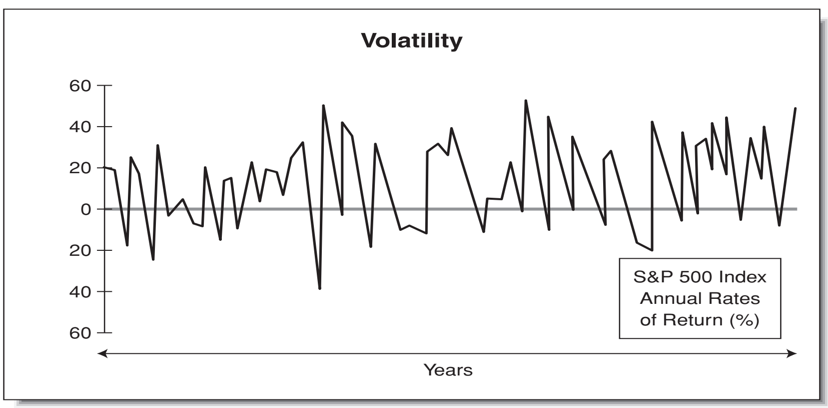

Figure 1.2

that as you see the shortcomings of these other efforts, the logic of *Buckets of Money* will become clear.

Ideas That Sound Good—but Aren't Good and Sound

Time the Market

Yes, the market jumps around a lot. We all know this. So what do we do? Well, if we can anticipate those jumps and sell just before it goes down and buy just before it goes up, we'll be golden, right? Yes, we would be golden, indeed.

But here's the rub: *Nobody is smart enough to do that.* The market is affected by all sorts of factors, here and abroad: interest rates, government policies, consumer confidence, bad news, good news, currency fluctuations, the ups and downs of earnings, and even the health of heads of state. Not me, not you, not Warren Buffett, not Bill Gates, not Peter Lynch knows what's going to happen tomorrow or even five years from tomorrow.

In fact, speaking of Lynch, I once interviewed him. I asked this fabled money manager at Fidelity Investments what he thought was ahead for the stock market. "We'll see," he said. I asked him the same question about the bond market. "We'll see," he repeated. I asked him about interest rates, and he said, "If I could predict the direction of interest rates three times in a row, I'd be a billionaire." This was Peter Lynch, the most successful and admired money manager of his generation and one of my heroes, and he doesn't know. If *he* doesn't, neither do you or I.

In about 20 of the last 70 calendar years, stocks have lost money. In truth, when the market makes big gains, it often does so in leaps within a few days' time. So if you're not fully invested, it's easy to miss a major move.

In short, you can't predict a good day. As Figure 1.3 shows, $1 invested in the S&P 500 for 20 years (1982–2002) would have grown to $10.94. But miss just the 16 best months (out of 240) in that 20 years, and you end up with only $2.79. The moral is that *It's better to stay invested in a broad array of good stocks or good mutual funds.* But most people don't. They get impatient. They see that some other fund or stock is going gangbusters, and they can't help but chase the front runners. They get a hold of that 1-800-SWITCHMYFUND number and use it all the time to jump on this fund or drop that one—and end up shooting their portfolio in the foot. As you probably have figured out by now, I'm not the biggest fan of market timing.

That's because it *can't* be done. I'm certain of it, and many studies bear this out. And if timing really worked, everybody in the know would do it. Then it would be a self-defeating exercise

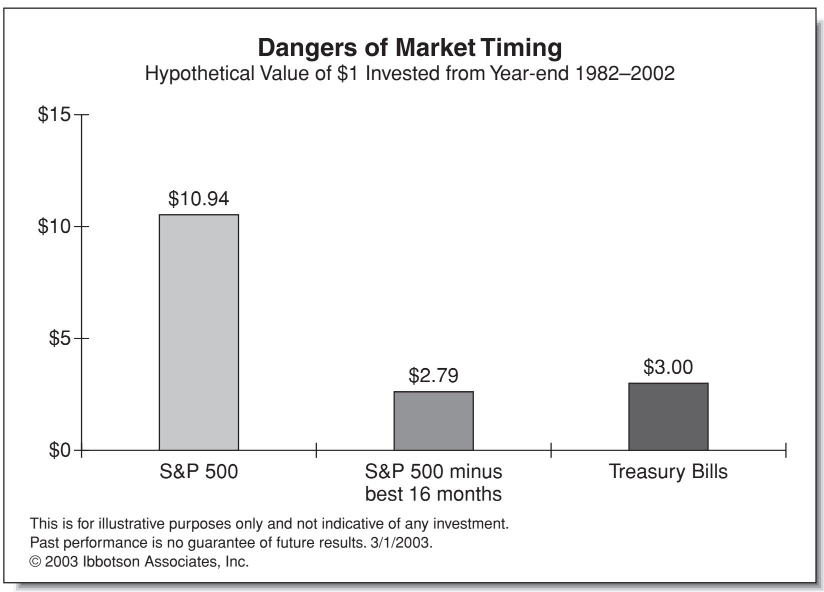

Figure 1.3

anyway. The truth is, stock prices move—up or down—so rapidly and sometimes so utterly without warning than even if you were able to get out of the market before it took a tumble, you wouldn't know when to get back in. Thus, you'd likely end up worse off than if you'd never gotten out.

Which is exactly what happens to market timers and which bring us to . . .

LUCIA'S LAW 5

Too much trading can be hazardous to your wealth.

As I say, you can't predict a good day. And if you pick a bad day to get in or out of the market, you may be paying for it for a long time. Figure 1.4 shows the results of a five-year study in which the more investors traded, the less well they did.

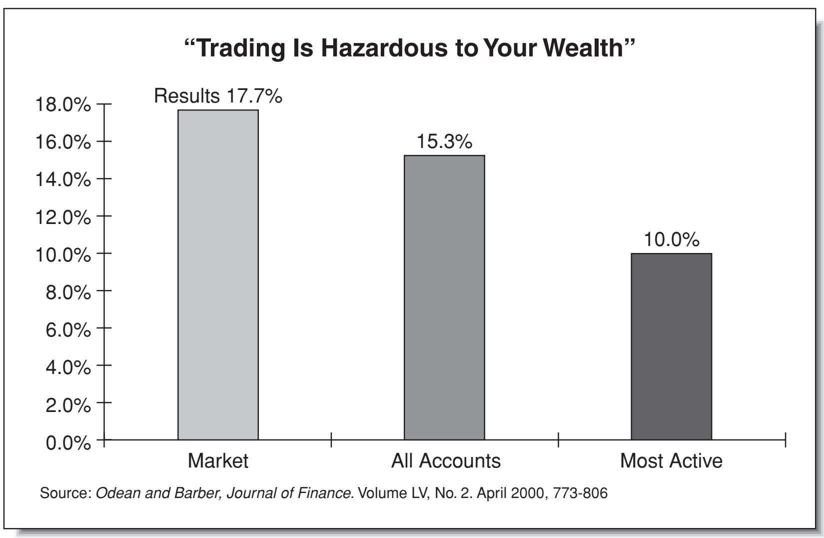

Figure 1.4

Follow the Leader

Another tactic that leads investors astray is following the latest financial Pied Piper. Millions of people scan the ratings of mutual fund managers, for example, to find those whose funds performed best the previous year. But rarely is "Past performance is not necessarily an indicator of future results" more true than here.

After all, whom would you choose: the manager who made the most money in the 1987 crash, or the one who lost more than average in 1987? Well, according to the *Hulbert Financial Digest,* in the five years following the 1987 crash, the managers who did best in the crash made 1.4 percent while the crash losers earned an average of 5.1 percent. (Why are we even buying all these magazines that purport to tell us who the best fund managers are? Beats me. Maybe we should be looking for lists of the *worst* managers!)

In fact, *Hulbert* reports, for the decade ending in 1992, if you jumped each year to the best fund manager of the past 12 months, you'd have gained 51.2 percent over 10 years. But if you had begun each year investing with the *worst* manager of the previous 12 months, your account would have gone up 220 percent over the same period! Even so, both would have earned less than the S&P 500 Index, which climbed 308 percent during that time.

Thus, I conclude . . .

LUCIA'S LAW 6

Trying to pick the best mutual fund is an exercise in futility.

A whole financial magazine industry has sprouted up around the idea of trying to get you into the hottest of the 10,000 or so mutual funds. But, according to one study, the reality is this: If you pick a manager or a fund that finished in the bottom fourth of all funds, you have a 50 percent chance of finishing above the median five years later. And if you pick a top-quartile manager or fund, you have a 48 percent chance of finishing above that same median. So, in short, it seems to me that whether you pick the top fund or the worst, your chances of doing well over time are about the same.

The predictive abilities of the magazines and newsletters don't amount to much over the long term. Even the much-vaunted Morningstar ratings service, while great for the information it provides, hasn't been flawless when predicting future winners. Don't get me wrong—I believe Morningstar has tremendous resources, and I use those resources every day. But Morningstar, you, and I are not clairvoyant. All fund ratings are based on what happened yesterday, but no one knows what will happen tomorrow. My advice: Pick what seems to be a mix of good but diverse funds and stick with them.

As for those self-proclaimed investment gurus who flood you with junk mail or claim on TV to have a lock on future riches, they're doing little more than reading tea leaves. Ask yourself: If their strategy is *so* great, wouldn't they be so really, really rich that they wouldn't need to appear on infomercials selling some get-rich-quick scheme? You bet.

Be American, Buy Only American

Another strategy people bandy about is to stay away from foreign stocks. Overseas companies are less safe, these investors say. I say, "Nuts to that." Yes, our economy has often done well in recent decades. But don't make the mistake of believing that the international markets have nothing to offer. Figure 1.5 shows that

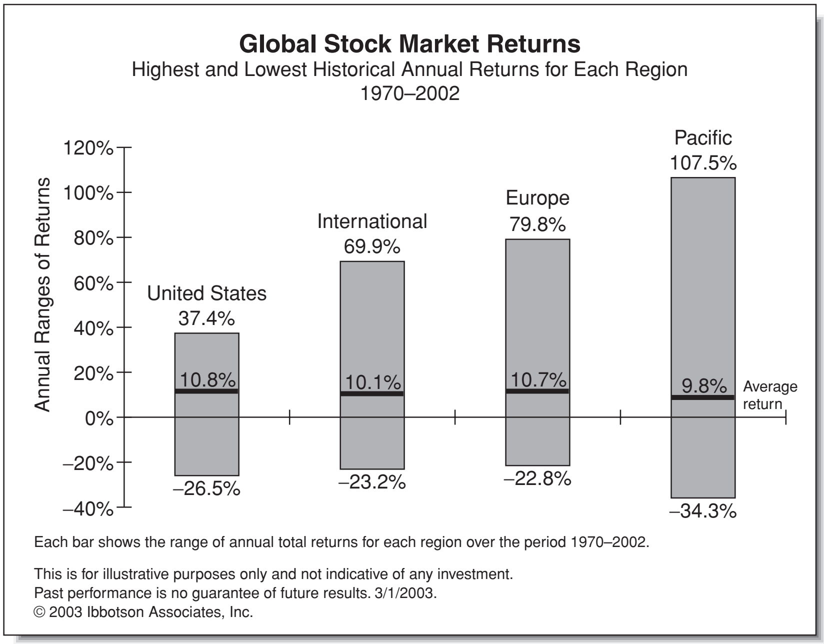

Figure 1.5

while the American stock market did well over the past 32 years, it wasn't the best-performing market.

Two decades ago, as author Ric Edelman points outs in *The Truth About Money*, America accounted for almost 50 percent of the world's total stock market capitalization. Today, it represents 43 percent. Does that mean we're in decline? Actually, it just means that we're a smaller piece of a very rapidly growing pie. And that's why you need to have at least some of your money in international stocks.

While I usually recommend an allocation of 10 percent to 20 percent, Figure 1.6 shows how you can put as much as 40 percent of your portfolio in foreign equities and have no more risk—and a *much* higher potential return—than if you were totally invested

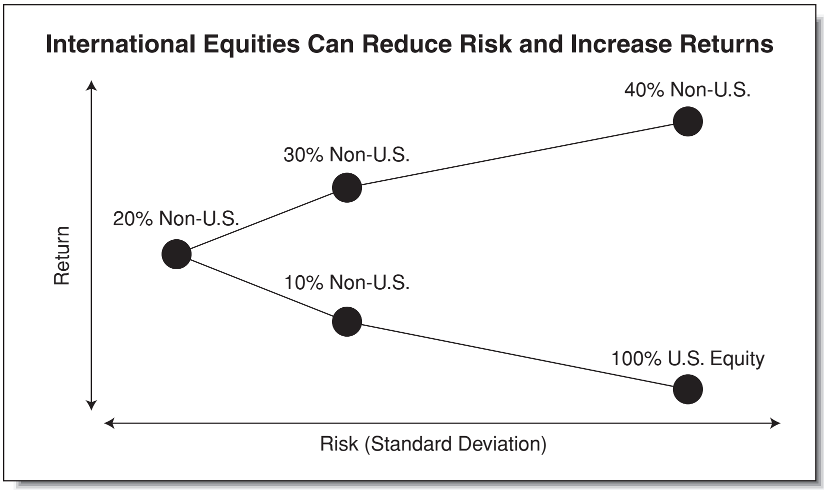

Figure 1.6

in U.S. stocks. Thus, if you don't invest overseas, you may miss out on the often stellar performance of international stocks.

Stick with One Investing Style

Others advocate using just one style of investing. Value investors, for example, look for bargain stocks that have been beaten down and are due for a rise; they buy low in hopes of later selling high. Growth investors, on the other hand, like more expensive, high-flying companies; they buy high in hopes of selling even higher. Still others prefer to concentrate on certain sectors, such as only large companies, or only small companies, or just those in the energy field or the retail field or the electronics field . . . or *something*. But none of those schemes work consistently.

And just because you're invested in a mutual fund rather than an individual stock doesn't mean you're diversified. Some stock funds are so specialized that they are almost as risky as owning a single firm's stock. (What's more, even a stock fund's name can be misleading. The manager of a large growth fund may load up on small-capitalization stocks when they're hot. It pays to read the prospectus and annual report.)

The truth is, all styles of investing are cyclical and fraught with peril. Figure 1.7, for example, shows how the results of investing by styles defy predictability. Figure 1.8 illustrates how the return of different investment classes varies markedly from year to year.

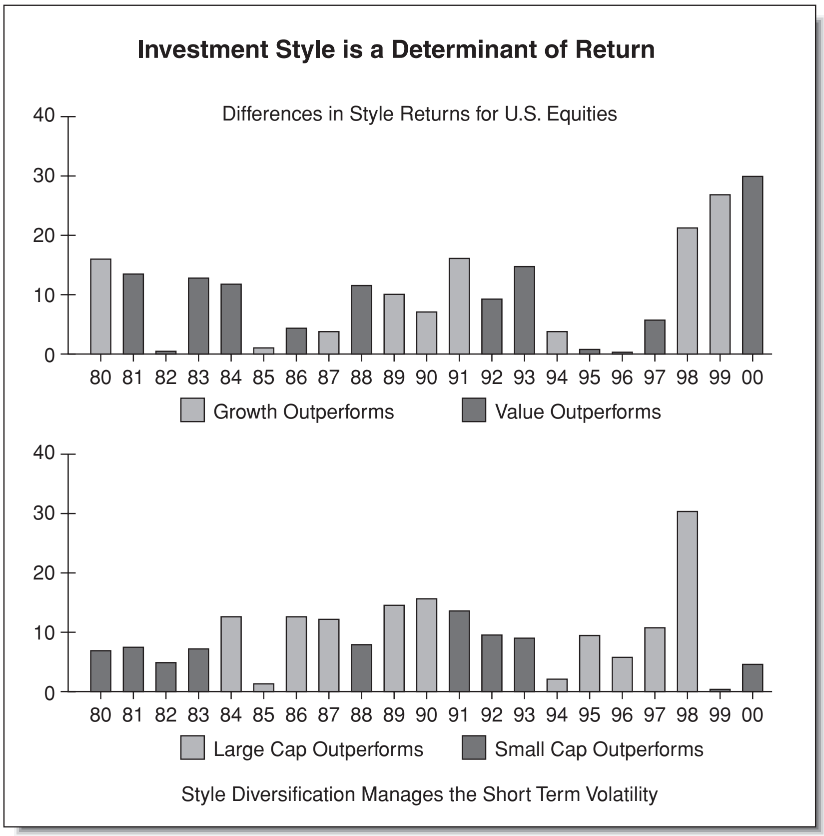

Figure 1.7

Relative Performance of Market Sectors

1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
FOREIGN STOCK	FOREIGN STOCK	FOREIGN STOCK	SMALL CAP Value	LARGE CAP Growth	BONDS	SMALL CAP Growth	SMALL CAP Value	FOREIGN STOCK	FOREIGN STOCK	LARGE CAP Growth	LARGE CAP Growth	LARGE CAP Growth	LARGE CAP Growth	SMALL CAP Growth	SMALL CAP Value
LARGE CAP Growth	LARGE CAP VALUE	LARGE CAP Growth	FOREIGN STOCK	LARGE CAP VALUE	LARGE CAP Growth	SMALL CAP Value	LARGE CAP VALUE	SMALL CAP Value	LARGE CAP Growth	LARGE CAP VALUE	LARGE CAP VALUE	SMALL CAP Value	FOREIGN STOCK	LARGE CAP Growth	BONDS
SMALL CAP Value	BONDS	LARGE CAP VALUE	LARGE CAP VALUE	SMALL CAP Growth	LARGE CAP VALUE	LARGE CAP Growth	SMALL CAP Growth	LARGE CAP VALUE	LARGE CAP VALUE	SMALL CAP Growth	SMALL CAP Value	LARGE CAP VALUE	LARGE CAP VALUE	FOREIGN STOCK	LARGE CAP VALUE
SMALL CAP Growth	LARGE CAP Growth	BONDS	SMALL CAP Growth	BONDS	SMALL CAP Growth	LARGE CAP VALUE	BONDS	SMALL CAP Growth	SMALL CAP Value	SMALL CAP Value	SMALL CAP Growth	SMALL CAP Growth	BONDS	LARGE CAP VALUE	SMALL CAP Growth
LARGE CAP VALUE	SMALL CAP Value	SMALL CAP Value	LARGE CAP Growth	SMALL CAP Value	SMALL CAP Value	BONDS	LARGE CAP Growth	BONDS	SMALL CAP Growth	BONDS	FOREIGN STOCK	BONDS	SMALL CAP Growth	BONDS	FOREIGN STOCK
BONDS	SMALL CAP Growth	SMALL CAP Growth	BONDS	FOREIGN STOCK	FOREIGN STOCK	FOREIGN STOCK	FOREIGN STOCK	LARGE CAP Growth	BONDS	FOREIGN STOCK	BONDS	FOREIGN STOCK	SMALL CAP Value	SMALL CAP Value	LARGE CAP Growth

Figure 1.8

The Moral of the Story

Just as we've seen all along, nobody is smart enough to know what's going to be in favor or out of favor in five years or so. Still, folks make wrong, short-term decisions all the time and for the wrong reasons. They buy high when a stock or mutual fund is said to be "hot." And then they sell in a panic when, inevitably, it dips.

Ric Edelman puts it so succinctly: "Stocks are not the problem—you are the problem, because you let your emotions get in the way."

Edelman and I and every other capable financial planner say you must invest in stocks if you're going to keep ahead of inflation. But by now you're probably asking: "If, as you say, I need to be in the market but I can't begin to time its ups and downs, and can't consistently pick the best stocks or funds, and can't count on the best managers, and can't rely on a certain style of investing, how can I financially prepare for retirement?"

The answer: Buy quality, well-diversified investments, and then have a plan that gives you the means as well as the discipline and/or courage to hold them for years. That's also—*surprise!*—the gist of the *Buckets of Money* principle. But before we jump right into *Buckets*, let's look more closely at the important question of what we mean by "diversified."