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Chapter **1**

Making More Money, Taking Less Risk

In my years of work as a financial advisor, educator, and a columnist answering many readers' questions, I've seen the same, avoidable mistakes being made over and over. Often, these investing mistakes occurred for one simple reason: a lack of investment understanding. People didn't know what their investing options were and why particular options were inferior or superior to others.

By reading this book, you can prevent yourself from making investment mistakes. And you can take advantage of an excellent investment vehicle: mutual funds — the best of which offer you diversification, which reduces your risks, and low-cost access to highly diversified portfolios and professional money managers, who can boost your returns with less risk. Funds are a vehicle to help you achieve your financial and personal goals. Mutual funds and exchange-traded funds can fit nicely in the context of your overall financial plans and goals. This chapter gives you an investment overview so you can see how mutual funds and exchange-traded funds fit into the overall investment world.

Introducing Mutual Funds and Exchange-Traded Funds

If you already understand stocks and bonds, their risks and potential returns, and the benefits of diversification, terrific. You can skip/breeze through some of this chapter. Most people, however, don't really comprehend investment basics, which is one of the major reasons people make investment mistakes in the first place.

After you understand the specific types of securities (stocks, bonds, and so on) that funds can invest in, you've mastered one of the important building blocks to understanding mutual funds and exchange-traded funds. A *mutual fund* is a vehicle that holds other investments: When you invest in a mutual fund, you're contributing to a big pool of money that a mutual fund manager uses to buy other investments, such as stocks, bonds, and/or other assets that meet the fund's investment objectives.

Exchange-traded funds (ETFs) are a very close relative of mutual funds and differ from them in one particular way. ETFs trade like stocks on a stock exchange and thus can be bought or sold during the trading day when the financial markets are open. (In Chapter 2, I explain one exception to this rule. A type of mutual fund, known as a closed-end fund, which accounts for a mere 1 percent of mutual fund assets, trades on a stock exchange during the trading day and has a fixed number of shares outstanding.)

Differences in investment objectives are how funds broadly categorize themselves, like the way an automaker labels a car a *sedan* or a *sport utility vehicle*. This label helps you, the buyer, have a general picture of the product even before you see the specifics. On the dealer's lot, the salespeople take for granted that you know what *sedan* and *sport utility vehicle* mean. But what if the salesperson asks you whether you want a Pegasus or a Stegosaurus? If you don't know what those names mean, how can you decide?

Fund terms, such as *municipal bond fund* or *small-cap stock fund*, are thrown around casually. Fact is, thanks to our spending-oriented culture, too many folks know car models better than types of funds! In this chapter (and in Chapter 2), I explain the investment and fund terms and concepts that many writers assume you already know (or perhaps that they don't understand well enough themselves to explain to you). But don't take the plunge into funds until you determine your overall financial needs and goals.

Making Sense of Investments

Your eyes can perceive dozens of different colors, and hundreds, if not thousands, of shades in between. In fact, you can see so many colors that you can easily forget what you discovered back in your early school days — that all colors are based on some combination of the three primary colors: red, blue, and yellow. Well, believe it or not, the world of investments is even simpler than that. The seemingly infinite number of investments out there is based on just two primary kinds of investments: lending investments and ownership investments.

Lending investments: Interest on your money

Lending is a type of investment in which the lender charges the borrower a fee (generally known as *interest*) until the original loan (typically known as the *principal*) gets paid back. Familiar lending investments include bank certificates of deposit (CDs), United States (U.S.) Treasury bills, and bonds issued by corporations, such as Chipotle.

In each case, you're lending your money to an organization — the bank, the federal government, or a company — that pays you an agreed-upon rate of interest. You're also promised that your principal (the original amount that you loaned) will be returned to you in full on a specific date.

The best thing that can happen with a lending investment is that you're paid all the interest in addition to your original investment, as promised. Although getting your original investment back with the promised interest won't make you rich, this result isn't bad, given that the investment landscape is littered with the carcasses of failed investments that return you nothing — including lunch money loans that you never see repaid!



WARNING

Lending investments have several drawbacks:

- » **You may not get everything you were promised.** Under extenuating circumstances, promises get broken. When a company goes bankrupt (remember Bear Stearns, Enron, Lehman, Sears, WorldCom, and so on), for example, you can lose all or part of your original investment (from purchased bonds).
- » **You get what you were promised, but because of the ravages of inflation, your money is simply worth less than you expected it to be worth.** Your money has less purchasing power than you thought it would. Suppose that you put \$5,000 into an 18-year lending investment that yielded 4 percent.

You planned to use it in 18 years to pay for one year of college. Although a year of college cost \$5,000 when you invested the money, college costs rose 8 percent a year; so in 18 years when you needed the money, one year of college cost nearly \$20,000. But your investment, yielding just 4 percent, would be worth only around \$10,100 — nearly 50 percent short of the cost of college because the cost of college rose faster than did the value of your investment.

- » **You don't share in the success of the organization to which you lend your money.** If the company doubles or triples in size and profits, the growth is good for the company and its owners. As a bondholder (lender), you're sure to get your interest and principal back, but you don't reap any of the rewards. If Elon Musk had approached you years ago for money for his then new company Tesla, would you rather have loaned him the money or *owned* a piece of his company?

Ownership investments: More potential profit (and risk)

You're an *owner* when you purchase an asset, whether a building or part of a multinational corporation, that has the ability to generate earnings or profits. Real estate and stock are common ownership investments.



REMEMBER

Ownership investments can generate profits in two ways:

- » **Through the investment's own cash flow/income:** For example, as the owner of a duplex, you receive rental income from tenants. If you own stock in a corporation, many companies elect to pay out a portion of their annual profits (in the form of a *dividend*).
- » **Through appreciation in the value of the investment:** When you own a piece of real estate in an economically vibrant area or you own stock in a growing company, your investment should increase in value over time. If and when you sell the investment, the difference between what you sold it for and what you paid for it is your (pre-tax) *profit*. (The IRS, of course, will eventually expect its share of your investment profits.) This potential for appreciation is the big advantage of being an owner versus a lender.

On the downside, ownership investments may come with extra responsibilities. If the furnace goes out or the plumbing springs a leak, you, as the property owner, are the one who must fix and pay for it while your tenant gets to kick back in their recliner watching football games and eating nachos. And you're the one who must pay for insurance to protect yourself against risks, such as fire damage or accidents that occur on your property.

Moreover, where the potential for appreciation exists, the potential for *depreciation* also exists. Ownership investments can decline in value as we saw happen in the early 2000s, late 2000s, and in early 2020. Real estate markets can slump, stock markets can plummet, and individual companies can go belly up. For this reason, ownership investments tend to be riskier than lending investments.

Surveying the Major Investment Options

When you understand that fundamentally two major kinds of investments — ownership and lending — exist, you can more easily understand how a specific investment works . . . and whether it's an attractive choice to help you achieve your specific goals.

Which investment vehicle you choose for a specific goal depends on where you're going, how fast you want to get there, and what risks you're willing to take. Here's an inventory of investment vehicles to choose from, along with my thoughts on which vehicle would be a good choice for your situation.

Savings and money market accounts

You can find savings and money market accounts at banks; money market funds are available through mutual fund companies. All are lending investments based on short-term loans and are about the safest in terms of short-term risk to your investment among the various lending investments around. Relative to the typical long-term returns on growth-oriented investments, such as stocks, the interest rate (also known as the *yield*) paid on savings and money market accounts is low but doesn't fluctuate as much over time. (The interest rate on savings and money market accounts generally fluctuates as the level of overall market interest rates changes.)

Bank savings accounts are backed by an independent agency of the federal government through Federal Deposit Insurance Corporation (FDIC) insurance. If the bank goes broke, you still get your money back (up to \$250,000 per depositor, per insured bank). Money market funds, however, aren't insured.



TIP

Should you prefer a bank account because your investment (principal) is insured? No. Savings accounts and money market funds have essentially equivalent safety, but money market funds tend to offer higher yields. Chapter 11 provides more background on money market funds.

Bonds

Bonds are the most common lending investment traded on securities markets. Bond funds also account for about 20 percent of all mutual fund assets and about 15 percent of all exchange-traded funds. When issued, a bond includes a specified *maturity date* — the date when your principal is repaid. Also specified when a bond is issued is the interest rate, which is typically *fixed* (meaning it doesn't change over time).

Bonds, therefore, can fluctuate in value with changes in interest rates. If, for example, you're holding a bond issued at 2 percent and the market level of interest rates increases to 4 percent for newly issued similar bonds, your bond will decrease in value. Why would anyone want to buy your bond at the price you paid if it yields just 2 percent when they can get a similar bond yielding 4 percent somewhere else? (See Chapter 12 for more information.)

Bonds differ from each other in the following ways:

- » **The type of institution to which you're lending your money:** Institutions include state and local governments (municipal bonds), the federal government (Treasury), mortgage holders (the Government National Mortgage Association, or GNMA), and corporations (corporate bonds). Foreign governments or corporations can also issue bonds. The taxability of the interest paid by a bond is tied to the type of entity issuing the bond. Corporate, mortgage, and foreign government bond interest is fully taxable. Interest on government bonds issued by U.S. entities is usually free of state and/or federal income tax.
- » **The credit quality of the borrower to whom you lend your money:** The probability that a borrower will pay you the interest and return your entire principal on schedule varies from institution to institution. Bonds issued by less-creditworthy institutions tend to pay higher yields to compensate investors for the greater risk that the loan will not be fully repaid.
- » **The length of maturity of the bond:** Short-term bonds mature in a few years, intermediate bonds in around 5 to 10 years, and long-term bonds within 30 years. Longer-term bonds generally pay higher yields, but their value is more sensitive to changes in interest rates.

Stocks

Stocks are the most common ownership investment traded on securities markets. They represent shares of ownership in a company. Companies that sell stock to the general public (called *publicly held* companies) include aircraft manufacturers,

automobile manufacturers, banks, computer software producers, ecommerce companies, food manufacturers, hotels, mining companies, oil and gas firms, publishers, restaurant chains, supermarkets, wholesalers, and many types of other (legal) businesses!

When you hold stock in a company, you share in the company's profits in the form of annual dividends (although some companies don't pay dividends) as well as in an increase (you hope) in the stock price if the company grows and makes increasing profits. That's what happens when all is going well. The downside is that if the company's business declines, your stock can plummet or even go to \$0 per share.

Besides occupying different industries, companies also vary in size. In the financial press, you often hear companies referred to by their *market capitalization*, which is the total value of their outstanding stock. This is what the stock market and the investors who participate in it think a company is worth.

You can choose from two very different ways to invest in bonds and stocks. You can purchase individual securities, or you can invest in a portfolio of securities through a mutual fund or exchange-traded fund. I discuss stock funds in Chapter 13 and individual securities (and other alternatives to funds) in Part 2.

Overseas/international investments

Overseas or international investment is a potentially misleading category. The types of overseas investment options, such as stocks and bonds and real estate, aren't fundamentally different from your domestic options. However, international investments are often categorized separately because they come with a different set of risks and rewards.



TIP

Here are some good reasons to invest a portion of your money overseas:

- » **Diversification:** International securities markets don't move in lockstep with U.S. markets, so adding foreign investments to a domestic portfolio generally offers you a smoother ride over the long term.
- » **Growth potential:** When you confine your investing to U.S. securities, you're literally missing a world of opportunities. The majority of investment opportunities are overseas. If you look at the total value of all stocks and bonds outstanding worldwide, the value of U.S. securities is now in the minority (at about 40 percent). The United States isn't the world — and some overseas economies are growing faster.

Some people hesitate to invest in overseas securities because they feel that doing so hurts the U.S. economy and contributes to a loss of U.S. jobs. Fair enough. But I have two counterarguments:

- » If you don't profit from the growth of economies and companies overseas, someone else will. If money is to be made there, Americans may as well make some of it.
- » The United States already participates in a global economy — making a distinction between U.S. companies and foreign companies is no longer appropriate. Many companies headquartered in the United States also have overseas operations. Some U.S. firms derive a large portion of their revenue and profits from their international divisions. Conversely, many firms based overseas also have operations in the United States. Increasing numbers of companies are worldwide operations.



Dividends and stock price appreciation recognize no national boundaries! You aren't unpatriotic if you invest globally. Profits from a foreign company are distributed to all stockholders, no matter where they live.

Real estate

Perhaps the most fundamental of ownership investments, real estate has made many people wealthy. Not only does real estate produce consistently good rates of return (averaging around 8 to 9 percent per year) over long investment periods, but you can also purchase it with borrowed money. This leverage helps enhance your rate of return when real estate prices are rising.

As with other ownership investments, the value of real estate depends on the health and performance of the economy, as well as on the specifics of the property that you own:

- » If the local economy grows and more jobs are being produced at higher wages, real estate should do well.
- » If companies in the community are laying off people and excess housing is sitting vacant because of previous overbuilding, rents and property values are likely to fall.



For investors who have time, patience, and capital, real estate can make sense as part of an investment portfolio — check out *Real Estate Investing For Dummies* (Wiley), which I coauthored with Robert Griswold. If you don't want the headaches that come with purchasing and maintaining a real estate property, you can buy mutual funds and exchange-traded funds that invest in real estate properties and related companies (see Chapter 14).

Gold, silver, currencies, and the like

Whenever bad things happen, especially inflation, credit crises, and international conflicts, some investors seek out gold, silver, and other precious metals. Over the short term, these commodities may produce hefty returns, but their long-term record is more problematic. Over the very long-term, gold has kept investors just up with the rate of inflation — eking out an annualized return that is 0.5 percent per year above the rate of inflation. See Chapter 14 for all the details and how you can diversify your portfolio by using specialty funds investing in this sector.

With the proliferation of cryptocurrencies, I must briefly discuss investing in currencies. There are very few funds that invest in currencies, and they all have pretty dismal or, at best, mediocre long-term track records. This makes sense because currencies — which are essentially keeping your money in cash — are poor investments. Over the long term, for example, the purchasing power of holding the U.S. dollar declines at a rate of about 1.5 percent per year.

Will cryptocurrencies be any different? By financial market standards, their track record is quite short. Believers point to the crazy price increases enjoyed by select cryptocurrencies (such as Bitcoin and Ethereum) in the marketplace of now more than 17,500 cryptocurrencies, and more are coming quickly.

The explosion of cryptocurrencies is in itself revealing. Crypto creators come up with an idea for how to promote a new crypto, and by getting in on the ground floor, they hope to reap large profits if others buy in and hopefully drive up the price.

Annuities

Annuities are investment products with some tax and insurance twists. They behave like savings accounts, except that they should give you slightly higher yields, and insurance companies back them. As with other types of retirement accounts, the money you put into an annuity compounds without taxation until withdrawal. However, unlike most other types of retirement accounts — 401(k)s, SEP-IRAs — an annuity gives you no upfront tax deductions for your contributions.

Annuities also charge relatively high fees. That's why it makes sense to consider contributing to an annuity *after* you fully fund the tax-deductible retirement accounts that are available to you. The best annuities available today are distributed by *no-load* (commission-free; see Chapter 7 for more on load and no-load funds) fund companies. For more information about the best annuities and situations for which annuities may be appropriate, be sure to read Chapter 15.

Life insurance

Some insurance agents love to sell cash-value life insurance. That's because these policies — usually known as *universal*, *whole*, or *variable life* policies — combine life insurance protection with an account that has a cash value. They generate big commissions for the agents who sell them.



WARNING

Cash-value life insurance isn't a good investment vehicle. First, you should be saving and investing through tax-deductible retirement savings plans, such as 401(k)s, SEP-IRAs, and IRAs. Contributions to a cash-value life insurance plan provide you *no* upfront tax benefit. Second, you can earn better investment returns through efficiently managed funds that you invest in outside of a life policy.

The only reason to consider cash-value life insurance is that the proceeds paid to your beneficiaries can be free of estate taxes. Especially in light of recent years' tax law changes, you need to have a substantial estate at your death to benefit from this feature. For tax year 2022, the federal estate tax-free limit is \$12.06 million. Married couples can pass along double these estate tax-free amounts (note that states often have lower limits and bypass trusts may be necessary to double these amounts at the state level). And, by giving away money to your heirs while you're still alive, you can protect even more of your nest egg from the federal estate taxes. (Term life insurance is best for the vast majority of people. Consult the latest edition of my book *Personal Finance For Dummies* [Wiley], which has all sorts of good stuff on insurance and other important personal finance issues.)



REMEMBER

Don't fall prey to life insurance agents and their sales pitches. You shouldn't use life insurance as an investment, especially if you haven't exhausted your ability to contribute to retirement accounts. (Even if you've exhausted contributing to retirement accounts, you can do better than cash-value life insurance by choosing tax-friendly funds and/or variable annuities that use mutual funds; see Chapters 11 through 15 for the details.)

Limited partnerships



WARNING

Avoid limited partnerships (LPs) sold directly through brokers and financial planners. They are inferior investment vehicles. That's not to say that no one has ever made money on them, but LPs are so burdened with high sales commissions and investment-depleting management fees that you can do better with other vehicles.

LPs invest in real estate and a variety of businesses. They pitch that you can get in on the ground floor of a new investment opportunity and make big money. Usually, they also tell you that while your investment is growing at 20 percent or more per year, you'll get handsome dividends of 8 percent or so per year. It sounds too good to be true because it is.



WARNING

Many of the yields on LPs have turned out to be bogus. In some cases, partnerships propped up their yields by paying back investors' *principal* (original investment), without telling them, of course. The other hook with LPs is tax benefits. Those few loopholes that did exist in the tax code for LPs have largely been closed. The other problems with LPs overwhelm any small tax advantage, anyway.

The investment salesperson who sells LPs stands to earn a commission of up to 10 percent or more. That means that only 90 cents (or less) per dollar that you put into an LP actually gets invested. Each year, LPs typically siphon off 2 percent or more of your money for management and other expenses. Efficient, no-load mutual funds, in contrast, put 100 percent of your capital to work (thanks to no commissions) and charge 1 percent per year or less in operating fees.

Most LPs have little or no incentive to control costs. In fact, they may have a conflict of interest that leads them to charge more to enrich the managing partners. And, unlike mutual funds and exchange-traded funds, in LPs you can't vote with your feet. If the partnership is poorly run and expensive, you're stuck. That's why LPs are called *illiquid* — you can't withdraw your money until the partnership is liquidated, typically seven to ten years after you buy in. (If you want to sell out to a third party in the interim, you have to sell at a huge discount. Don't bother unless you're totally desperate for cash.)



REMEMBER

The only thing limited about an LP is its ability to make you money. If you want to make investments that earn you healthy returns, stick with stocks (using mutual funds), real estate, or your own business.

Reviewing Important Investing Concepts

If you reviewed the beginning of this chapter, you have the fundamental building blocks of the investing world. Of course, as the title of this book suggests, I focus on a convenient and efficient way to put it all together — mutual funds. But before doing that, this section reviews some key investing concepts that you continually come across as an investor.

Getting a return: Why you invest

An investment's *return* measures how much the investment has grown (or shrunk, as the case may be). Return figures are usually quoted as a rate or percentage that measures how much the investment's value has changed over a specified period of

time. So if an investment has a five-year annualized return of 8 percent, then every year for the past five years that investment, on average, has gotten 8 percent bigger than it was the year before.

So what kind of returns can you expect from different kinds of investments? I say *can* because we're looking at history, and history is a record of the past. Using history to predict the future, especially the near future, is dangerous. History won't exactly repeat itself, not even in the same fashion and not necessarily when you expect it to.



TIP

Over the past century, ownership investments like stocks and real estate returned around 8 to 9 percent per year, handily beating lending investments such as bonds (around 5 percent) and savings accounts (roughly 4 percent) in the investment performance race. Inflation averaged around 3 percent per year, so savings account and bond returns barely kept up with increases in the cost of living. Factoring in the taxes that you must pay on your investment earnings, the returns on lending investments actually didn't keep up with these increases. (For comparisons of various funds' returns, see Chapter 17.)

Measuring risks: Investment volatility

If you read the previous section, you know you should put all your money in stocks and real estate, right? The returns sure look great. So what's the catch?

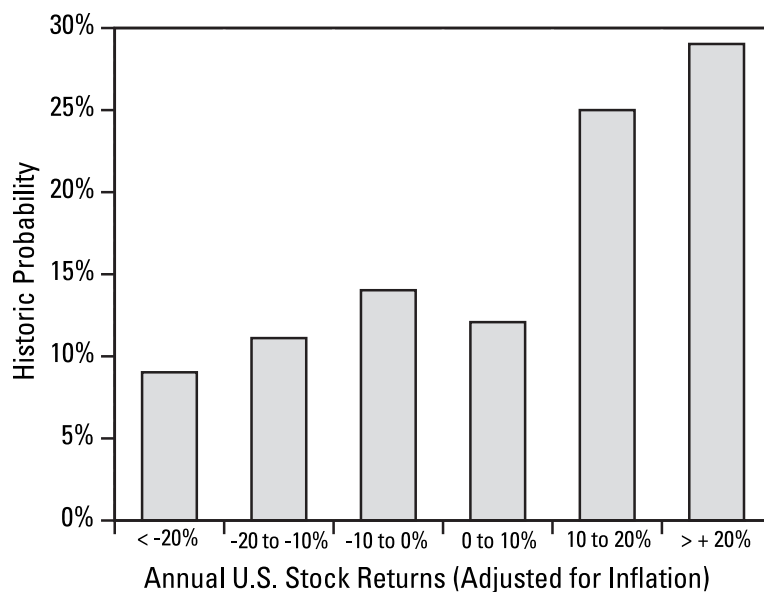


REMEMBER

The greater an investment's potential return, the greater (generally) its risk, particularly in the short term. But the main drawback to ownership investments is *volatility* (the size of the fluctuations in the value of an investment). Last century, for example, stocks declined by more than 10 percent in a year approximately once every five years. Drops in stock prices of more than 20 percent occurred about once every ten years (see Figure 1-1). Thus, to earn those generous long-term stock market returns of about 9 percent per year, you had to tolerate volatility and be able to hold onto the investment for a number of years to wait out sharp, short-term declines. That's why you absolutely should *not* put all your money in the stock market.

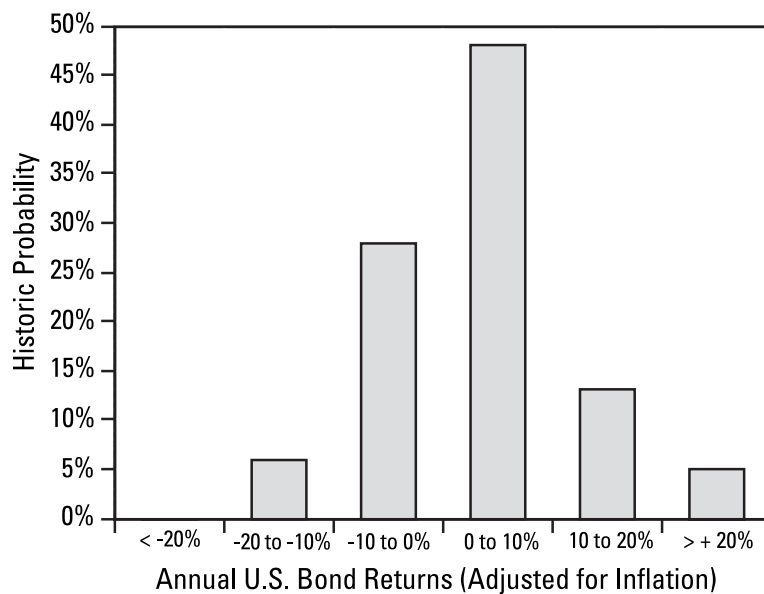
In Figure 1-2, you see bonds that have had fewer years in which they've provided rates of return that were as tremendously negative or positive as stocks. Bonds are less volatile, but, as I discuss in the preceding section, on average you earn a lower rate of return.

FIGURE 1-1:
Historic
probability of
different
U.S. stock
returns.



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FIGURE 1-2:
Historic
probability of
different
U.S. bond
market returns.



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TIP

Some types of bonds have higher yields than others, but nothing is free, either. A bond generally pays you a higher rate of interest as compared with other bonds when it has

- » **Lower credit quality**, which compensates for the higher risk of default and the higher likelihood that you'll lose your investment.
- » **Longer-term maturity**, which compensates for the risk that you'll be unhappy with the bond's interest rate if interest rates move up.
- » **Callability**, which retains an organization's or company's right to buy back (pay off) the issued bonds before the bonds mature.

Companies like to be able to pay off early if they've found a cheaper way to borrow the money. Early payback is a risk to bondholders because they may get their investment money returned to them when interest rates have dropped.

Diversifying: A smart way to reduce risk

Diversification is one of the most powerful investment concepts. It requires you to place your money in different investments with returns that aren't completely correlated. Now for the plain-English translation: With your money in different places, when one of your investments is down in value, the odds are good that at least one other is up.



TIP

To decrease the odds that all your investments will get clobbered at the same time, put your money in different types or classes of investments. The different kinds of investments include money market funds, bonds, stocks, real estate, and precious metals. You can further diversify your investments by investing in international as well as domestic markets.



REMEMBER

You should also diversify within a given class of investments. For example, with stocks, diversify by investing in different types of stocks that perform well under various economic conditions. For this reason, mutual funds and exchange-traded funds, which are diversified portfolios of securities, are highly useful investment vehicles. You buy into funds, which in turn pools your money with that of many others to invest in a vast array of stocks or bonds.

You can look at the benefits of diversification in two ways:

- » Diversification reduces the volatility in the value of your whole portfolio. In other words, when you diversify, you can achieve the same rate of return that a single investment can provide but with reduced fluctuations in value.
- » Diversification allows you to obtain a higher rate of return for a given level of risk.