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Get Yourself Ready

Before doing something risky, you probably think good and hard about what you stand to gain and what you might lose. Surprisingly, many investors, especially those just starting out, lose that innate sense of risk and reward. They chase the biggest possible returns without considering the sleepless nights they'll suffer through as those investments swing up and down. Some start buying investments they've heard that others made money on without thinking about whether those investments are appropriate for them. Worst of all, some fall prey to fraudsters who promise huge returns in get-rich-quick schemes.

So, we've decided to start from the top and make sure that the basics are covered. In this chapter, you discover tips for saving money to use for investing and get a grip on investing lingo. You also find out what kind of investor you are by using online tools that measure your taste for risk. After you've become familiar with your inner investor, you can start thinking about forming an investment plan that won't give you an ulcer.

It's only natural if you're feeling skittish when it comes to investing, especially if you're just starting out. After all, it has been a brutal couple of decades even for veteran investors. Some people think all the chaos is just too much to bear and choose to avoid stocks altogether. That decision is a mistake, though. Prudent investing can be a great way for you to reach your financial goals. You just need an approach that will maximize your returns while cutting your risks.

Turn Yourself into a Big Saver

Investing can help you accomplish some great things. It can help you pay for a child's college tuition, buy the house you've been eyeing, retire in style, or travel to the moon. Okay, maybe not the last one. But you get the idea. Investing helps your money grow faster than inflation. And by investing online, you

can profit even more by reducing the commissions and fees you must pay to different advisors and brokers.



One thing online investing can't do is make something out of nothing. To make money investing online, you have to save money first. Don't get frustrated, though, because you don't need as much to get started as you might fear. If you have a job or source of income, building up ample seed money isn't too hard.

If you want to be an investor, you must find ways to spend less money now so that you can save the excess. That means you must retrain yourself from being a consumer to being an investor. Many beginning investors have trouble getting past this point because being a consumer is so easy. Consumers buy things that they can use and enjoy now, but almost all those objects lose value over time. Cars, electronic gadgets, and clothing are all examples of things consumers "invest" their money in. You don't even have to have money to spend — plenty of credit card companies will gladly loan it to you. Consumers fall into this spending pattern vortex and end up living paycheck to paycheck with nothing left to invest.

Investors, on the other hand, find ways to put off current consumption. Instead of spending money, they invest it into building businesses or goods and services that can earn money, rather than deplete it.



Here are a few things you can do now to help you change from being a consumer to being an investor:

- **Start with what you can manage by putting aside a little each month.**
 - **Keep increasing what you put aside.** If you do it gradually, you won't feel the sting of a suddenly pinched pocket.
 - **Hunt for deals and use coupons and discounts.** Put aside the saved money.
 - **Buy only what you need.** Don't be fooled into buying things you don't need because they're on sale.
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Decide How You Plan to Save

After you've determined how much you need to save and how much you can save, it's time to put your plan into action. The way you do this really depends on how good you are at handling your money and saving. The different methods are as follows:

- **Automatic withdrawals:** Ever heard the cliché "Pay yourself first"? It's a trite saying that actually makes sense. The idea is that before you go shopping for that big-screen TV or start feeling rich after payday, you should set aside money for savings. Some people have

the discipline to do this themselves, but many do not. For the latter group of people, the best option is to set up *automatic withdrawals*, which are a way of giving a brokerage firm or bank permission to automatically extract money once a month. When the money is out of your hands, you won't be tempted to spend it.

- **Retirement plans:** If your goal is investing for retirement, you want to find out what retirement savings plans are available to you. When you're starting to invest, taking advantage of available retirement plans is usually your best bet.
- **On your own:** If you have money left over after paying all your bills, don't let it sit in a savings account. Leaving cash in a low-interest-bearing account is like giving a bank a cheap loan. Put your money to work for you. Brokers make it easy for you to get money to them via electronic transfers.

Learn the Lingo

Just about any profession, hobby, or pursuit has its own lingo. Car fanatics, chess players, and computer hobbyists have terms of art that they seem to learn through osmosis. Investing is no different. You might have heard but not completely understood many terms, such as *stocks* and *bonds*. As you read through this

book and browse the websites we mention, you'll probably periodically stumble on unfamiliar words.

Don't expect a standard dictionary to help much. Investing terms can be so specialized and precise that your dusty ol' dictionary might not be a big help. Fortunately, a number of excellent online investing glossaries explain in detail what investing terms mean. Here are a couple for you to check out:



- **Investopedia** (www.investopedia.com) has one of the most comprehensive databases of investing terms, with thousands of entries. The site not only covers the basics but also explains advanced terms in great detail. It's also fully searchable so you won't waste time getting the answer.
- **Harvey's Hypertextual Finance Glossary** (<http://people.duke.edu/~charvey/Classes/wpg/glossary.htm>) is all about quick answers. The database, written by Campbell Harvey, a professor of finance at Duke University, explains most basic investment terms in one or two sentences.

Gut-Check Time: How Much Risk Can You Take?

It's time to get a grip — a grip on how much you can invest, that is. Most beginning investors are so interested in finding stocks that make them rich overnight that they lose sight of risk. But academic studies show that risk and return go hand in hand. That's why you need to know how much risk you can stomach before you start looking for investments and buying them online.

Several excellent online tools can help you get a handle on how much of a financial thrill seeker you are. Most are structured like interviews that ask you a number of questions and help you decide how much volatility you can comfortably stomach. These interviews are kind of like personality tests for your investment taste. Answering these questionnaires right away will help you understand what kind of investor you are:



- **Vanguard's Investor Questionnaire**

(<https://personal.vanguard.com/us/FundsInvQuestionnaire>) asks ten salient questions to determine how much of a risk taker you are with

your money. It determines your ideal *asset allocation* (a fancy term for an investing road map). Take note of the breakdown. The closer to 100 percent that Vanguard recommends you put in stocks, the more risk-tolerant you are, and the closer to 100 percent in bonds, the less risk-tolerant you are.

- **Index Funds Advisors Risk Capacity Survey** (www.ifa.com/SurveyNET/index.aspx) offers a quick risk survey that can tell you what kind of investor you are after answering just five questions. You can also find a complete risk capacity survey that hits you with a few dozen questions. Whichever you choose, the survey can characterize what kind of investor you are and even display a painting that portrays your risk tolerance.
- **Charles Schwab Investor Profile Questionnaire** (www.schwab.com/resource/investment-questionnaire) gets you to think about the factors that greatly determine how you should be investing, such as your investment time horizon and tolerance for risk. The Schwab questionnaire can be printed so you don't have to be in front of a computer to take it. At the bottom of the questionnaire is a chart that helps you see how aggressive or conservative you should be with your portfolio.



Approach investing like a chef with a recipe in hand. Instead of tossing all sorts of ingredients into your portfolio pot and guessing what it will taste like, it's best to know what needs to go into the pot to get what you want. In investing, this plan is called an *asset allocation*.

An asset allocation might be general and tell you what percentage of holdings to put in stocks, bonds, and cash. But it can also get more detailed and exotic, calling for a dash of large Canadian company stocks, a pinch of international stocks, and just a touch of emerging markets.

Asset allocations are designed to let all the investments in your portfolio blend together into a stew that will be most likely to generate the highest possible return for the lowest amount of risk.



The advantages of creating and sticking with an asset allocation include

- **Diversification:** Hands down, diversification is the biggest advantage of having an asset allocation. An asset allocation calls for certain percentages of your portfolio to be in certain investments. For instance, you might put 70 percent in stocks and 30 percent in bonds. You want your investments to be spread into different

investments that tend to move up and down at different times. This diversification will hold the value of your total portfolio steady — and reduce risk — over time.

- **Rebalancing:** A great way to boost your returns without taking on additional risk, rebalancing pretty much does what the term implies. Periodically, one group of investments in your asset allocation will fall in value. Stocks might fall and bonds rally, for instance. When that happens, the percentage of your portfolio in stocks will fall below your plan and the percentage in bonds will rise. To stick to your allocation and maintain the percentages, you need to buy more of the investments that have fallen in value and sell those that have gained. And when you do that, you'll be buying investments when they're cheaper and selling them when they get pricier, which isn't a bad strategy.
- **Discipline:** Staying in control is priceless with online investing. Because trading online is so inexpensive and easy, it's tempting to chase after popular stocks that are in the news or new investments other investors are talking about. Many of those investments end up disappointing investors, though, because they're overvalued. If you stick with your asset allocation, you can avoid this pain.

What Kind of Investor Do You Plan to Be?

Investing might not seem controversial, but it shouldn't surprise you that anytime you're talking about money, people have some strong opinions about the right way to do things. The first way investors categorize themselves is by whether they are passive or active. Because these two approaches are so different, the following sections help you think about what they are and which camp you see yourself in.

How to know if you're a passive investor

Passive investors don't try to beat the stock market. They merely try to keep up with it by owning all the stocks in an index. An *index* is a basket of stocks or bonds that track a market by measuring movement by all the investments in it. For instance, the S&P/TSX Composite Index tracks about 250 of the biggest Canadian companies listed on the Canadian Stock Exchange (TSX). Passive investors are happy matching the market's performance.



You know you're a passive investor if you

- **Aren't interested in choosing individual stocks:** These investors buy large baskets of stocks that mirror the

performance of popular stock indexes. Passive investors don't worry if a small upstart company they invested in will release its new product on time and whether it will be well received. They typically own small pieces of hundreds of stocks instead.

- **Want to own mutual funds and exchange-traded funds:** Because passive investors aren't looking for the next Apple or Microsoft, they buy mutual and exchange-traded funds that buy hundreds of stocks.

Mutual funds pool money from many investors so it can then be invested in stocks, bonds, or other assets. By pooling money, mutual funds give many investors some of the benefits that larger investors enjoy, especially the ability to spread money over multiple investments, or *diversify*.

Like index mutual funds, most *exchange-traded funds* (ETFs; see Chapter 2) invest in baskets of stocks tied to a stock market index. ETFs have proven to be so popular that new types are constantly being created, including variants that own investments in commodities or stocks picked by money managers. ETFs differ from mutual funds in several key ways, including that they trade during the day just like an individual stock and have potential tax advantages over mutual funds. These important differences give ETFs an edge over mutual funds for some investors.

- **Want to reduce taxes:** Passive investors tend to buy investments and forget about them until many years later when they need the money. This approach can be lucrative because by holding onto diversified investments for a long time and not selling them, passive investors can postpone when they have to pay taxes.
- **Do not want to stress about stocks' daily, monthly, or even annual movements:** Passive investors tend to buy index or mutual funds and forget about them. They don't need to sit in front of financial TV shows, surf countless financial websites, read magazines, or worry about where stocks are moving. They're invested for the long term, and everything else is just noise to them.

Sites for passive investors to start with

One of the toughest things about being a passive investor is sitting still during a bull market when everyone else seems to be making more than you. Yes, you might be able to turn off the TV, but inevitably you'll bump into someone who brags about their giant gains and laughs at you for being satisfied with 10 percent average annual market returns.



When that happens, it's even more important to stick with your philosophy. Following the crowd at this moment undermines the value of your strategy. That's

why even passive investors are well served going to websites where other passive investors congregate:

- **Bogleheads** (www.bogleheads.org) is an electronic water cooler for fans of Vanguard index funds and passive investors to meet, encourage, and advise each other. They call themselves Bogleheads in honor of the founder of Vanguard, John Bogle.
- **The Arithmetic of Active Management** (www.stanford.edu/~wfs Sharpe/art/active/active.htm) is a reprint of an article by an early proponent of passive investing, William Sharpe, who explains why active investing can never win.
- **Vanguard** (www.vanguard.ca/en/investor/home) contains many helpful stories about the power of index investing and offers them for free, even if you don't have an account.

How to know whether you're an active investor

Active investors almost feel sorry for passive investors. Why would anyone be satisfied just matching the stock market and not even try to do better? Active investors feel that if you're smart enough and willing to spend time doing homework, you can exceed 10 percent annual returns. Likewise, active

investors question the logic of holding stocks even as markets plunge. Active investors also find investing to be thrilling, almost like a hobby. Some active investors try to find undervalued stocks and hold them until they're discovered by other investors. Another class of active investors are short-term traders, who bounce in and out of stocks trying to get quick gains.

You're an active investor if you

- **Think long-term averages of stocks are meaningless:** Active investors believe they can spot winning companies that no one knows about yet or are underappreciated, buy their shares at just the right time, and sell them for a profit.
- **Are willing to spend a lot of time searching for stocks:** These are the investors who sit in front of financial TV shows, analyze stocks that look undervalued, and do all sorts of prospecting trying to find gems.
- **Believe they can hire mutual fund managers who can beat the market:** Some active investors think that certain talented mutual fund managers are out there and that if they just give their money to those managers, they'll win.
- **Suspect certain types of stocks aren't priced correctly and many investors make bad decisions:** Active investors believe they can outsmart the masses and routinely capitalize on their mistakes of the great unwashed.

- **Understand the risks:** Most active traders underperform index funds, some without even realizing it. Before deciding to be an active trader, be sure to test out your skills with online simulations, or make sure that you're measuring your performance correctly. If you're losing money picking stocks, stop doing it.



Here's a quick method for measuring your performance correctly. If you haven't deposited money into or taken any money out of your brokerage account, it's relatively easy to measure your rate of return for the year. Just follow these steps:

1. Get your account balance at the end of the year and write it down.

You can get your year-end balance from your online broker's website or from a printed statement.

2. Get your account balance at the end of the previous year and write it down.

Again, this information is available from your broker's website or from a printed statement.

3. Subtract the answer in Step 2 from the answer in Step 1.

4. Divide the answer in Step 3 by the answer in Step 2, and then multiply by 100.

Say your portfolio was worth \$12,000 on December 31, 2021, and \$10,000 on December 31, 2020. You would subtract \$10,000 from \$12,000 and get \$2,000. Divide \$2,000 by \$10,000 and multiply by 100, and the answer is 20 percent. You earned a 20 percent rate of return in that year.



Don't worry about dividends and splits when using this approach. And don't concern yourself if you've bought or sold stocks. As long as your dividends and sale proceeds go into the brokerage account, this way of calculating your return reflects all these things.

Many investors try, but few are able to consistently beat the market. Consider Bill Miller, portfolio manager for the Legg Mason Capital Management Value Trust mutual fund. Miller had beaten the market for 15 years and turned into a poster child for active investors, proof that beating the market was possible if you were smart enough. But even Miller's streak came to an end in 2006. That's when his Legg Mason Value Trust fund didn't just trail the market, it lagged by a mile, returning just 5.9 percent while the market gained 15.8 percent. The fund lagged the market in 2007 by 12.2 percent and again in 2008 by 18.1 percent. While the fund beat the market in 2009, active investors had already lost their hero. Even now, more than a decade later, there's yet to be a mutual fund with an equivalent record.

Sites for the active investor to start with

Ever hear of someone trying to learn a foreign language by moving to the country and picking it up through immersion? The idea is that by just being around the language, and through the necessity of buying food or finding the restroom, the person eventually gets proficient.



If you're interested in active investing, you can do the same thing by hitting websites that are common hang-outs for active investors and picking up how these types of investors find stocks that interest them and trade on them. These sites can show you the great pains active investors go through in their attempt to beat the market. Here are a few to start looking at:

- **TheStreet.com** (www.thestreet.com) collects trading ideas and tips from writers mainly looking for quick-moving stocks and other investments.
- **Investor's Business Daily** (www.investors.com) provides tools and research for investors looking for promising stocks. The site highlights stocks that have moved up or down by a large amount, which usually catches the attention of traders.
- **Seeking Alpha** (<http://seekingalpha.com>) provides news and commentary for investors of all skill levels who are trying to beat the market.