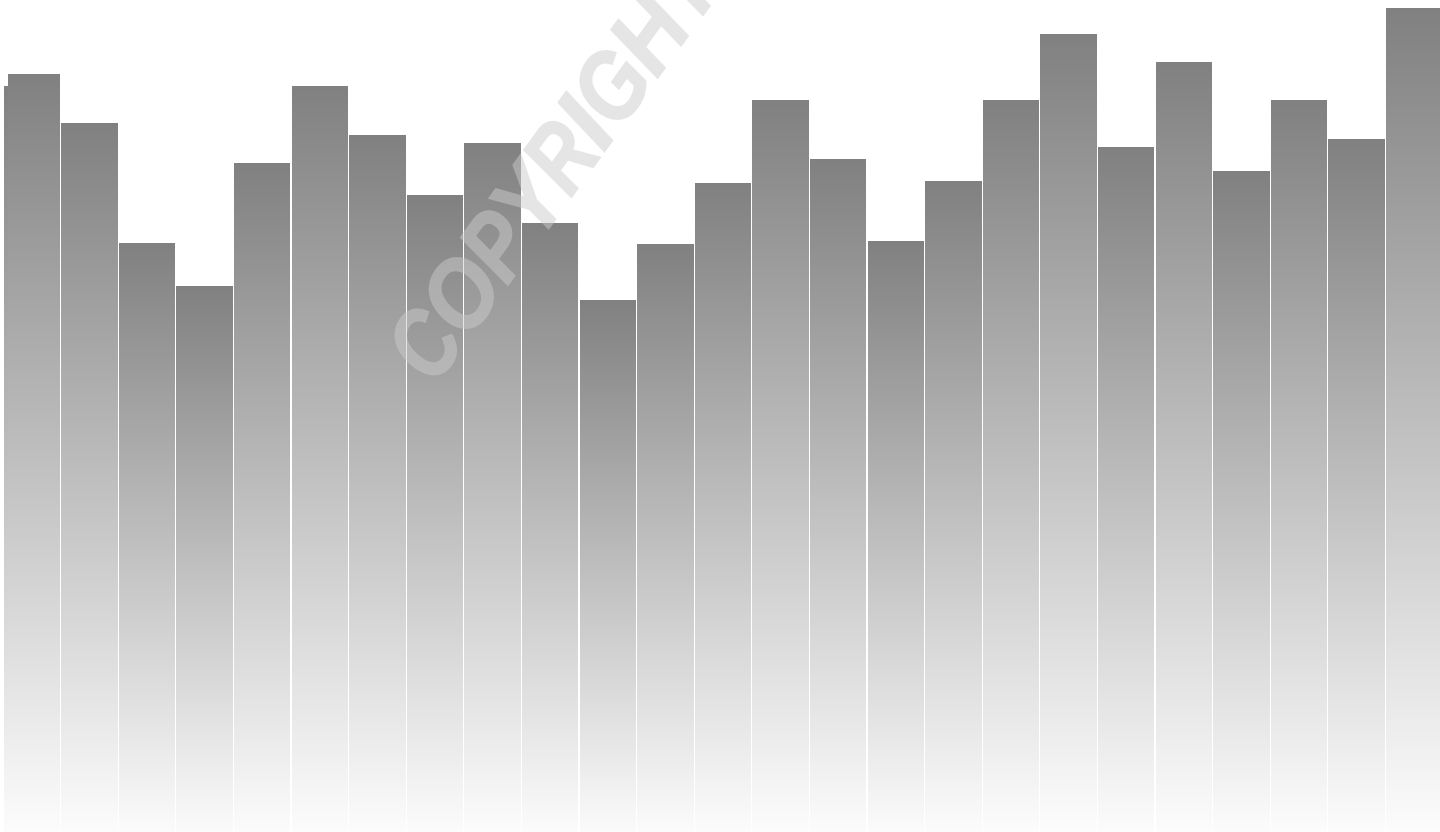


Why You Should Invest in Stocks

"Some regard private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful see it for what it really is—the strong horse that pulls the whole cart."—Winston Churchill

We all have financial goals in life: to pay for college for our children, to be able to retire by a reasonable age, to buy the things we want. Unfortunately, spending less than we earn is typically not enough for us to reach our goals. We have to do more; we have to invest our savings and put our money to work. Stocks are quite simply one of the best ways to make your investment dollars work the hardest.

Investing in stocks is not rocket science. The only real characteristics shared among successful stock investors are basic math skills, a critical eye, patience, and discipline. Combine these with an understanding of how money flows and how businesses compete with one another, along with a dash of accounting knowledge, and you have all the mental tools needed to get started. We will teach you all these in this workbook series.

Although you don't need an advanced college degree to invest in stocks, selecting stocks is nevertheless an intellectual exercise. It requires effort, but it can bear many fruits. After all, investing in stocks not only leads to potentially higher returns on your investment dollars, it also leads to a greater understanding of how the world works.

What Is a Stock?

Perhaps the most common misperception among new investors is that stocks are simply pieces of paper to be traded. This is simply not the case. In stock investing, trading is a means, not an end.

Lesson 101: Stocks Versus Other Investments

A stock is an ownership interest in a company. A business is started by a person or small group of people who put their money in. How much of the business each founder owns is a function of how much money each invested. At this point, the company is considered "private." Once a business reaches a certain size, the company may decide to "go public" and sell a chunk of itself to the investing public. This is how stocks are created.

When you buy a stock, you become a business owner. Period. Over the long term, the value of that ownership stake will rise and fall according to the success of the underlying business. The better the business does, the more your ownership stake will be worth.

Picking Stocks

If stocks are ownership interests in businesses, selecting which stocks to own is really an exercise in picking which businesses you want to own.

Why Invest in Stocks?

Stocks are but one of many possible ways to invest your hard-earned money. Why choose stocks instead of other options, such as bonds, rare coins, or antique sports cars? Quite simply, the reason that savvy investors invest in stocks is that they provide the highest potential returns. And over the long term, no other type of investment tends to perform better. (Lesson 103 will talk all about the historical returns of stocks.)

On the downside, stocks tend to be the most volatile investments. This means that the value of stocks can drop in the short term. Sometimes stock prices may fall for a protracted period. For instance, those who put all their savings in stocks in early 2000 are probably still underwater today. Bad luck or bad timing can easily sink your returns, but you can minimize this by taking a long-term investing approach.

Picking Stocks

There's also no guarantee you will actually realize any sort of positive return. If you have the misfortune of consistently picking stocks that decline in value, you can lose money, even over the long term!

Of course, we think that by educating yourself and using the knowledge in this workbook series, you can make the risk acceptable relative to your expected reward. We will help you pick the right businesses to own and help you spot the ones to avoid. Again, this effort is well worth it, because over the long haul, your money can work harder for you in equities than in just about any other investment.

Your Investment Choices

Let's see how stocks stack up to some of your other investment options:

Mutual Funds. Stock mutual funds can offer similar returns to investing in stocks on your own, but without all the extra work. When you invest in a fund, your money is pooled with that of other investors, and then it is managed by a group of professionals who try to earn a return by selecting stocks for the pool. (Shameless plug: We at Morningstar have a whole separate set of investing workbooks dedicated to mutual fund investing and finding the best funds.)

Beyond requiring much less effort, one key advantage of funds is that they can be less volatile. Simple statistics says that a portfolio is going to experience less volatility than the individual components of the portfolio. After all, individual stocks can and sometimes do go to zero, but if a mutual fund held 50 stocks, it would be very unlikely that all 50 of those stocks become worthless.

The flipside of this reduced volatility is that fund returns can be muted relative to individual stocks. In investing, risk and return are intimately correlated—reduce one, and odds are you will reduce the other. Another disadvantage to offloading all the effort of picking individual stocks is that

you must pay someone else for this service. The professionals running mutual funds do not do so for free. They charge fees, and fees eat into returns.

Plus, the more money you have invested in mutual funds, the larger the absolute value of fees you will pay every year. For instance, paying 1% a year in fees on a $1,000 portfolio is not a big deal, but it's a much larger deal if the portfolio is worth $500,000. In the past, mutual funds often made the most sense for those with relatively small amounts to invest because they were the most cost-efficient. But with the advent of $10 (or less) per-trade commissions on stocks, this is no longer necessarily the case.

Just as picking the wrong stock is a risk, so is picking the wrong fund. What if the group of people you selected to manage your investment does not perform well? Just like stocks, there is no guarantee of a return in mutual funds.

It's also worth noting that investing in a mix of mutual funds and stocks can be a perfectly prudent strategy. Stocks versus funds (or any other investment vehicle) need not be an either/or proposition.

Pros and Cons of Stock Investing

Pros	Potentially higher long-term returns.	**Cons**	Greater volatility.
	Full control of portfolio mix. You choose what you want to own.		Price to entry: the learning curve.
	Greater tax control.		Lots of ongoing work. (No pain, no gain.)
	If done right, lower trading costs & fees.		

Bonds. At their most basic, bonds are loans. When you buy a bond, you become a lender to an institution, and that institution pays you interest. As long as the institution does not go bankrupt, it will also pay back the principal on the bond, but no more than the principal.

There are two basic types of bonds: government bonds and corporate bonds. U.S. government bonds (otherwise known as T-bills or Treasuries) are issued and guaranteed by Uncle Sam. They typically offer a modest return with low risk. Corporate bonds are issued by companies and carry a higher degree of risk (should the company default) as well as return.

Bond investors must also consider interest rate risk. When prevailing interest rates rise, the market value of existing bonds tends to fall. (The opposite is also true.) The only way to alleviate interest rate risk is by holding the bond to maturity. Investing in corporate bonds also tends to require just as much homework as stock investing, yet bonds generally have lower returns.

Given their lower risk, there is certainly a place for bonds or bond mutual funds in most portfolios, but their relative safety comes with the price of lower expected returns compared with stocks over the long term.

Real Estate. Most people's homes are indeed their largest investments. We all have to live somewhere, and a happy side effect is that real estate tends to appreciate in value over time. But if you are going to use real estate as a true investment vehicle by buying a second home, a piece of land, or a rental property, it's important to keep the following in mind.

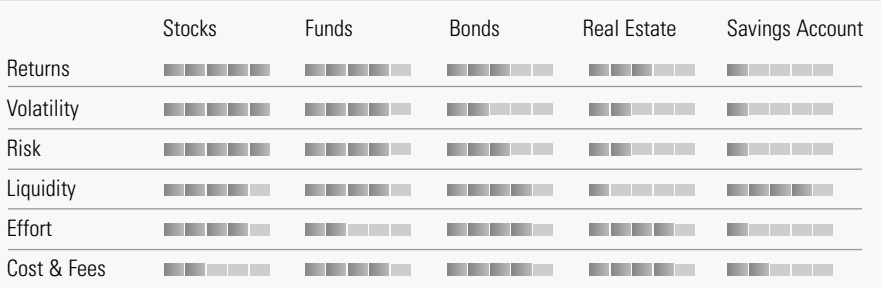
First, despite the exceptionally strong appreciation real estate values have had the past several years, real estate can and does occasionally decline in value. Second, real estate taxes will constantly eat into returns. Third, real estate owners must worry about physically maintaining their properties or must pay someone else to do it. Likewise, they often must deal with tenants and collect rents. Finally, real estate is rather illiquid and takes time to sell—a potential problem if you need your money back quickly.

Some people do nothing but invest their savings in real estate and do quite well. But just as stock investing requires effort, so does real estate investing.

Bank Savings Accounts. The problem with bank savings accounts and certificates of deposit is that they offer very low returns. The upside is that there is essentially zero risk in these investment vehicles, and your principal is protected. These types of accounts are fine as rainy-day funds—a place to park money for short-term spending needs or for an emergency. But they really should not be viewed as long-term investment vehicles.

The low returns of these investments are a problem because of inflation. For instance, if you get a 3% return on a savings account, but inflation is also dropping the buying power of your dollar by 3% a year, you really aren't making any money. Your real return (return adjusted for inflation) is zero, meaning that your money is not really working for you.

How Stocks Stack Up



The Bottom Line

Though investing in stocks may indeed require more work and carry a higher degree of risk compared with other investment opportunities, you cannot ignore the higher potential return that stocks provide. And as we will show in the next lesson, given enough time, a slightly higher return on your investments can lead to dramatically larger dollar sums for whatever your financial goals in life may be.

Investor's Checklist

- Investing in stocks is an intellectual exercise that requires effort, but it is an effort that can bear many fruits.
- Among the potential investments one can make, stocks provide the largest long-term returns, but they also have the largest volatility.
- Stocks are ownership interests in companies. They are not simply pieces of paper to be traded.

Investor's Checklist

- ►
- ►
- ►

Answers to this quiz can be found on page 165

1 Which of the following types of investments provide the largest long-term returns?

a Stocks.

b Bonds.

c Savings accounts.

2 Which of the following types of investments are the most volatile in their pricing?

a Stocks.

b Bonds.

c Savings accounts.

3 Which of the following skills sets is NOT needed to be a successful investor?

a Discipline.

b A critical eye.

c Advanced statistics.

4 Over the long term, which type of investment provides the lowest real (inflation adjusted) returns?

a Stocks.

b Mutual funds.

c Savings accounts.

5 When you buy a stock, you are:

a Making a loan to a company.

b Buying an ownership interest in a company.

c Investing in the government.

Quiz

1 Why do you want to invest at all? Write down your financial goals in life in the space below. The effort you put into these workbooks will certainly help you toward these goals.

Answers to this worksheet can be found on page 175

2 What are some of the things that concern you about stock investing? Write them here. Are you willing to see the value of your investments continuously fluctuate (sometimes significantly) in order to receive a higher long-term return?

3 Can you describe what a stock actually is?

4 Write below some products and brands you like. Figure out which companies make these. Chances are you can become an owner in these businesses.

Product names	Company

Worksheet

"When my mother used to sing me songs about compound interest, there wasn't any need to go any further."—Warren Buffett

When you were a kid, perhaps one of your friends asked you the following trick question: "Would you rather have $10,000 per day for 30 days or a penny that doubled in value every day for 30 days?" Today, we know to choose the doubling penny, because at the end of 30 days, we'd have about $5 million versus the $300,000 we'd have if we chose $10,000 per day.

Compound interest is often called the eighth wonder of the world because it seems to possess magical powers, like turning a penny into $5 million. The great part about compound interest is that it applies to money, and it helps us to achieve our financial goals, such as becoming a millionaire, retiring comfortably, or being financially independent.

The Components of Compound Interest

A dollar invested at a 10% return will be worth $1.10 in a year. Invest that $1.10 and get 10% again, and you'll end up with $1.21 two years from your original investment. The first year earned you only $0.10, but the second generated $0.11. This is compounding at its most basic level: gains begetting more gains. Increase the amounts and the time involved, and the benefits of compounding become much more pronounced.

Online Calculators

In addition to a financial calculator, spreadsheet, or table of present values, the following Web sites will help you to calculate compound interest:

American Savings Education Council: Financial Calculators
www.choosetosave.org/tools/financalc.htm

Math.com: Saving/Compounding Calculator

Lesson 102: The Magic of Compounding

Online Calculators

www.choosetosave.org/tools/fincalcs.htm

www.math.com/students/calculators/source/compound.htm

Compound interest can be calculated using the following formula:

$$FV = PV\ (1 + i)^N$$

FV = Future Value (the amount you will have in the future)
PV = Present Value (the amount you have today)
i = Interest (your rate of return or interest rate earned)
N = Number of Years (the length of time you invest)

Who Wants to Be a Millionaire?

As a fun way to learn about compound interest, let's examine a few different ways to become a millionaire. First we'll look at a couple of investors and how they have chosen to accumulate $1 million.

1. Jack saves $25,000 per year for 40 years.
2. Jeff starts with $1 and doubles his money each year for 20 years.

While most would love to be able to save $25,000 every year like Jack, this is too difficult for most of us. If we earn an average of $50,000 per year, we would have to save 50% of our salary!

In the second example, Jeff uses compound interest, invests only $1, and earns 100% on his money for 20 consecutive years. The magic of compound interest has made it easy for Jeff to earn his $1 million and to do it in only half the time as Jack. However, Jeff's example is also a little unrealistic since very few investments can earn 100% in any given year, much less for 20 consecutive years.

Rule of 72

A simple way to know the time it takes for money to double is to use the rule of 72. For example, if you wanted to know how many years it would take for an investment earning 12% to double, simply divide 72 by 12, and the answer would be approximately six years. The reverse is also true. If you wanted to know what interest rate you would have to earn to double your money in five years, then divide 72 by five, and the answer is about 15%.

Rule of 72

Time Is on Your Side

Between these two extremes, there are realistic situations in which compound interest helps the average individual. One of the key concepts about compounding is this: The earlier you start, the better off you'll be. So what are you waiting for?

Let's consider the case of two other investors, Luke and Walt, who'd also like to become millionaires. Say Luke put $2,000 per year into the market between the ages of 24 and 30, that he earned a 12% aftertax return, and that he continued to earn 12% per year until he retired at age 65. Walt also put in $2,000 per year, earned the same return, but waited until he was 30 to start and continued to invest $2,000 per year until he retired at age 65. In the end, both would end up with about $1 million. However, Luke had to invest only $12,000 (i.e., $2,000 for six years), while Walt had to invest $72,000 ($2,000 for 36 years) or six times the amount that Walt invested, just for waiting only six years to start investing.

Why Investing Early Is Important

Walt	Age	Amount Invested in $	With 12% Interest
	24	—	—
	25	—	—
	26	—	—
	27	—	—
	28	—	—
	29	—	—
	30	2,000	2,240
	35	2,000	18,178
	40	2,000	46,266
	45	2,000	95,767
	50	2,000	183,005
	55	2,000	336,748
	60	2,000	607,695
	65	2,000	1,085,197

Luke	Age	Amount Invested in $	With 12% Interest
	24	2,000	2,240
	25	2,000	4,749
	26	2,000	7,559
	27	2,000	10,706
	28	2,000	14,230
	29	2,000	18,178
	30	—	20,359
	35	—	35,880
	40	—	63,233
	45	—	111,438
	50	—	196,393
	55	—	346,111
	60	—	609,966
	65	—	1,074,968

total amount invested	$72,000

total amount invested	$12,000

Clearly, investing early can be at least as important as the actual amount invested over a lifetime. Therefore, to truly benefit from the magic of compounding, it's important to start investing early. We can't stress this fact enough! After all, it's not just how much money you start with that counts, it's also how much time you allow that money to work for you.

In our first example, Jack had to save $25,000 a year for 40 years to reach $1 million without the benefit of compound interest. Luke and Walt, however, were each able to become millionaires by saving only $12,000 and $72,000, respectively, in relatively modest $2,000 increments. Luke and Walt earned $988,000 and $928,000, respectively, due to compound interest. Gains beget gains, which beget even larger gains. This is again the magic of compound interest.

Last Is Certainly Not Least

Interestingly, if you start with $1 and double your money every year for 20 years, it's the last year that's most powerful. After the 19th doubling, you'd have only about $500,000. So, although compound interest is magical, patience is the real virtue.

Why Is Compound Interest Important to Stock Investing?

In addition to the amount you invest and an early start, the rate of return you earn from investing is also crucial. The higher the rate, the more money you'll have later. Let's assume that Luke from our previous example had two sisters who, at age 24, also began saving $2,000 a year for six years. But unlike Luke, who earned 12%, sister Charlotte earned only 8%, while sister Rose did not make good investment decisions and earned only 4%. When they all retired at age 65, Luke would have $1,074,968, Charlotte would have $253,025, and Rose would have only $56,620. Even though Luke earned only 8 percentage points more per year on his investments, or $160 per year more on the initial $2,000 investment, he would end up with about 20 times more money than Rose.

Last Is Certainly Not Least

Why Return Matters

In the table below we check in on Luke and his sisters, Rose and Charlotte, from age 24 to 30 and every five years after that until retirement, at age 65.

Age	Amount Invested in $	**Rose** 4% Rate of Return	**Charlotte** 8% Rate of Return	**Luke** 12% Rate of Return
24	2,000	2,080	2,160	2,240
25	2,000	4,243	4,493	4,749
26	2,000	6,493	7,012	7,559
27	2,000	8,833	9,733	10,706
28	2,000	11,266	12,672	14,230
29	2,000	13,797	15,846	18,178
30	—	14,348	17,113	20,359
35	—	17,457	25,145	35,880
40	—	21,239	36,946	63,233
45	—	25,841	54,286	111,438
50	—	31,439	79,764	196,393
55	—	38,251	117,200	346,111
60	—	46,538	172,205	609,966
65	—	56,620	253,025	1,074,968

Clearly, a few percentage points in investment returns or interest rates can mean a huge difference in your future wealth. Therefore, while stocks may be a riskier investment in the short run, in the long run the rewards can certainly outweigh the risks.

The Bottom Line

Compound interest can help you attain your goals in life. In order to use it most effectively, you should start investing early, invest as much as possible, and attempt to earn a reasonable rate of return.

total amount invested	$12,000

Investor's Checklist

- The three components that determine how much money you will have in the future are: the amount of money invested, the length of time invested, and the rate of return. The earlier you invest, the more you invest, and the higher the rate of return, the more money you'll have in the future.
- The formula for compound interest is FV ⊖ PV (1 ⊕ i)^{N}. You can use a business calculator or a financial calculator on the Internet to easily figure out what is needed to achieve your financial goals.
- The rule of 72 is an easy rule of thumb that tells you how often your money doubles. Divide 72 by the percentage rate of return to determine the number of years required for your money to double at that rate of return.
- With compound interest, the last few years of compounding make the most difference.
- The primary attraction to investing in stocks is that the long-run rate of return is higher than the interest earned in bank accounts or bonds.

Investor's Checklist

-
-
-
-
-

1 Using the rule of 72, an investment earning 10% per year would double in approximately how many years?

a 10.

b 7.

c 5.

Answers to this quiz can be found on page 165

2 Using the rule of 72, if you invested $10,000 at 12% per year, in 12 years, you would have how much money?

a $20,000

b $30,000

c $40,000

3 Which of the following is not a component of compound interest?

a Time.

b Interest rate.

c Financial calculator.

4 If you had invested $1 and doubled your investment 20 years in a row, you would have $1 million dollars. In the last year (year 20), you would have made how much money?

a $100,00

b $50,000

c $500,000

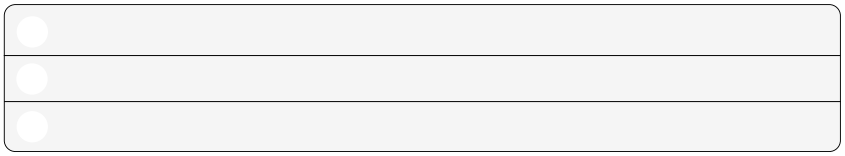
5 Which of the following is not true?

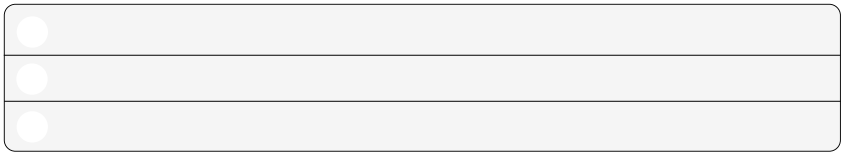
a The earlier you invest, the more money you'll have in the future.

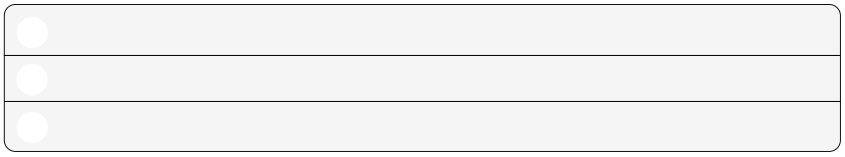
b The lower the interest rate, the more money you'll have in the future.

c The longer you invest, the more money you'll have in the future.

Quiz







Answers to this worksheet can be found on page 175

1 In the column on the left-hand side, write down your current age. Then for each successive box, add six years. Therefore, if you are 30, you'll have listed 30, 36, 42, etc. To the right of your first age box write down $30,000.

Using the rule of 72, assume you are a superstar investor and can double your investments every six years through a 12% rate of return. Therefore, if you are 30, at age 36 you'd write $60,000 and keep on doubling the amount for each age at each successive box. Vary your initial investment amount to your circumstance and continue doubling your investments as long as you wish.

How much money do you have at your planned retirement age? Are you surprised? Why isn't everyone a millionaire?

Age	Money	Age	Money

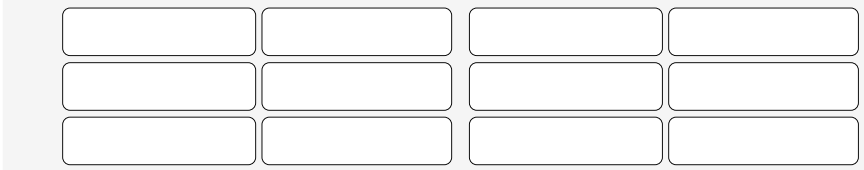
2 Using an Internet Web site or a financial calculator, determine two different ways you could become a millionaire. For example, Luke became a millionaire by investing $2,000 per year for six years beginning at age 24 and earning 12% annually until age 65.

1.

2.

3 Of the three components of compound interest, which can you control when investing, if any, and why?

Worksheet



"I have but one lamp by which my feet are guided, and that is the lamp of experience. I know of no way of judging the future but by the past."—Patrick Henry

In the last lesson, we noticed that the difference of only a few percentage points in investment returns or interest rates can have a huge impact on your future wealth. Therefore, in the long run, the rewards of investing in stocks can outweigh the risks. We'll examine this risk/reward dynamic in this lesson.

Volatility of Single Stocks

Individual stocks tend to have highly volatile prices, and the returns you might receive on any single stock may vary wildly. If you invest in the right stock, you could make bundles of money. For instance, Eaton Vance, an investment-management company, has had the best-performing stock for the last 25 years. If you had invested $10,000 in 1979 in Eaton Vance, assuming you had reinvested all dividends, your investment would have been worth $10.6 million by December 2004.

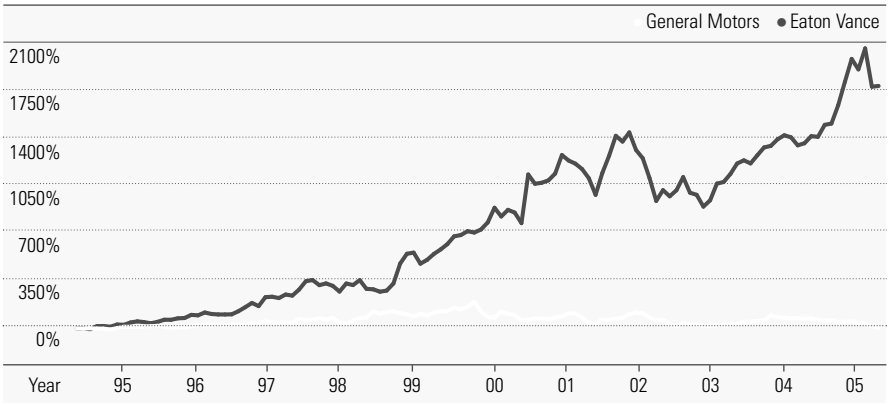
On the downside, since the returns on stock investments are not guaranteed, you risk losing everything on any given investment. There are hundreds of recent examples of dot-com investments that went bankrupt or are trading for a fraction of their former highs. Even established, well-known companies such as Enron, WorldCom, and Kmart filed for bankruptcy, and investors in these companies lost everything.

Between these two extremes is the daily, weekly, monthly, and yearly fluctuation of any given company's stock price. Most stocks won't double in the coming year, nor will many go to zero. But do consider that the average difference between the yearly high and low stock prices of the typical stock on the New York Stock Exchange is nearly 40%.

Lesson 103: Investing for the Long Run

In addition to being volatile, there is the risk that a single company's stock price may not increase significantly over time. In 1965, you could have purchased General Motors' stock for $50 per share (split adjusted). In the following decades, though, this investment has only spun its wheels. By May 2005, your shares of General Motors would be worth only about $30 each. Though dividends would have provided some ease to the pain, General Motors' return has been terrible. You would have been better off if you had invested your money in a bank savings account instead of General Motors' stock.

Tale of Two Returns: General Motors Versus Eaton Vance



Clearly, if you put all of your eggs in a single basket, sometimes that basket may fail, breaking all the eggs. Other times, that basket will hold the equivalent of a winning lottery ticket.

The Stock Market Crash of 1929

The biggest stock market crash in the United States during the 20th century occurred in 1929. In reality, the 1929 crash should really be referred to as the stock market crash of 1929 to 1932. While the market fell by 17% for the year in 1929, the market declined an incredible 89% from the high in 1929 to the low of 1932. The largest one-day crash occurred on Monday, Oct. 19, 1987, when the Dow Jones Industrial Average declined 22%.

The Stock Market Crash of 1929

Volatility of the Stock Market

One way of reducing the risk of investing in individual stocks is by holding a larger number of stocks in a portfolio. However, even a portfolio of stocks containing a wide variety of companies can fluctuate wildly. You may experience large losses over short periods. Market dips, sometimes significant, are simply part of investing in stocks.

For example, consider the Dow Jones Industrials Index, a basket of 30 of the most popular, and some of the best, companies in America. (For more information on the S&P 500 and the Dow Jones Industrial Average, see Lesson 111.) If during the last 100 years you had held an investment tracking the Dow, there would have been 10 different occasions when that investment would have lost 40% or more of its value.

Annual Returns Over the Years

	Simple Annual Returns									
	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09
1900	7%	-9%	0%	-24%	42%	38%	-2%	-38%	47%	15%
1910	-18%	0%	8%	-10%	-31%	82%	-4%	-22%	11%	30%
1920	-33%	13%	22%	-3%	26%	30%	0%	29%	48%	-17%
1930	-34%	-53%	-23%	67%	4%	39%	25%	-33%	28%	-3%
1940	-13%	-15%	8%	14%	12%	27%	-8%	2%	-2%	13%
1950	18%	14%	8%	-4%	44%	21%	2%	-13%	34%	16%
1960	-9%	19%	-11%	17%	15%	11%	-19%	15%	4%	-15%
1970	5%	6%	15%	-17%	-28%	38%	18%	-17%	-3%	4%
1980	15%	-9%	20%	20%	-4%	28%	23%	2%	12%	27%
1990	-4%	20%	4%	14%	2%	33%	26%	23%	16%	25%
2000	-6%	-7%	-17%							

As shown in the preceding chart, the yearly returns in the stock market also fluctuate dramatically. The highest one-year rate of return of 67% occurred in 1933, while the lowest one-year rate of return of negative 53% occurred in 1931. It should be obvious by now that stocks are volatile, and there is a significant risk if you cannot ride out market losses in the short term. But don't worry; there is a bright side to this story.

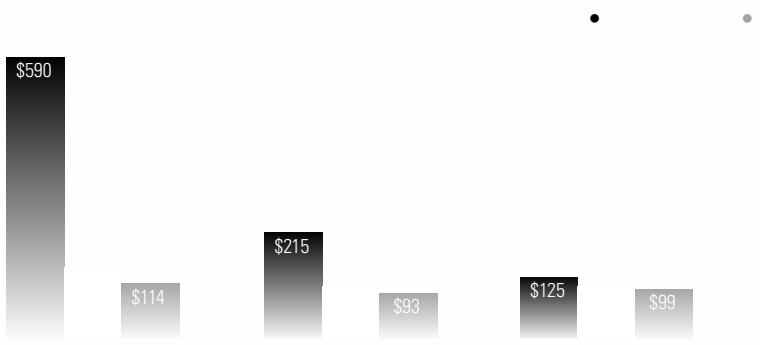
Over the Long Term, Stocks Are Best

Despite all the short-term risks and volatility, stocks as a group have had the highest long-term returns of any investment type. This is an incredibly important fact! When the stock market has crashed, the market has always rebounded and gone on to new highs. Stocks have outperformed bonds on a total real return (after inflation) basis, on average. This holds true even after market peaks.

Average Total Returns after Major 20th-Century Market Peaks ($100 Initial Investment)

Major market peaks include 1901, 1906, 1915, 1929, 1937, 1946, 1968

As shown in the chart above, if you had deplorable timing and invested $100 into the stock market during any of the seven major market peaks in the 20th


$590
$114
$215
$93
$125
$99

century, that investment, over the next 10 years, would have been worth $125 after inflation, but it would have been worth only $107 had you invested in bonds, and $99 if you had purchased government Treasury bills. In other words, stocks have been the best-performing asset class over the long term, while government bonds, in these cases, merely kept up with inflation.

This is the whole reason to go through the effort of investing in stocks. Again, even if you had invested in stocks at the highest peak in the market, your total after-inflation returns after 10 years would have been higher for stocks than either bonds or cash. Had you invested a little at a time, not just when stocks were expensive but also when they were cheap, your returns would have been much greater.

Time Is on Your Side

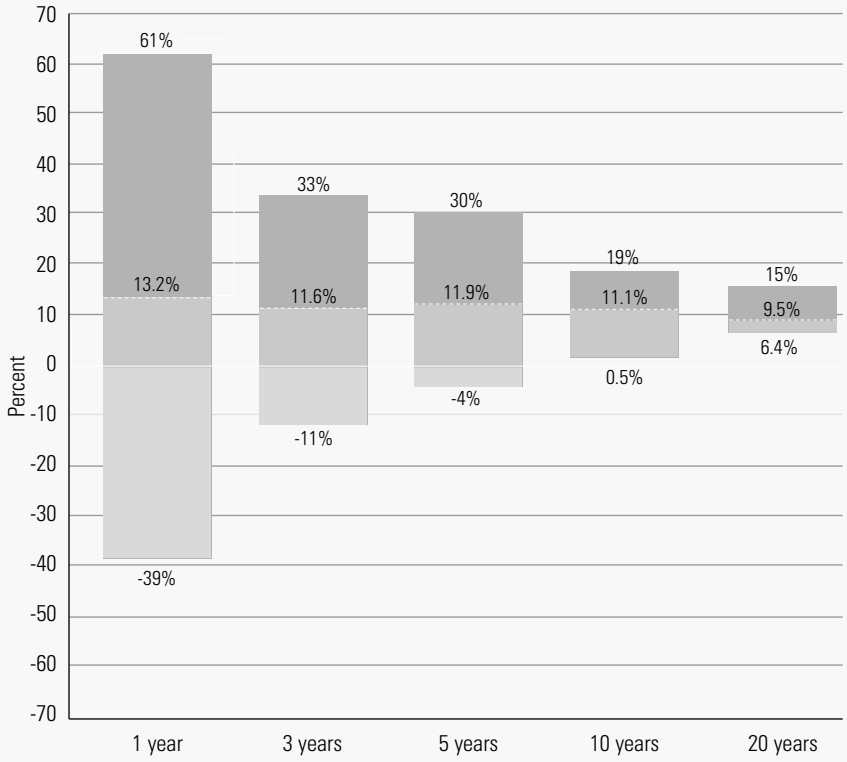
Just as compound interest can dramatically grow your wealth over time, the longer you invest in stocks, the better off you will be. With time, your chances of making money increase, and the volatility of your returns decreases.

The average annual return for the S&P 500 stock index for a single year has ranged from negative 39% to positive 61%, while averaging 13.2%. After holding stocks for five years, average annualized returns have ranged from negative 4% to positive 30%, while averaging 11.9%. Finally, if your holding period is 20 years, you never lost money, with 20-year returns ranging from positive 6.4% to positive 15%, with the average being 9.5%.

These returns easily surpass those you can get from any of the other major types of investments. Again, as your holding period increases, the expected return variation decreases, and the likelihood for a positive return increases. (See chart on next page.) This is why it is important to have a long-term investment horizon when getting started in stocks.

Average Annual Returns of U.S. Stocks for Different Holding Periods

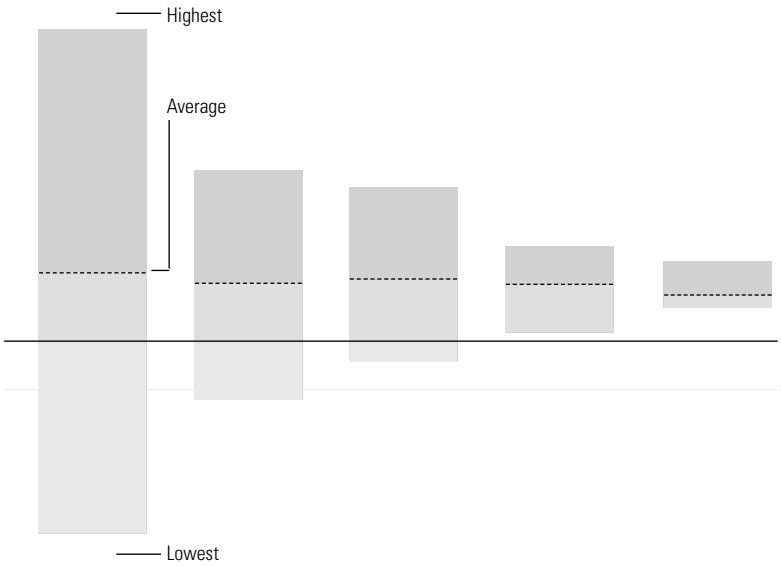
The longer you invest, the lower the volatility of your returns.



From *Investing for Dummies*

Why Stocks Perform the Best

While historical results certainly offer insight into the types of returns to expect in the future, it is still important to ask the following questions: Why, exactly, have stocks been the best-performing asset class? And why should we expect those types of returns to continue? In other words, why should we expect history to repeat?


Highest
Average
Lowest

Quite simply, stocks allow investors to own companies that have the ability to create enormous economic value. Stock investors have full exposure to this upside. For instance, in 1985, would you have rather lent Microsoft money at a 6% interest rate, or would you have rather been an owner, seeing the value of your investment grow several-hundred fold?

Because of the risk, stock investors also require the largest return compared with other types of investors before they will give their money to companies to grow their businesses. More often than not, companies are able to generate enough value to cover this return demanded by their owners.

The Worst of Times… The Best of Times

Though stocks typically perform best over the long term, there can be extended periods of poor performance. For example, the Dow Jones Industrial Average peaked in 1966 and didn't surpass its old high again until 16 years later in 1982. But the following 20 years were great for stocks, with the Dow increasing more than tenfold by 2002.

Meanwhile, bond investors do not reap the benefit of economic expansion to nearly as large a degree. When you buy a bond, the interest rate on the original investment will never increase. Your theoretical loan to Microsoft yielding 6% would have never yielded more than 6%, no matter how well the company did. Being an owner certainly exposes you to greater risk and volatility, but the sky is also the limit on the potential return.

The Bottom Line

While stocks make an attractive investment in the long run, stock returns are not guaranteed and tend to be volatile in the short term. Therefore, we do not recommend that you invest in stocks to achieve your short-term goals. To be effective, you should invest in stocks only to meet long-term objectives that are at least five years away. And the longer you invest, the greater your chances of achieving the types of returns that make investing in stocks worthwhile.

The Worst of Times…
The Best of Times

Investor's Checklist

- Stock returns are not guaranteed. While stock market returns over a five-year period have averaged about 12% annually, the stock market can also decline for several years in a row.
- The worst fall in the stock market was between 1929 and 1932 when the market declined by 89%. There have been about 10 periods in the last century when the stock market has plunged by more than 40%.
- Individual stocks are volatile. The difference between the yearly high and low price for the typical stock on the New York Stock Exchange is near 40%.
- The longer you invest in stocks, the greater the chances you will make money. In any 20-year period over the last 200 years, stocks have returned a positive real (after inflation) rate of return.
- Even if you had invested in stocks at only the highest peaks in the market, your total real returns after 10 years would have been higher for stocks than either bonds or cash.

Investor's Checklist

- ►
- ►
- ►
- ►
- ►

1 The average yearly difference between the high and low of the typical stock is between:

a 30% and 50%.

b 10% and 30%.

c 50% and 70%.

Answers to this quiz can be found on page 166

2 If you were saving to buy a car in three years, what percentage of your savings for the car should you invest in the stock market?

a 50%.

b 70%.

c 0%.

3 If you were investing for your retirement, which is more than 10 years away, based on historical returns in the 20th century, what percentage of the time would you have been better off by investing only in stocks versus a combination of stocks, bonds, and cash?

a 50%.

b 100%.

c 0%.

4 Well-known stocks like General Motors:

a Always outperform the stock market.

b Are too highly priced for the average investor.

c Can underperform the stock market.

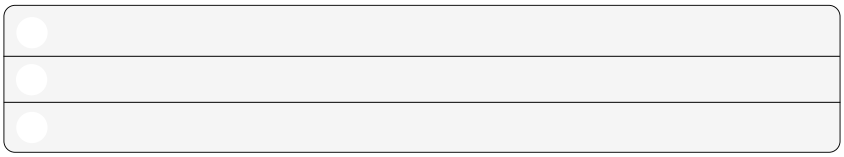
5 Which of the following is true:

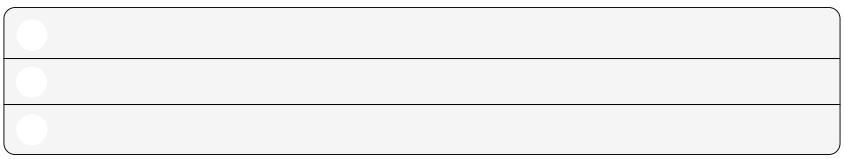
a After adjusting for inflation, bonds outperform stocks.

b When you invest in stocks, you will earn 12% interest on your money.

c Stock investments should be part of your long-term investment portfolio.

Quiz





Answers to this worksheet can be found on page 176

1 Assuming you had to save money for a down payment on your car, would you invest in the stock market? How would your answer change if you had to invest for your retirement?

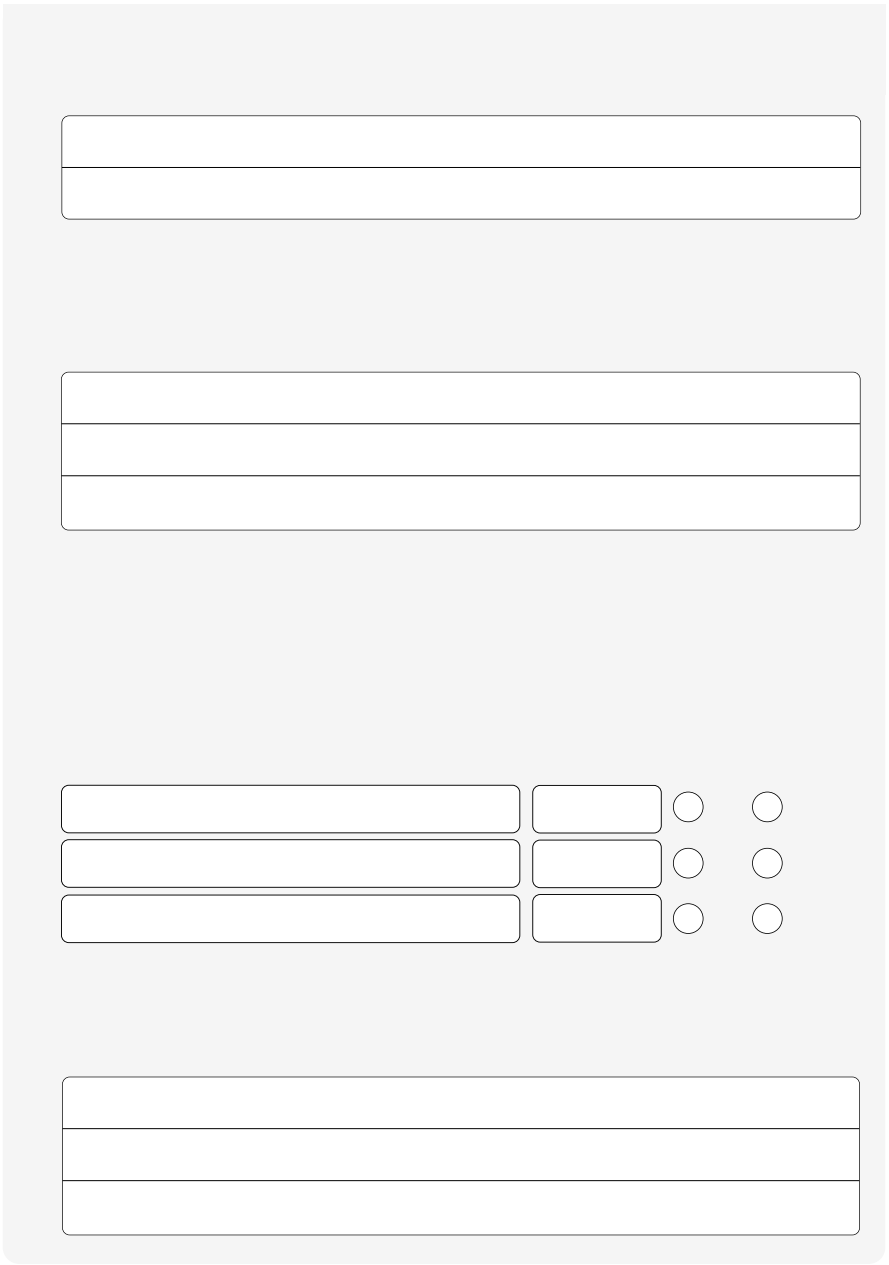
2 Janet has recently graduated from college and would like to start saving to become financially independent by age 55. She wants to invest 100% of her money in stocks. What would you advise her to do?

3 Write down your financial goals in life and the amount of time in years before you expect to reach those goals. If you are going to invest in stocks to achieve these goals, are the goals far enough out to minimize the risk of short-term volatility wiping out your returns? Are you willing to hold on through the dips your investment portfolio will inevitably experience in order to benefit from the long-term returns of stocks?

Goal	Time (Years)	Far enough out for stocks?
		Yes No
		Yes No
		Yes No

4 Write down the kind of returns you expect by investing in stocks over the next year. What about the next 10 years? Are these expectations consistent with what stocks have returned historically?

Worksheet



"The gambling known as business looks with austere disfavor upon the business known as gambling."—Ambrose Bierce

Different people have different notions of what stock investing is all about. Before we go any further in this workbook series, we want to put things into focus and set you on the right path.

Investing Does Not Equal Trading

Your perception of stock investing may involve highly caffeinated, frantic traders sweating in front of a half dozen computer screens packed with information, while phones ring off the hook in the background.

Feel free to dump these images from your mind because solid stock investing is not about trading, having the fastest computers, or getting the most up-to-the-second information. Though some professionals make their living by creating a liquid market for stocks, actively "day trading" is simply not how most good investing is done by individuals.

Beyond having to expend an incredible amount of effort to track stocks on an hour-by-hour basis, active day traders have three powerful factors working against them. First, trading commissions can rack up quickly, dramatically eroding returns. Second, there are other trading costs in terms of the bid/ask spread, or the small spread between what buyers are bidding and sellers are asking at any moment. These more hidden frictional costs are typically only a small fraction of the stock price, but they can add up to big bucks if incurred often enough. Finally, frequent traders tend not to be tax efficient, and paying more taxes can greatly diminish returns.

Lesson 104: What Matters and What Doesn't

Just as someone can be a great racecar driver without being a mechanical engineer, you can be a great investor without having a clue about how the trades actually get executed in the market. How your orders flow from one computer system to the other is of little consequence.

Just remember that investing is like a chess game, where thought, patience, and the ability to peer into the future are rewarded. Making the right moves is much more important than moving quickly.

Investing Means Owning Businesses

If the mechanics of actual trading mean little, what does matter? Do charts of stock prices hold the answers? We've said it once, and we'll say it again and again: When you buy stocks, you are buying ownership interests in companies. Stocks are not just pieces of paper to be traded.

So if you are buying businesses, it makes sense to think like a business owner. This means learning how to read financial statements, considering how companies actually make money, spotting trends, and figuring out which businesses have the best competitive positions. It also means coming up with appropriate prices to pay for the businesses you want to buy. Notice that none of this requires lightning-fast reflexes!

You should also buy stocks like you would any other large purchase: with lots of research, care, and the intention to hold as long as it makes sense. Some people will spend an entire weekend driving around to different stores to save $60 on a television, but they put hardly any thought into the thousands of dollars they could create for themselves by purchasing the right stocks (or avoiding the wrong ones). Again, investing is an intellectual exercise, but one that can have a large payoff.

You Buy Stocks, Not the Market

We've all seen the prognosticators on television, predicting where the market is going to go in the future. One thing to remember when listening to these market premonitions is that stock investing is about buying individual stocks, not the market as a whole. If you pick the right stocks, you can make money no matter what the broader market does.

Another reason to heavily discount what the prognosticators say is that correctly predicting market movements is nearly impossible. No one has done it consistently and accurately. There are simply too many moving parts, and too many unknowns. By limiting the field to individual businesses of interest, you can focus on what you can actually own while dramatically cutting down on the unknowns. You can save a lot of energy by simply tuning out market predictions.

We established in the previous lesson that stocks are volatile. Why is that? Does the value of any given business really change up to 50% year-to-year? (Imagine the chaos if the value of our homes changed this much!) The fact is, "Mr. Market" tends to be a bit of an extremist in the short term, overreacting to both good and bad news. We will talk more about this phenomenon later, but it is nevertheless a good fact to know when starting.

A Broken Clock

With so many predictions about the stock market floating around, simple statistics says there are bound to be a handful of them that come true. When thinking about this, it is helpful to remember the saying: "A broken clock is correct twice a day."

Competitive Positioning Is Most Important

Future profits drive stock prices over the long term, so it makes sense to focus on how a business is going to generate those future earnings. At Morningstar, we believe competitive positioning, or the ability of a business to keep competitors at bay, is the most important determining factor of future profits.

A Broken Clock

Despite where the financial media may spend most of its energy, competitive positioning is more important than the economic outlook, more important than the near-term flow of news that jostles stock prices, and even more important than management quality at a company.

It may be helpful to think of the investing process as if you were planning a trip across the ocean. You cannot do anything about the current weather or the tides (the current economic conditions). You can try to wait out bad weather that might sink your ship, but then you are also giving up time. And as we showed in Lesson 102, time is a precious resource in investing.

The main thing you can control is what ship to board. Think of the seaworthiness of a ship as the competitive positioning of a business, and the horsepower of the engine as its cash flow. Some ships have thick, reinforced metal hulls, while others have rotting wood. Clearly, you would pick the ships that are the most seaworthy (with the best competitive positioning) and have the most horsepower (cash flow).

Though the ship's captain (company management) certainly matters, the quality of the ship is more important. On a solid vessel, as long as the captain does not mess up, there is not much difference between a good and a great captain. Meanwhile, there is nothing the best skipper can do if the boat's engine is broken and the boat is constantly taking on water (poor business). To relate this to stocks, business economics trump management skill.

It's also worth noting that all ships will experience waves (volatility). And though it is true that a rising tide lifts all ships, the tides have nothing to do with the quality of the boats on the sea. All else equal, a better ship is still going to arrive faster, and a company with the best competitive positioning is going to create the most value for its shareholders. We will talk about exactly how to spot the best ships later in this book (Lesson 112) as well as throughout the second workbook in this series.

The Bottom Line

It is very easy for new stock investors to get started on the wrong track by focusing only on the mechanics of trading or the overall direction of the market. To get yourself in the proper mind-set, tune out the noise and focus on studying individual businesses and their ability to create future profits. In the coming lessons, we will begin to build the skills you will need to become a successful buyer of businesses.

Investor's Checklist

- Active traders have three things working against them: the bid/ask spread, commissions, and taxes.
- Stocks are not just pieces of paper to be traded; they are pieces of businesses.
- The stock market as a whole is nearly impossible to predict, but predicting the outcome of individual businesses is a more manageable exercise.
- Mr. Market is highly temperamental, over-reacting to both good and bad news.
- Future profits drive stock prices over the long term, and the competitive positioning of a business is the most important factor in its ability to generate future earnings.

Investor's Checklist

- ►
- ►
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Answers to this quiz can be found on page 166

1 In general, the more frequently you trade:

- a The higher your expected return from stock investing.
- b The less you will pay in total trading commissions.
- c The higher your tax bill.

2 The stock market tends to:

- a Be temperamental, over-reacting to near-term news.
- b Be perfectly efficient, always valuing future cash flow accurately.
- c Move with the phases of the moon.

3 What will drive the price of a company's stock the most over the long term?

- a Economic conditions over the next year.
- b The future profits and cash flow a company can generate.
- c The education level of top management.

4 To be a successful stock investor, you need:

- a To be able to think quickly, with fast reflexes.
- b A powerful computer with up-to-the-minute information.
- c Patience and the ability to think about future trends.

5 What should you pay the most attention to?

- a Charts of stock prices.
- b A company's competitive positioning.
- c The predicted movement of the overall stock market.

Quiz

1 Before reading this lesson, what were your impressions about stocks and the people investing in them? What kind of skills did you think you needed? What are your impressions now?

Answers to this worksheet can be found on page 177

2 Write down the three forces that frequent traders have to work against. How does taking a long-term investing approach minimize these costs?

1.

2.

3.

3 Can you name some investment approaches you've seen promoted that do not make any sense to you? (Example: Using astrology to pick stocks.)

4 Where do you think the Dow Jones Industrial Average will be next month? Next year? Why?

Worksheet