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Chapter **1**

Making Sense of Your Investing Options

So many subject areas and disciplines are packed full of jargon. Some of this is the result of “progress” and advances, and some of it is caused by workers in the field not going out of their way to explain and define things.

In this chapter, I give you the lay of the land regarding the enormous numbers of investment choices and foreign-sounding terminology that await you in the world of investing. I also explain the types of companies that offer investments and their strengths and weaknesses. And should you want to hire some investing help, I detail the various professionals pitching their services to you and the common credentials they hawk to convince you of their expertise.

Growing Your Money in Ownership Investments

The most exciting thing about investing during your younger adult years is that you can be more aggressive with money that you’ve earmarked to help you accomplish long-term goals. To achieve typical longer-term financial goals, such as

being financially independent (also known as retiring), the money that you save and invest generally needs to grow at a rate much faster than the rate of inflation. If you put your money in a bank account that pays little or no interest, for example, you're more likely to fall short of your goals.

Ownership investments are investments like stocks, where you own a piece of a company, real estate, or a small business that has the capability to generate revenue and profits. Over the long term, consider ownership investments if you want your money to grow much faster than the rate of inflation and don't mind more volatility in your investments' values.

The downside to such investments is that they can fall more significantly in value than *non-ownership investments* (for example, bank accounts, bonds, and so on), especially in the short term. So don't put money into ownership investments that you may need to tap in the short term for rent money or your next vacation. To reduce the risk of ownership investments, *diversify* — that is, hold different types of ownership investments that don't move in tandem.

I highlight three major ownership investments in the following sections: stocks, real estate, and small business.

Sharing in corporate growth and profits: Stocks

If you want the potential to share in the growth and profits of companies, you can gain it through buying shares of their stock. Stocks are shares of ownership in a company. You can buy stock directly in individual companies through a brokerage account, or you can buy a collection of stocks via a mutual fund or exchange-traded fund (see Chapter 10).

If you've followed the financial markets at all over some time or have friends or family who have spoken to you about this, you may have heard of companies/stocks like Amazon, Apple, Chipotle, McDonald's, Microsoft, Netflix, Ross Stores, Tesla, Ulta Beauty, and so on. Those who bought and held stocks like these made big returns over the past decade. Remember, though, that we're saying and seeing this now with the benefit of hindsight — looking in the rearview mirror. And, I'm sure you know that the future will be different than the past, so running out and buying these stocks now is far less likely to make you a mint going forward.

Now, what if I told you I've invested in and made good money in all of these stocks over the past decade? The fact is I have, but I never personally chose any of these particular stocks. I've owned these stocks and numerous other good companies

and their stocks through mutual funds I've invested in. Of course, it's impossible for any fund manager to only have a portfolio of the best winners or winners in general. Some of their stock picks will be mediocre and others worse.



REMEMBER

You don't need to be a business genius to make money in stocks. Stocks in the United States, for example, have returned an average of 9 percent per year over the past two-plus centuries. That may not sound like a high return but at that rate of return, your money will double every eight years! Simply make regular and systematic investments, and invest in proven companies and funds while minimizing your investment expenses and taxes. Of course, there's no guarantee that every stock or stock fund that you buy will increase in value. In Chapter 8, I explain proven and time-tested methods for making money in stocks.

Profiting from real estate

You don't need to be a big shot to make money investing 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. Historically, investment real estate has produced annual returns comparable to investing in stocks.

Among the key attributes of private real estate investment are the following:

- » You build wealth through your rental income exceeding your expenses and through property-value appreciation.
- » You can leverage your investment by borrowing money.
- » You must be comfortable dealing with property management, which includes finding and retaining tenants and keeping up (and possibly improving) your property.

This last point is super important. Buying and managing investment real estate is time intensive. Those whom I've seen succeed investing in real estate actually enjoy the challenge and work involved. And, over time, you can hire people to help you with managing properties if you don't want to spend so much time personally at it.

See Chapter 12 for the details on investing in real estate.

Succeeding in small business

I know people who have hit investing home runs by owning or buying businesses. Most people work full-time at running their businesses, increasing their chances of doing something big financially with them. Investing in the stock market, by contrast, tends to be more part-time in nature.

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. I can speak from firsthand experience (as can other small-business owners) in saying that emotionally and financially, entrepreneurship is a roller coaster.

Besides starting your own company, you can share in the economic rewards of the entrepreneurial world through buying an existing business or investing in someone else's budding enterprise. See Chapter 14 for more details.

Making “riskier” choices: Options, cryptocurrencies, and so on

I know from my many interactions with younger adults these days that there are some more exciting and enticing vehicles such as call options and cryptocurrencies. It's easy to get drawn into such things when you hear a story or two about someone hitting it big.

I'm certainly open to you taking sensible risks, and the fact of the matter is that the highest returning investment vehicles I discuss in this book do indeed carry notable risks. But options and cryptocurrencies carry enormous risks and actually far less upside than what many people believe or realize.

Rest assured that at relevant places in this book, I cover these other types of vehicles (especially in Chapter 15), but please know that these are generally vehicles you should stay away from.

Keeping Money in Lending Investments

In the first section of this chapter, “Growing Your Money in Ownership Investments,” I outline how you can make your dough grow much faster than the cost of living by using stocks, real estate, and small business. However, you may want or need to play it safer when investing money for shorter-term purposes, so you should then consider lending investments. Many people use such investments through local banks, such as in a checking account, savings account, or certificate of deposit. In all these cases with a bank, you're lending your money to the bank.

Another lending investment is bonds. When you purchase a bond that has been issued by the government or a company, you agree to lend your money for a pre-determined period of time and receive a particular rate of interest. A corporate bond may pay you 4 percent interest annually over the next ten 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 a company through one of its bonds that matures in, say, five years, and the firm doubles its revenue and profits over that period, you won't share in its growth. The company's stockholders are likely to reap the rewards of the company's success, but as a bondholder, you don't. You simply get interest and the face value of the bond back at maturity.

Similar to bank savings accounts, money market mutual funds are another type of lending investment. 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 credit-worthy corporations issue.



WARNING

Many people keep too much of their money in lending investments, thus allowing others to enjoy the rewards of economic growth. Although lending investments appear safer because you know in advance what return you'll receive, they aren't that safe. The long-term risk of these seemingly safe money investments is that your money will grow too slowly (perhaps not even keeping you ahead of or even with the rate of inflation) 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 fail to repay your loan.

Understanding Risks and Returns

Who among us wants to lose money? Of course you don't! You put your money into an investment in the hope and expectation that you will get back more in total than you put in. And you'd rather your chosen investments not fluctuate too widely in value. When it comes to investing, no concepts are more important to grasp than *risk* and *return*, which I explain in this section.

Realizing risks

The investments that you expect to produce higher returns (such as stocks) fluctuate more in value, particularly in the short term. However, if you attempt to avoid all the risks involved in investing, you probably won't succeed, and you

likely won't be happy with your investment results and lifestyle. In the investment world, some people don't go near stocks or real estate that they perceive to be volatile, for example. As a result, such investors often end up with lousy long-term returns and expose themselves to some high risks that they overlooked, such as the risk of inflation and taxes eroding the purchasing power of their money.

You can't live without taking risks. Risk-free activities or ways of living don't exist. You can sensibly minimize risks, but you can never eliminate them. Some methods of risk reduction aren't palatable because they reduce your quality of life.

Risks are also composed of several factors. Following are the major types of investment risks and a few of the methods you can use to reduce these risks while not missing out on the upside that investments offer:



WARNING

» **Market-value risk:** Although stocks can help you build wealth, they can also drop 20 percent or more in a relatively short period of time. Entering 2020, who was thinking about how a pandemic and the government's response might impact stock prices? Then, in a few weeks, stocks slid more than 30 percent due to government-mandated economic shutdowns. Although real estate, like stocks, has been a rewarding long-term investment, various real estate markets get clobbered from time to time.

» **Individual-investment risk:** A down market can put an entire investment market on a roller-coaster ride, but healthy markets also have their share of individual losers. Just as individual stock prices can plummet, so can individual real estate property prices.

With lending investments, you have a claim on a specific amount of a currency. Occasionally, currencies falter. Most folks ignore this low frequency but very high impact risk when thinking about lending investments.

» **Purchasing-power risk:** *Inflation* — which is an increase in the cost of living — can erode the value of your money and its *purchasing power* (what you can buy with that money). I often see skittish investors keep their money in bonds and money market accounts, thinking that they're playing it safe. The risk in this strategy is that your money won't grow enough over the years for you to accomplish your financial goals. In other words, the lower the return you earn, the more you need to save to reach a financial goal. As a younger investor with so many years and decades of investing in your future, you need to pay the most attention to the risk of generating low returns.

» **Liquidity risk:** Some investments are more *liquid* (how quickly an investment can be converted to cash) than others and more readily sold at fair market value on short notice. Bank savings accounts have no real liquidity risk. A real estate investment, by contrast, takes time and money to sell, and if you must sell most real estate quickly, you'll likely get a fair amount less than its current full market value.

- » **Career risk:** In your 20s and 30s, your ability to earn money is probably your biggest asset. Education is a lifelong process. If you don't periodically invest in your education, you risk losing your competitive edge. Your skills and perspectives can become dated and obsolete. Although that doesn't mean you should work 80 hours a week and never do anything fun, it does mean that part of your "work" time should involve upgrading your skills.

Managing risks

Throughout this book as I discuss various investments, I explain how to get the most out of each one. Because I've introduced the important issue of risk in this chapter, I would be remiss if I also didn't give you some early ideas about how to minimize those risks. Here are some simple steps you can take to lower the risk of investments that can upset the achievement of your goals:

- » **Do your homework.** When you purchase real estate, various inspections, for example, can save you from buying a money pit. With stocks, you can examine some measures of value and the company's financial condition and business strategy to reduce your chances of buying into an overpriced company or one on the verge of major problems.

- » **Diversify.** Placing significant amounts of your capital in one or a handful of securities is risky, particularly if the stocks are in the same industry or closely related industries. To reduce this risk, purchase stocks in a variety of industries and companies within each industry. Even better is buying diversified mutual funds and exchange-traded funds. Diversifying your investments can involve more than just your stock portfolio. You can also hold some real estate investments to diversify your investment portfolio.



TIP

If you worry about the health of the U.S. economy, the government, and the dollar, you can reduce your overall investment risk by also investing overseas so that you have a globally diversified portfolio of stocks. Most large U.S. companies do business overseas, so when you invest in larger U.S. company stocks, you get some international investment exposure. You can also invest in international company stocks, ideally through funds.

- » **Minimize holdings in costly markets.** Although I don't believe that most investors can time the markets — buy low, sell high — spotting a greatly overpriced market isn't too difficult. You should avoid overpriced investments because when they fall, they usually fall farther and faster than more fairly priced investments. Also, you should be able to find other investments that offer higher potential returns. Throughout this book, I explain some simple yet powerful methods you can use to measure whether a particular investment market is of fair value, of good value, or overpriced.

» **View market declines in a different light.** Instead of seeing declines and market corrections as horrible things, view them as potential opportunities or “sales.” If you pass up the stock and real estate markets simply because of the potential market-value risk, you miss out on a historic, time-tested method of building substantial wealth. Try not to give in to the human emotions that often scare people away from buying something that others seem to be shunning.

Making sense of returns

Each investment has its own mix of associated risks that you take when you part with your investment dollar and, likewise, offers a different potential rate of return. When you make investments, you have the potential to make money in a variety of ways.

To determine how much money you’ve made or lost on your investment, you calculate the total return. To come up with this figure, you determine how much money you originally invested and then factor in the other components, such as interest, dividends, and appreciation or depreciation.

If you’ve ever had money in a bank account that pays interest, you know that the bank pays you a small amount of interest in exchange for your allowing the bank to keep your money. The bank then turns around and lends your money to some other person or organization at a much higher rate of interest. The rate of interest is also known as the *yield*. So if a bank tells you that its savings account pays 1.5 percent interest, the bank may also say that the account yields 1.5 percent. Banks usually quote interest rates or yields on an annual basis. Interest that you receive is one component of the return you receive on your investment.

If a bank pays monthly interest, the bank also likely quotes a compounded effective annual yield. After the first month’s interest is credited to your account, that interest starts earning interest as well. So the bank may say that the account pays 1.5 percent, which compounds to an effective annual yield of 1.53 percent.

When you lend your money directly to a company — which is what you do when you invest in a bond that a corporation issues — you also receive interest. Bonds, as well as stocks (which are shares of ownership in a company), fluctuate in market value after they’re issued.

When you invest in a company’s stock, you hope that the stock increases (appreciates) in value. Of course, a stock can also decline, or depreciate, in value. This change in market value is part of your return from a stock or bond investment.

Stocks can also pay dividends, which are the company's way of sharing some of its profits with you as a stockholder and thus are part of your return. Some companies, particularly those that are small or growing rapidly, choose to reinvest all their profits back into the company.



REMEMBER

Unless you held your investments in a tax-sheltered retirement account, you owe taxes on your return. Specifically, the dividends and investment appreciation that you realize upon selling are taxed, although often at relatively low rates. The tax rates on so-called long-term capital gains and stock dividends are currently and historically lower than the tax rates on other income. I discuss the different tax rates that affect your investments and explain how to make tax-wise investment decisions that fit with your overall personal financial situation and goals in Chapter 4.

Where to Invest and Get Advice

Discussing the companies through which you can invest and where to get investing advice may seem out of place to you if you started reading this book from the beginning. But I'm doing this because I strongly believe that you should begin to think about and understand the lay of the land in these important areas so you can make the best choices.

Selecting the firm or firms through which to do your investing is a hugely important decision. So is the decision about from whom to get or pay for investing advice. In this section, I address both of these topics.

Finding the best fund companies and brokers

Insurance companies, banks, investment brokerage firms, mutual funds — the list of companies that stand ready to help you invest your money is nearly endless. Most people stumble into a relationship with an investment firm. They may choose a company because their employer uses it for company retirement plans or they've read about or been referred to a particular company. Maybe one of your parents or another relative recommended or got you started with a particular investment company.

When you invest in certain securities — such as stocks and bonds and exchange-traded funds (ETFs) — and when you want to hold mutual funds from different companies in a single account, you need brokerage services. Brokers execute your trades to buy or sell stocks, bonds, and other securities and enable you to

centralize your holdings of mutual funds, ETFs, and other investments. Your broker can also assist you with other services that may interest you.

Deciding which investment company is best for you depends on your needs and wants. In addition to fees, consider how important having a local branch office is to you. If you want to invest in mutual funds, you'll want to choose a firm that offers access to good funds, including money market funds in which you can deposit money awaiting investment or proceeds from a sale.



TIP

For the lowest trading commissions, you generally must place your trades online. But you should be careful. A low brokerage fee of, say, \$7 or \$10 per trade doesn't really save you money if you trade a lot and rack up significant total commissions. (As you may know, some brokers are offering free online trading for stocks and certain other securities, but of course, they have to make this up elsewhere with fees for other needed services and by paying you little to nothing on your cash balances.) Also you pay more in taxes when you trade more frequently and realize shorter-term (one year or less) profits.



WARNING

Trading online is an easy way to act impulsively and emotionally when making important investment decisions. If you're prone to such actions, or if you find yourself tracking and trading investments too closely, stay away from this form of trading and use the internet only to check account information and gather factual information. Increasing numbers of brokers offer account information and trading capabilities via apps, which, of course, can also promote addictive investment behaviors.

Please see Chapter 9 for more details on selecting the best investment brokerage firms and my top investment firm selections that offer mutual funds and ETFs and/or brokerage services.

Finding an acceptable advisor

I would always counsel folks who took personal finance courses I taught or who contacted me seeking advice to get educated before engaging the services of any financial advisor. How can you possibly evaluate the competence of someone you may hire if you yourself are financially clueless? You've got this book, so read it before you consider hiring someone for financial advice.

By taking the themes and major concepts of this book to heart, you greatly minimize your chances of making significant investment blunders, including hiring an incompetent or unethical advisor. You may be tempted, for example, to retain the services of an advisor who claims that he and his firm can predict the future economic environment and position your portfolio to take advantage. But you find in reading this book that financial advisors don't have crystal balls and that you

should steer clear of folks who purport to be able to jump into and out of investments based upon their forecasts.



WARNING

Finding a competent and objective financial advisor isn't easy. Historically, most financial consultants work on commission, and the promise of that commission can cloud their judgment. Among the minority of fee-based advisors, almost all manage money, which creates other conflicts of interest. The more money you give them to invest and manage, the more money these advisors make. That's why I generally prefer seeking financial (and tax) advice from advisors who sell their time (on an hourly basis) and don't sell anything else.

Because investment decisions are a critical part of financial planning, take note of the fact that the most common designations of educational training among professional money managers are MBA (master of business administration) and CFA (chartered financial analyst). Financial planners often have the CFP (certified financial planner) credential, and some tax advisors who work on an hourly basis have the PFS (personal financial specialist) credential.



INVESTIGATE

Advisors who provide investment advice and oversee at least \$100 million must register with the U.S. Securities and Exchange Commission (SEC); otherwise, they generally register with the state that they make their principal place of business. They must file Form ADV, otherwise known as the Uniform Application for Investment Adviser Registration. This lengthy document asks investment advisors to provide in a uniform format such details as a breakdown of where their income comes from, their education and employment history, the types of securities the advisory firm recommends, and the advisor's fee schedule.

You can ask the advisor to send you a copy of his Form ADV. You can also find out whether the advisor is registered and whether he has a track record of problems by calling the SEC at 800-732-0330 or by visiting its website at www.adviserinfo.sec.gov. Many states require the registration of financial advisors, so you should also contact the department that oversees advisors in your state. Visit the North American Securities Administrators Association's website (www.nasaa.org), and click the Contact Your Regulator link on the home page.

