Chapter 1

Examining Your Investment Choices

In This Chapter

- Defining investing
- Understanding why simple strategies work wonders
- Seeing how stocks, real estate, and small business build wealth
- Comprehending the role of lending and other investments

If you succeed in accumulating some money to invest, congratulations! You've accomplished a feat that the majority of people in the world haven't yet done. If you decide to move to the next step — actually investing some of that money — you've come to the right place. *Investing For Dummies,* 4th Edition, is your one-stop investment reference guide and counselor, ready to prepare you for the thrilling and rewarding world of investing.

In many parts of the world, life's basic necessities — food, clothing, shelter, and taxes — gobble the entirety of people's meager earnings. Although some Americans do struggle for basic necessities, the bigger problem for most Americans is that they consider just about *everything* — eating out, driving new cars, hopping on an airplane for vacation — to be a necessity. I've taken it upon myself (using this book as my tool) to help you recognize that investing — that is, putting your money to work for you — is *also* a necessity. If you want to accomplish important personal and financial goals, such as owning a home, starting your own business, helping your kids through college (and spending more time with them when they're young), retiring, and so on, you must know how to invest well.

It has been said, and too often quoted, that the only certainties in life are death and taxes. To these two certainties I add one more: being confused by and ignorant about investing. Because investing is a confounding activity, you may be tempted to look with envious eyes at those people in the world who appear to be savvy with money and investing. Remember that all of us start with the same level of financial knowledge — that is to say, with none! *No one* is born knowing this stuff! The only difference between those who know and those who don't is that those who know have invested their time and energy acquiring knowledge about the investment world.

Taking an Active Role in Selecting Your Investments

Before I discuss the major investing alternatives, I want to start with something that's quite basic, yet important. What exactly do I mean when I say "investing"?

Investing means that you have money put away for future use. If you put your money in your mattress, you've chosen an investment — one that pays no interest and is subject to theft and fire! Many people chose to invest their money in their mattresses during the Great Depression in the United States in the early 1930s. Why, you ask? Banks were failing, and the stock market fell off a cliff. Therefore, during the Great Depression, the mattress was a reasonable place to invest. (Although many people didn't know it then, an even better place to invest their money was in government-backed bonds that appreciated in value as inflation ebbed.)

Investing involves the process of making choices. Whether you place your money in the bank, a mattress, or a relative's business, you ultimately decide where you invest it. But some people invest some, or even all, of their money by default — without making a concerted decision. Others invest for reasons that don't match their current and long-term best interests. Do any of the following scenarios sound familiar?

- **You hold your investment in a "parking place" until you figure out what to do with your money.** Today, the equivalent of the Depression-era mattress is a bank account. When most people receive money, it goes into the local bank account (if it isn't spent first) where it may sit for years on end earning little, if any, interest.
- **Your investments were sold to you by a broker or financial advisor who was more interested in his profits than yours.** Many people hold investments that they don't understand, and the investments may not be appropriate for their financial situation and goals. Perhaps you're already a student of the investing school of hard knocks and have lost money on poor investments ravaged by high commissions and fees.
- **Your current investments are based on your previous circumstances.** Although your situation may change slowly from year to year, it may differ greatly from where you were five or ten years ago. Maybe you bought investments that made sense for you when you were in a much

higher or lower tax bracket. Perhaps your investment holdings require too much time to track and monitor.

- **You inherited your investments and stuck with them.** What made a good investment for your parents, grandparents, or other relatives doesn't necessarily make sense for you, and who says that what they held ever *was* a good investment? You can love a person and honor her memory, yet still be analytical and practical about the investments that she left you.

This book, beginning with this chapter, helps you understand your best investment options so that you may begin to choose and construct a *portfolio* (collection of investments) that fits your financial situation and goals.

Keeping It Simple

Many people think that in order to accumulate significant wealth, they need to do something complicated and out of the ordinary. The truth is that by following time-tested and simple principles and investment strategies, you can earn healthy returns and achieve financial independence just as my client George did.

The first and only time that I met with George was at his home. (This was back in the days when I made house calls for my financial counseling clients, which I enjoyed doing because meeting people on their home turf gave me a much better sense of their situation and personality.) George kept a ledger of his investments on a sheet of paper that was faded and smelled old. George was a millionaire, although you'd never know it. I can best describe George's home furnishings as spartan — probably from the years of family pets and children running around the house. The stuffing of his living room couch was falling out, and he had a Philco television set that was probably black and white.

Despite the fact that George never came close to earning a six-figure salary, he was able to retire at the age of 50. George didn't have any advanced degrees in business or any other subject, and he never went to college. He accumulated his wealth the old-fashioned (and best) way — through hard work, savings, and common-sense investing.

In his 20s and 30s, George worked overtime to come up with the necessary cash to buy a couple of real estate properties. He's owned real estate ever since. George also took about 10 percent of each paycheck and invested it in stocks.

REMEMBER

George didn't follow any gurus to figure out the right time to sell or trade his investments. He did some homework, bought sound investments, and turned, so to speak, into an investing couch potato. "After all the time, trouble, and work I spent to save up the money and then choose an investment, why would I want to sell it?" George asks. That's an excellent question that trigger-happy traders, especially those who predominate in the world of Internet trading, may ask themselves too late in life. Buying and then holding sound investments minimizes trading costs, taxes, and anxiety.

George hired me to get my opinion on whether his portfolio was properly balanced and what mutual funds he should invest in, given his tax situation. Upon hearing about my book, *Mutual Funds For Dummies* (Wiley), George agreed that meeting with me (for advice) and reading that book and a couple of others made the best use of his time and money and fulfilled his educational needs. You see, George was also smart enough to realize that consultants cost money and that you can find out a lot on your own if you get pointed in the right direction!

BEWARE

Proceed with caution: Financial advisors ahead

Too many advisors try to perpetuate the need for their services. I'll never forget the lunch that I had years ago with a tax attorney, Larry, whom I had heard on a local radio station. On the air, he seemed well-spoken and knowledgeable. He called himself "The People's Attorney." I met with Larry because I was curious to find out more about tax attorneys and the world of radio.

After talking for a while, I asked Larry what his goals were. Without missing a beat, he said, "To make as much money as possible in as short a period of time as possible." He went on to explain that his practice didn't just focus on taxes, but that he would "help" his clients with many other legal matters.

"The key, Eric," Larry said with an almost paternalistic tone in his voice, "is to work on anything that's an urgent matter. That way, the customer is willing to pay my hourly fee of $375." Gulp! Larry then offered me a proposition. If I directed all my clients' legal needs to him, he'd put me on a retainer — in other words, kick back money that he was earning from clients I sent his way. Larry and I finished lunch, and I went home with the beginnings of indigestion.

Over the next several weeks, I listened to Larry's radio show with fresh ears, and I noticed a repeated and disturbing pattern. "The People's Attorney" was short on specifics in response to callers' questions and often went out of his way to make his answers sound complicated. One caller asked Larry about using a computer software program to create a will, to which Larry warned ominously, "Would you use a computer on yourself to perform brain surgery?! There are so many things that can go wrong."

Well, preparing a will and making most investments aren't even close to performing brain surgery. You can make intelligent, sound, wealth-building investment decisions using your common sense and some relatively simple strategies without turning over your financial affairs to financial advisors. Sadly, many advisors are only out to keep you in the dark and dependent on them so they can maximize their profits — rather than *your* profits. (Throughout this book, I explain when it may make sense for you to obtain professional advice and the best method for finding that help.)

While I talked with George, the telephone rang, and after he said hello, he waited to find out who was calling with all the anticipation of a young child in line at an amusement park. Then his eyes really lit up as he realized it was his granddaughter and she would soon be visiting.

George is a wealthy person in many ways. Nearly 80, he possesses great health and appears to have lots of friends and family. He enjoyed his career working in a manufacturing environment. George also served his country in World War II and earned a Purple Heart. In addition to being with his close-knit family and friends, he spends his time volunteering and traveling. Although George has significant financial wealth and the ability to save and invest wisely, he says of his money, “I know that I can’t take it with me.”

You, dear reader, can accomplish what George did. The first step for you on the road to wealth is to read and internalize the simple yet powerful strategies in this book.

Understanding Common Investments

Literally tens of thousands of different investments exist. There are thousands of stocks, bonds, mutual funds, and other vehicles. Unfortunately for the novice, and even for experts who are honest with you, knowing the name of the investment or company is just the tip of the iceberg. Underneath each of these investments lurks a veritable mountain of details.

REMEMBER

If you wanted to and had the ability, you could make a full-time endeavor out of analyzing financial statements and talking to business employees, customers, suppliers, and so on. However, I don’t want to scare you away from investing just because some people do it on a full-time basis. Making wise investments need not take a lot of your time. If you know where to get high-quality information, and you purchase quality, managed investments, you can leave the investment management to the best experts. Then you can do the work that you’re best at and have more free time for fun stuff.

An important part of the “making wise investments” process is knowing when you have enough information to do things well on your own versus when you should hire others to help you. For example, investing in foreign stock markets is generally more difficult to research and understand compared with domestic markets. Thus, hiring a good money manager, such as through a mutual fund, makes more sense when investing overseas than going to all the time, trouble, and expense of trying to pick your own individual stocks.

I’m here to give you enough information to help you make your way through the complex investment world. In the following sections, I clear a path so that you can identify the major investments and understand what each is good for.

Building wealth through ownership investments

If you want your money to grow, and you don't mind a bit of a roller-coaster-type ride from time to time in your investment's values, ownership investments are for you. *Ownership investments* are those where you own a piece of some company or other asset (such as stock, real estate, or a small business) that has the ability to generate revenue and, potentially, profits.

If you want to build wealth, observing how the world's wealthiest have built their wealth is enlightening. Not surprisingly, the champions of wealth around the globe gained their fortunes largely through owning a piece (or all) of a successful company that they (or others) have built. Take the case of Bill Gates, founder and chief executive officer of Microsoft — and college dropout. Microsoft is the world's largest producer of personal computer software (among other related software business lines).

Every time I, or millions of other people, buy a personal computer with one of these Microsoft software packages, or simply buy or upgrade a Microsoft software package, Microsoft makes more money. As the largest stockholder in the company, Gates stands to make more money as increasing sales and profits drive up the stock's price. Microsoft's profits and stock price have skyrocketed since the company first issued shares of stock back in 1986. (If you had invested $10,000 in Microsoft in 1986, when the stock was first offered to the general public, that would have grown to more than $3 million!)

In addition to owning their own businesses, many well-to-do people have built their nest eggs by investing in real estate and the stock market. And of course, some people come into wealth the old-fashioned way — they inherit it. Even if your parents are among the rare wealthy ones and you expect them to pass on big bucks to you, you need to know how to invest your money intelligently. Investing like the big boys and girls is a smart move, as long as you understand and manage the risks.

If you understand and are comfortable with the risks and take sensible steps to diversify (don't put all your eggs in the same basket), ownership investments are the key to building wealth. In order to accomplish typical longer-term financial goals, such as retiring, the money that you save and invest needs to grow at a healthy clip. If you dump all your money in bank accounts that pay little if any interest, you're likely to fall short of your goals.

Not everyone needs to make his money grow, of course. Suppose that you inherit a significant sum and/or maintain a restrained standard of living and work your whole life simply because you enjoy doing so. In this situation, you may not need to take the risks involved with a potentially faster-growth investment. You may be more comfortable with *safer* investments, such as paying off your mortgage faster than necessary. Chapter 3 helps you think through such issues.

The stock market

Stocks are an example of an ownership investment because they represent shares of ownership in a company.

If you want to share in the growth and profits of companies like Microsoft, you can! You simply buy shares of their stock through a brokerage firm. However, just because Microsoft makes money in the future, there's no guarantee that the value of its stock will increase. In fact, the value of your Microsoft stock can decrease. But at least the next time you call Microsoft and fork over $50 for technical support, you'll have some small satisfaction knowing that you indirectly profit.

Some companies today even sell their stock directly to investors, allowing you to bypass brokers altogether. You can also invest in stocks via a stock mutual fund, where a fund manager decides which individual stocks to include in the fund. (I discuss the various methods for buying stock in Chapter 6.)

The stock market is a fine way to build wealth. In fact, Thomas has used the stock market to build his wealth over the years. At the age of 75, he is the proud owner of a portfolio worth more than $1.2 million. Thomas worked for 30 years as a pressman for a newspaper and retired in his early 50s. When he retired, he was making about $9,000 per year. "I never had a college education but always made sure to save and invest money each month and watch it grow," says Thomas.

You don't need a B.A., M.B.A., M.D., or Ph.D. to make money in the stock market. If you can practice some simple lessons, such as making regular and systematic investments and investing in proven companies and funds while minimizing your investment expenses and taxes, you'll be a winner.

However, I don't believe that you can "beat the markets," and you certainly can't beat the best professional money managers at their own, full-time game. This book shows you time-proven, nongimmicky methods to make your money grow in the stock market as well as in other financial markets. (I explain how in Part II.)

Real estate

Another method that people of varying economic means use to build wealth is to invest in real estate. Owning and managing real estate is like running a small business. You need to satisfy customers (tenants), manage your costs, keep an eye on the competition, and so on. Some methods of real estate investing require more time than others, but many are proven ways to build wealth.

John, who works for a city government, and his wife, Linda, a computer analyst, have built several million dollars in investment real estate *equity* (the difference between the property's market value and debts owed) over the past three decades. "Our parents owned rental property, and we could see what it could do for you by providing income and building wealth," says John. Investing in real estate also appealed to John and Linda because they didn't know anything about the stock market, so they wanted to stay away from it. The idea of *leverage* — making money with borrowed money — on the real estate also appealed to them.

John and Linda bought their first property, a duplex, in 1971, when their combined income was $20,000 per year. Every time they moved to a new home, they kept the prior one and converted it to a rental. Now in their 50s, John and Linda own seven pieces of investment real estate and are multimillionaires. "It's like a second retirement, having thousands in monthly income from the real estate," says John.

John readily admits that rental real estate has its hassles. "We haven't enjoyed getting calls in the middle of the night, but now we have a property manager who can help with this when we're not available. It's also sometimes a pain finding new tenants," he says.

Overall, John and Linda figure that they've been well rewarded for the time they spent and the money they invested. The income from John and Linda's rental properties allows them to live in a nicer home.

TIP

Ultimately, to make your money grow much faster than inflation and taxes, you must absolutely, positively do at least one thing — take some risk. Any investment that has real growth potential also has shrinkage potential! You may not want to take the risk or have the stomach for it. Don't despair: I discuss lower-risk investments in this book as well. You can find out about risks and returns in Chapter 2.

Who wants to invest like a millionaire?

Having a million dollars isn't nearly as rare as it used to be. In fact, according to the Spectrem Group, a firm that conducts research on wealth, there are now nearly 8 million U.S. households that have at least one million dollars in wealth (excluding the value of their primary home). There are now nearly one million households with five million dollars or more in wealth.

Interestingly, households with wealth of at least one million rarely let financial advisors direct their investments. Only one of ten such households allows advisors to call the shots and make the moves, whereas 30 percent don't use any advisors. The remaining 60 percent consult an advisor on an as-needed basis and then make their own moves.

As in past surveys, recent wealth surveys show that affluent investors achieved and built upon their wealth with ownership investments, such as their own small businesses, real estate, and stocks.

Small business

I know people who have hit investing "home runs" by owning or buying a business. Unlike the part-time nature of investing in the stock market, most people work at running their business full time, increasing their chances of doing something big financially with it. If you try to invest in individual stocks, by contrast, you're likely to work at it part time, competing against professionals who invest practically around the clock.

A decade ago, Calvin set out to develop a corporate publishing firm. Because he took the risk of starting his business and has been successful in slowly building it, today, in his early 50s, he enjoys a net worth in excess of $10 million and can retire if he wants. Even more important to many business owners — and the reason that financially successful entrepreneurs such as Calvin don't call it quits after they've amassed a lot of cash — are the nonfinancial rewards of investing, including the challenge and fulfillment of operating a successful business.

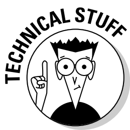
Sandra has worked on her own as an interior designer for more than two decades. She previously worked in fashion, as a model, and then as a retail store manager. Her first taste of interior design was redesigning rooms at a condominium project. "I knew when I did that first building and turned it into something wonderful and profitable that I loved doing this kind of work," says Sandra. Today, Sandra's firm specializes in the restoration of landmark hotels, and her work has been written up in numerous magazines. "The money is not of primary importance to me . . . my work is driven by a passion . . . but obviously it has to be profitable," she says. Sandra has also experienced the fun and enjoyment of designing hotels in many parts of the United States and overseas, including one in Japan.

Most small business owners (myself included) quickly point out that the entrepreneurial life is not a walk through the rose garden (although it does have its share of thorns). Emotionally and financially, entrepreneurship is sometimes a roller coaster. In addition to the financial rewards, however, small business owners can enjoy seeing the impact of their work and knowing that it makes a difference. Combined, Calvin and Sandra's firms created dozens of new jobs.

Not everyone needs to be sparked by the desire to start her own company to profit from small business. You can share in the economic rewards of the entrepreneurial world through buying an existing business or investing in someone else's budding enterprise. I talk more about evaluating and buying a business in Part IV of this book (and in the latest edition of *Small Business For Dummies,* written by Jim Schell and me; published by Wiley).

Generating income from lending investments

The other major types of investment include those in which you lend your money. Suppose that like most people, you keep some money in your local bank — most likely in a checking account, but perhaps also in a savings account or certificate of deposit (CD). No matter what type of bank account you place your money in, what you're doing is lending your money to the bank.



How long and under what conditions you lend money to your bank depends on the specific bank and account that you use. With a CD, you commit to lend your money to the bank for a specific length of time — perhaps six months or even a year. In return, the bank probably pays you a higher rate of interest than if you put your money in a bank account offering you immediate access to the money. (You may demand termination of the CD early; however, you'll be penalized.)

As I discuss in more detail in Chapter 8, you can also invest your money in bonds — another type of lending investment. When you purchase a bond that has been issued by the government or a company, you agree to lend your money for a predetermined period of time and receive a particular rate of interest. A bond may pay you 6 percent interest over the next five years, for example.

An investor's return from lending investments is typically limited to the original investment plus interest payments. If you lend your money to Microsoft through one of its bonds that matures, say, in ten years, and Microsoft triples in size over the next decade, you won't share in its growth. Microsoft's stockholders and employees reap the rewards of the company's success, but as a bondholder, you don't.

Many people keep too much of their money in lending investments, thus allowing others to reap the rewards of economic growth. Although lending investments appear safer because you know in advance what return you will receive, they aren't that safe. The long-term risk of these seemingly safe money investments is that your money will grow too slowly to enable you to accomplish your personal financial goals. In the worst cases, the company or other institution to which you're lending money can go under and stiff you for your loan.

Considering cash equivalents

Cash equivalents are any investments that you can quickly convert to cash without cost to you. Of course, the cash in your wallet qualifies as a cash equivalent. With most checking accounts, for example, you can write a check or withdraw cash by visiting a teller — either the live or the automated type.

WARNING!

The double whammy of inflation and taxes

Bank accounts and bonds that pay a decent return are reassuring to many investors. Earning a small amount of interest sure beats losing some or all your money in a risky investment.

The problem is that money in a savings account, for example, that pays 3 percent isn't actually yielding you 3 percent. It's not that the bank is lying — it's just that your investment bucket contains some not-so-obvious holes.

The first hole is taxes. When you earn interest, you must pay taxes on it (unless you invest the money in a retirement account, in which case you generally pay the taxes at a later date, when you withdraw the money). If you're a moderate-income earner, you end up losing about a third of your interest to taxes. Your 3 percent return is now down to 2 percent.

But the second hole in your investment bucket can be even bigger than taxes: inflation. Although a few products become cheaper over time (computers, for example), most goods and services increase in price. Inflation in the United States is running right around 3 percent per year. Inflation depresses the purchasing power of your investment's returns. If you subtract the 3 percent "cost" of inflation from the remaining 2 percent after payment of taxes, I'm sorry to say that you lost 1 percent on your investment.

To recap: For every dollar you invested in the bank a year ago, despite the fact that the bank paid you your 3 pennies of interest, you're left with only 99 cents in real purchasing power for every dollar you had a year ago. In other words, thanks to the inflation and tax holes in your investment bucket, you can buy less with your money now versus what you could have a year ago, even though you've invested your money for a year.

Money market mutual funds are another type of cash equivalent. Investors, both large and small, invest hundreds of billions of dollars in money market mutual funds because the best money market funds produce higher yields than bank savings accounts. The yield advantage of a money market fund almost always widens when interest rates increase because banks move about as fast as molasses on a cold winter day to raise savings account rates.

Why shouldn't you take advantage of an extra 1 or 2 percent yield? Many bank savers sacrifice this yield because they think that money market funds are risky — but they're not. Money market mutual funds generally invest in ultra-safe things such as short-term bank certificates of deposit, U.S. government-issued Treasury bills, and commercial paper (short-term bonds) that the most creditworthy corporations issue.

Another reason people keep too much money in traditional bank accounts is that the local bank branch office makes the cash seem more accessible. Money market mutual funds, however, offer many quick ways to get your cash. You can write a check (most funds stipulate the check must be for at least $250) or call the fund and request that it mail or wire you money.

By all means, keep your checking account at the local bank so that you can write smaller checks to pay your cable television, phone, and utility bills. Having local access to an ATM for fast cash withdrawals is also a plus. But move that extra money that's dozing away in your bank savings account, for example, into a higher-yielding money market mutual fund! Even if you have just a few thousand dollars, the extra yield more than pays for the cost of this book. If you're in a high tax bracket, you can also use tax-free money market funds. (See Chapter 8 to find out more about money market funds.)

Steering clear of futures and options

Suppose you think that IBM's stock is a good investment. The direction that the management team is taking impresses you, and you like the products and services that the company offers. Profits seem to be on a positive trend; everything's looking up.

You can go out and buy the stock — suppose that it's currently trading at around \$100 per share. If the price rises to \$150 in the next six months, you've made yourself a 50 percent profit (\$150 – \$100 = \$50) on your original \$100 investment. (Of course, you have to pay some brokerage fees to buy and then sell the stock.)

But instead of buying the stock outright, you can buy what are known as call options on IBM. A *call option* gives you the right to buy shares of IBM under specified terms from the person who sells you the call option. You may be able to purchase a call option that allows you to exercise your right to buy IBM stock at, say, \$120 per share in the next six months. For this privilege, you may pay \$10 per share.

If IBM's stock price skyrockets to, say, \$150 in the next few months, the value of your options that allow you to buy the stock at \$120 will be worth a lot — at least \$30. You can then simply sell your options, which you bought for \$10 in this example, at a huge profit — you've tripled your money.

Although this talk of fat profits sounds much more exciting than simply buying the stock directly and making far less money from a stock price increase, options have two big problems:

- If IBM's stock price goes nowhere or rises only a little during the six-month period when you hold the call option, the option expires as worthless, and you lose all — that is, 100 percent — of your investment. In fact, in my example, if IBM's stock trades at \$120 or less at the time the option expires, the option is worthless.
- A call option represents a short-term *gamble* (in this example, over the next six months) on IBM's stock price — not an *investment* in IBM. IBM could expand its business and profits greatly in the years and decades

> ahead, but the value of the call option hinges on the ups and downs of IBM's stock price over a relatively short period of time. If the stock market happens to dip in the next six months, IBM may get pulled down as well, despite the company's improving financial health.

Futures are similar to options in that both can be used as gambling instruments. Futures deal mainly with the value of commodities such as heating oil, corn, wheat, gold, silver, and pork bellies. Futures have a delivery date that's in the not-too-distant future. (Do you really want bushels of wheat delivered to your home? Or worse yet, pork bellies?) You can place a small down payment — around 10 percent — toward the purchase of futures, thereby greatly leveraging your "investment." If prices fall, you need to put up more money to keep from having your position sold.

My advice: Don't gamble with futures and options.

TECHNICAL STUFF

The only real use that you may (if ever) have for these *derivatives* (so called because their value is "derived" from the price of other securities) is to hedge. Suppose that you hold a lot of a stock that has greatly appreciated, and you don't want to sell now because of the tax bite. Perhaps you want to postpone selling the stock until next year because you plan on not working, or you can then benefit from the lower, long-term capital gains tax rate. You can buy what's called a *put option,* which increases in value when a stock's price falls (because the put option grants you the right to sell your stock to the purchaser of the put option at a preset stock price). Thus, if the stock price does fall, the rising put option value offsets some of your losses on the stock you still hold. Using put options allows you to postpone selling your stock without exposing yourself to the risk of a falling stock price.

Passing on precious metals

Over the millennia, gold and silver have served as mediums of exchange or currency because they have intrinsic value and can't be debased the way that paper currencies can (by printing more money). These precious metals are used in jewelry and manufacturing.

As investments, gold and silver perform well during bouts of inflation. For example, from 1972 to 1980, when inflation zoomed into the double-digit range in the United States and stocks and bonds went into the tank, gold and silver prices skyrocketed more than 500 percent.

WARNING!

Generally over the long term, however, precious metals are lousy investments. They don't pay any dividends, and their price increases generally just keep you up with, but not ahead of, increases in the cost of living. Although investing in precious metals is better than keeping cash in a piggy bank or stuffing it in a mattress, the investment returns aren't nearly as good as bonds, stocks, and real estate.

Counting out collectibles

The term "collectibles" is a catchall category for antiques, art, autographs, baseball cards, clocks, coins, comic books, diamonds, dolls, gems, photographs, rare books, rugs, stamps, vintage wine, writing utensils, and a whole host of other items. Although connoisseurs of fine art, antiques, and vintage wine wouldn't like the comparison of their pastime with buying old playing cards or chamber pots, the bottom line is that collectibles are all objects with little intrinsic value. Wine is just a bunch of old mushed-up grapes. A painting is simply a canvas and some paint that at retail would set you back a few bucks. Stamps are small pieces of paper, less than an inch square. Baseball cards — heck, my childhood friends and I used to stick these between our bike spokes!

I'm not trying to diminish contributions that artists and others make to our culture. And I know that some people place a high value on some of these collectibles. But true investments that can make your money grow, such as stocks, real estate, or a small business, are assets that can produce income and profits. Collectibles have little intrinsic value and are thus subject to the whims and speculations of buyers and sellers.

Here are some other major problems with collectibles:

- **Markups are huge.** The spread between the price that a dealer pays for an object and then sells the same exact object for is often around 100 percent. Sometimes the difference is even greater, particularly if a dealer is the second or third middleman in the chain of purchase. So at a minimum, your purchase must typically double in value just to get you back to even. And that may take 10 to 20 years or more!
- **Lots of other costs add up.** If the markups aren't bad enough, with some collectibles you incur all sorts of other costs. If you buy more expensive pieces, you may need to have them appraised. You may have to pay storage and insurance costs as well. And unlike the markup, you pay some of these fees year after year after year of ownership.
- **You can get stuck with a pig in a poke.** Sometimes, you may overpay even more for a collectible because you don't realize some imperfection or inferiority of an item. Worse, you may buy a forgery. Even reputable dealers have been duped by forgeries.
- **Your pride and joy can deteriorate over time.** Damage from sunlight, humidity, temperatures that are too high or too low, and a whole host of vagaries can ruin the quality of your collectible. Insurance doesn't cover this type of damage or negligence on your part.

- **The returns stink.** Even if you ignore the substantial costs of buying, holding, and selling, the average returns that investors earn from collectibles rarely keep ahead of inflation and are generally inferior to stock market, real estate, and small business investing. Objective collectible return data are hard to come by. Never, ever trust "data" that dealers or the many collectible trade publications provide.

The best returns that collectible investors reap come from the ability to identify, years in advance, items that will *become* popular. Do you think you can do that? You may be the smartest person in the world, but you should know that most dealers can't tell what's going to rocket to popularity in the coming decades. Dealers make their profits the same way as other retailers, from the spread or markup on the merchandise that they sell. The public and collectors have fickle, quirky tastes that no one can predict. Did you know that Beanie Babies, Furbies, Pet Rocks, or Cabbage Patch Kids were going to be such hits?

You can find out enough about a specific type of collectible to become a better investor than the average person, but you're going to have to be among the best — perhaps the top 10 percent of such collectors — to have a shot at earning decent returns. To get to this level of expertise, you need to invest hundreds if not thousands of hours reading, researching, and educating yourself about your specific type of collectible.

Nothing is wrong with *spending* money on collectibles, but I don't want you to fool yourself into thinking that they're investments. You can sink lots of your money into these non-income-producing, poor-return "investments." At their best as investments, collectibles give the wealthy a way to buy quality stuff that doesn't depreciate.

TIP

If you must buy collectibles, here are some tips to keep in mind:

- Collect for your love of the collectible, your desire to enjoy it, or your interest in finding out about or mastering a subject, not because you expect high investment returns, because you probably won't get them.
- Keep quality items that you and your family have purchased and hope that someday they're worth something. Keeping these quality items is the simplest way to break into the collectible business. The complete sets of baseball cards I gathered as a youngster are now (30-plus years later) worth hundreds of dollars to, in one case, $1,000!
- Buy from the source and cut out the middlemen whenever possible. In some cases, you may be able to buy from the artist. (My brother purchases most of his pottery directly from artists.)

- Check collectibles that are comparable to the one you have your eye on, shop around, and don't be afraid to negotiate. An effective way to negotiate, after you decide what you like, is to make your offer to the dealer or artist by phone. Because the seller isn't standing right next to you, you don't feel pressure to decide immediately.
- Ask the dealer who thinks that the item is such a great investment for a written guarantee to buy back the item from you, if you opt to sell, for at least the same price you paid or higher within five years.
- Use a comprehensive resource to research, buy, sell, maintain, and improve your collectible, such as the books by Ralph and Terry Kovel or their Web site at www.kovels.com.