Investing 101

Updated and Expanded

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QUICK TAKE

What You'll LEARN

Everybody has little hang-ups that keep them from handling their money as wisely as they might like. In this chapter, you'll find problems that are common among investors:

- Saving too little—or not at all
- Getting greedy
- Being tax-wise and bottom-line foolish
- Emotional spending
- Matriarchal martyrdom
- Financial overdependence
- Running scared
- Competing with strangers
- Tinkering away your profit
- Forgetting what the money is for

What You'll DO

- Identify the personal problems that might be holding you back
- Identify potential solutions to help you get past financial roadblocks and begin investing wisely

How You'll USE This

By facing your money fears and foibles, you can separate fiction from reality. That allows you to put money in its proper perspective. Money is a tool to make your life calmer and more comfortable. This chapter gives you directions on how to use it without hurting yourself.

FIXING MONEY PROBLEMS 1

When I started writing about finance, the world according to Wall Street was promoting something called the "efficient markets theory." In a nutshell, this theory contends that the day-to-day price movements of stocks and bonds are ultimately rational—based on investors making informed and savvy choices about what to do with their cash at any given moment of the day. The idea was that we all went into the investment markets with a fist full of cash and all the accurate information we'd need. Then, our conversations would go something like this: "Hmm, that stock is a bargain at this price: Buy! Those bonds aren't yielding enough: Sell and redeploy our capital!" As the market moved to reflect the increasing demand on the savviest investments and the dearth of buyers for the less attractive investments, the prices would shift accordingly and investors would make new choices. Supply and demand are always in sync and investors are always rational.

The bulk of the world has now recognized this controversial theory to be largely irrelevant to individual investors.

It's not that people never make rational decisions about their money. They do—just not all the time and not even when taken as a group. Wall Street's favorite theory is now "behavioral finance." This theory explains why smart people often make dumb decisions about their money.

The great thing about this shift is that behavioral finance is something we all can relate to. We know instinctively—or from personal experience—that ignorance, fear, or greed can get in the way of making smart choices. Instead of decisions, we make excuses. Instead of making money, we make . . . well, a mess.

This book is going to tell you how to invest wisely. *Investing 101* is simple. It's straightforward. You'll get step-by-step instructions throughout. Anyone who reads and follows the directions will find investing easy to do. But if you let bad money habits overshadow your money smarts, your road to wealth will be long and bumpy.

How do you avoid that? Like anything else: You identify the problem and find a solution.

Here are some of the most common problems that face investors and simple ways to fix them. Many of these problems won't relate to you, so skip them, unless you simply want to gloat.

Certain investment roadblocks are universal and can be relevant for any investor. Other problems are more likely to strike women than men, or men than women. The following sections look at all three types.

UNIVERSAL PROBLEMS

PROBLEM: Saving too little, or not at all.

> "I would invest, but I just don't have the money," says the well-dressed twenty-five-year-old driving a BMW. "I'm going to start as soon as I get a raise."

Okay. That was a slight exaggeration. And it would be easier to save if you earned more money, but sometimes life is just not fair.

Now, be fair with yourself and answer honestly: When was the last time you bought lunch or dinner at a restaurant instead of going for the cheaper alternative of packing a sack lunch or making your own dinner? When was the last time you bought a suit, a high-tech gadget, or a pair of shoes that you knew you didn't need?

If you have a job that pays a decent wage—meaning anything that keeps you above subsistence level—you can afford to invest. Spend $2 less per day—the cost of one Starbucks coffee or one snack from the vending machines—and you've got $60 a month. That's enough to plop into an automatic investment plan with a mutual fund.

Still think it's a matter of poverty, not spending habits?

DID YOU KNOW?
Saving Habits and Salary Bumps

A number of studies have been done about whether individuals can afford to save, based on their income. They have found that aside from people at the polar ends of the income scale—the very rich and the very poor—the bulk of people in between think

> they could save, at least small amounts. Often, it's a matter of whether they do, rather than whether they can. Increases in salary often lead to incremental increases in spending rather than increases in savings. This suggests that saving is a matter of habit, not income. If you aren't saving now, you won't start when you get a raise.

SOLUTION: You need a budget.

> A budget doesn't necessarily spell deprivation. In fact, a good budget is like a good diet. It feeds both your wants and needs in a healthy and sustainable way.

To put together a good budget—a real budget—you need to gather some records:

- Pull out your check register and bank statements.
- Collect your credit card bills.
- And find either your most recent tax return or your pay stubs.

You'll need these to remind yourself of your monthly, annual, and semiannual expenses—from rent or house payments to car insurance. The chart on the following pages will help you plot out what you're shelling out each month.

You thought you were going to make up a projected budget? People who try to make up budgets without looking at their actual expenses are kidding themselves. The amount that you think you're spending—or think you ought to be—is almost always less than what you actually spend. By writing down your actual purchases, you're going to uncover your own personal money pits—places where you're spending more money than you meant to. It might be dining out. It might be dry cleaning. It might be a shopping habit.

This isn't about fitting your expenses into smaller boxes. This is about figuring out where your money is going and determining whether that's where you want it to go. If it is, leave things alone. But if lots of little outlays are robbing you of long-term happiness by making it impossible to save for big goals—like a house or car or retirement—you might want to nip and tuck here or there. So, fill out the worksheet to find the flab in your financial life.

MONTHLY BUDGET

INCOME:

Wages: ______

Tips: ______

Interest: ______

Other: ______

EXPENSES:

Income taxes: ______

Employment taxes: ______

Health insurance: ______

401(k) contributions: ______

Mortgage/rent: ______

Property tax: ______

Homeowner's/renter's insurance: ______

Water: ______

Gas: ______

Electric: ______

Garbage: ______

Phone: ______

Newspapers/magazines: ______

Cable: ______

Repairs: ______

Housekeeper/gardener: ______

Groceries: ______

Clothing: ______

Car payments: ______

Auto insurance: ______

Auto repairs: ______

Public transit: ______

Credit card payments: ______

Student/personal loan payments: ______

Child care: ______

Meals out: ______

Entertainment: ______

Other: ______

You've done the worksheets, but still can't figure out where the money is going? You're underestimating some expense because you're paying more cash than attention. Do this: Start carrying a notebook around with you. Jot down every expense, from the $1 bagel to the $50 you spend filling up your car. Review your notebook after a month. Include the expenses in the budget and see if there's something you can trim to add to savings. Realize that if you cut just $3.35 per day, you've found $100 a month to save. Voilà.

PROBLEM: Getting greedy.

> You bought a stock figuring that it was going to go to $50. Then lo and behold, it popped up to $65. Based on all of your market knowledge, this is an incredibly high price for this stock. Its price/earnings ratio (see Chapter 5) has never been this high, and you can't imagine why it might be now. And yet, if it went to $65, it could go to $70, right? Maybe you ought to hang on just a little longer and see.

The fact is, the stock could go higher. Or it could go much, much lower. Consider 1999, when the prices of technology stocks had soared into the stratosphere and market pundits were contending that the sky was the limit. "It's a new paradigm!" they shouted. It was hype. During the following three years, those stocks crashed and burned. A few have recovered. Many have not. People who were smart enough to sell when the prices were high made a killing. Those who got greedy got killed.

SOLUTION: Target price.

> Every time you buy a stock, you should have a target—a price at which you would either sell the stock or reevaluate its prospects before you decide to leave it in your portfolio (see Chapter 6). Don't let emotion—regardless of whether that emotion is fear, greed, or hope—rule your actions.

Evaluate all your stocks once a year. Make reasonable decisions about whether each one is a buy, a hold, or a sell. If you realize that you wouldn't buy a stock today given its future prospects and that there are better opportunities out there, sell it. Live with the idea that you

may never sell at the peak. That's okay, as long as you also don't sell at the nadir.

PROBLEM: Being tax-wise and bottom-line foolish.

> I hear it all the time: "Never pay off your house. Your mortgage interest is tax deductible!" I'm always tempted to respond, "Okay, humor me for a minute here and let's go through the math. If I pay $1 in mortgage interest, I'll get to deduct it, which will save me, say, thirty cents on my federal income tax return. Aren't I still out seventy cents?"

There are dozens of equally "tax-wise" investments being marketed in today's world. My favorite is the variable tax-deferred annuity. What these say they do is allow you to save additional money for retirement in investments that mimic stock mutual funds.

The money you invest in this type of annuity isn't tax deductible going in, but the investment gains are not taxed as returns and accumulate in the account. This allows you to trade all you want within the annuity and not immediately pay taxes on your gains. That's the selling point that continues to push variable annuity sales ever higher. Roughly $90.6 billion in variable annuities were purchased during the first half of 2007. Total assets in these accounts were nearly 1.5 trillion, according to LIMRA International Inc., an insurance research and consulting firm.

Annuities are able to offer this benefit because they're an insurance product. The insurance you get with an annuity generally is a guarantee that if the stock market crashes, which causes you to have a heart attack and die, your heirs are guaranteed to get at least as much as you originally invested in the annuity. That's not much of a guarantee, but you pay for it dearly. The typical mortality and expense ratio on an annuity is around 1 percent. In other words, if the investments you hold within the annuity yield 10 percent, you'll get 9 percent of that after the mortality expense is taken off the top. (To get a good read on the dollars-and-cents impact of that fee, read "The Real Cost of Fund Fees" in Chapter 8.)

But there's a second cost too. Ironically, it's a tax.

When you earn a profit on a long-term investment in a taxable account, you pay tax at preferential capital gains rates—usually 15 percent. However, money pulled out of a retirement account—and tax-deferred annuities fall into this category—is taxed at ordinary income tax rates, which can be as high as 35 percent. Even though you

don't have to pay taxes right away on money earned in an annuity, when you do pay, the tax rate is so much higher that it almost always overwhelms the short-term benefit of the annuity.

SOLUTION: Do the math.

Figure out whether the tax benefit of an investment is worth the cost. All too often, it's not.

FOR WOMEN ESPECIALLY

By and large, women start investing later in life than men, set less money aside, and invest more conservatively. That has the unpleasant effect of leaving them poor in their old age. Some 80 percent of the elderly people living in poverty are women. So what's their excuse?

PROBLEM: Emotional spending.

Do you shop when you have a fight with your boss or your spouse? Do you find that you "need" to hit the mall whenever you're feeling down, as a way of boosting your spirits? Letting your psyche drive your spending is a common problem.

The bad news is your credit card balance is likely to rise faster than your spirits. As a result, you're sentencing yourself to a life of servitude—working harder or more hours to pay your debts, which makes you all the more depressed.

If you need to get rid of your boss or your spouse, stop spending and start saving. Having money in the bank creates financial independence, which can lead to emotional and physical independence if you want it to. But how do you reverse the emotional drag that you've previously shopped away?

SOLUTION: Find a healthier alternative.

Ideas:

- Take a walk.
- Go to the gym.
- Play catch with your kids.

- Pull out a board game.
- Ask a friend to come over for wine and whining.
- Volunteer—help build a house for Habitat for Humanity; take a foster child to lunch; feed the homeless.

The possibilities are endless. Better yet, these won't cost you much and will make you happier and healthier.

PROBLEM: Matriarchal martyrdom.

Some women are natural-born martyrs. "How can I save for myself when Johnny needs a new soccer uniform and we haven't even gotten close to funding Susie's college account?" they worry. Is that a gravy spot on your husband's shirt? He'd be happier and more successful at work if he had a better wardrobe—even if that meant there was no money left to fund your retirement account, right?

Certainly, it would be nice to think of yourself once in a while, you admit, but how can you when you're so busy being the family caregiver? After all, somebody has to take care of the rest of the family, and no one else has stepped up to the plate to do it. All of your worldly concerns are going to be put on the back burner until you take care of theirs—today, tomorrow, and forever. Right?

It's lovely to take good care of your loved ones, but realize that when you are strong physically and financially, you can solve a lot more problems for your kids than if you're weak. That's precisely why young parents need to balance their long-term financial needs with the pressing day-to-day expenses of managing a young family.

SOLUTION: Set some priorities.

Make your retirement account one of them. If you are working and have access to a company 401(k) plan, contribute to it. It is, hands down, the best way to save for your retirement needs. If you don't have a 401(k)—if you don't even have a paying job—set up an automatic savings account with a mutual fund (see Chapter 12). Even if all you're saving is $50 a month, you'll have started taking care of yourself and making yourself financially strong. You owe that to yourself and to your family.

But your kids are the ones giving you a hard time about money? They say that you owe them clothes, cars, and a college account? Ask them which one is going to agree to support you in your old age. Draw up a contract and have them sign it. "Since I (Johnny) decided that my Camaro was more important than my parents' retirement savings, I agree to always have a bedroom in my home where my parents can live. I promise to clean their room once a week, and cook their favorite dinners, just like they did for me. . . . " A notary might be advisable.

PROBLEM: Financial overdependence.

Why save and invest for yourself when there's always been someone willing to take care of you? First there was Dad. Then there was your husband. Both of them are kind and thoughtful and wonderful providers.

But what happens if they both predecease you? Women usually live longer than men.

Then there's that other uncomfortable fact of life: About half of marriages end in divorce. Are you prepared to take care of yourself if you're forced to because of death or divorce? Roughly 90 percent of women are going to need to take care of themselves financially at some point in their lives. Think about it.

SOLUTION: First steps.

Not everyone is familiar with the story of Cinder Edna, but it's one of my favorites. The tale, written by Ellen Jackson, goes like this: There are two girls living next-door to one another, both ill-treated by their stepfamilies. One is Cinderella. The other, Cinder Edna. When Cinderella is done with her myriad chores, she sits in the cinders, by the fire. When Cinder Edna finishes, she takes in odd jobs to earn extra money. When the ball comes around, Cinder Edna doesn't need a fairy godmother. She's got a dress on layaway and a bus pass. Guess who ends up the happiest?

We women need to do much the same. If you're reading this book, you're already taking the first step. Put a toe in the market by joining an investment club or starting a monthly investment program with a mutual fund. You can learn about mutual funds in Chapter 8. If you want to join an investment club, you can find information on the Web

at www.better-investing.org. If you find investing too dull or too demanding, read Chapter 14, "The Lazy Investor's Portfolio Planner"—and follow the instructions.

PROBLEM: Running scared.

Multiple studies have shown that women invest far more conservatively than men do, preferring bonds and bank accounts to company stocks. They do this because they imagine that buying stocks is like gambling. They know stock prices can vary significantly over short periods of time, and they don't want to lose their hard-earned cash. This is an understandable, but a serious—and costly—misunderstanding about how markets work.

SOLUTION: Take reasonable risks.

Read Chapter 2 and concentrate on the section "Considering Rates of Return." It explains how taking reasonable risks can boost your investment returns and why being too cautious can leave you poor. Then divvy up your money based on goals—instructions are in Chapter 3. Put your short-term money in safe investments that let you sleep at night; and put your long-term money in stocks and mutual funds. Do your best not to peek at that portfolio too often—look once or twice a year. By not looking too often, you'll miss most of the market's volatility—the stuff that makes you nervous—and you'll get the portfolio growth that can make you rich.

FOR MEN ESPECIALLY

Although men typically have more money than women do, they still make some surprising mistakes with it. Sometimes they invest too aggressively; sometimes they worry too much and second-guess their best judgment; sometimes they get so caught up in saving and investing that they forget what the money is for. By and large, it appears that the bulk of their problems stem from one thought: This is a game. I've got to win, either for the pure competition or for the spoils. Such thinking

sours investment returns—often substantially. Though the following problems are mostly male afflictions, women sometimes fall victim to them as well.

PROBLEM: Competing with strangers.

> You go to a cocktail party and start talking to some guy. He's wearing a nice suit, he's confident, and he starts telling you that he's making a killing in the stock market. "Yeah, I doubled my money on Google in three months," he brags. "Then I bought this little penny stock and whammo! It tripled in value!"

You stand there quietly, wondering why you've been doing it so wrong. Here you are investing in companies with track records, earnings, sales, and supposedly skilled managers, and what is your portfolio earning? A paltry 10 percent, you grouse. "What kind of loser am I? Why didn't I buy that penny stock?" you think. You begin to question your whole investment strategy. You need to be more like that guy . . . that cocktail-party guy.

You go home, and you buy some of that guy's stock. Maybe you sell some of your boring stocks and mutual funds. When you lose money on those new investments, you know that it's your fault. You're a loser—not a winner like that cocktail-party guy.

In the meantime, you've derailed a perfectly good portfolio.

SOLUTION: Match your goals to your investments.

> Remember what your mother used to tell you: "If your friends all jumped off a bridge, would you follow them?" Don't be taken in by a big talker.

Naturally, what the cocktail-party guy didn't mention was that two weeks before he met you, he was downtrodden because his portfolio had declined in value by half, and he was wondering whether he'd have enough cash to make his mortgage. Why didn't he tell you about that? Well, it's not really cocktail-party chatter, is it?

You should know that anyone who makes a fortune overnight can also lose a fortune overnight. Risk and reward go hand in hand in the financial markets. Create a reasonable investment strategy by matching your goals to your investments. You can do that in Chapter 3.

PROBLEM: Tinkering away your profit.

> You saw it on *Tool Time*. You do it in your portfolio. Here you have a perfectly functioning item, be it a lawn mower or a stock. But you know that if you just fiddle with it a little bit, you could make it better.

When you're dealing with tools, the worst thing that can happen is you'll have to replace them. When you're dealing with your portfolio, the stakes are considerably higher. But now that you can check your stocks on the Web—and trade for just a few bucks a pop—it's tough to leave well enough alone.

Tinkerers are particularly apt to sell stocks when they've got a bit of a profit. "Lock that in," they say. Naturally, if the stock keeps rising, they've missed out. Worse still, every time you sell a stock at a profit in a taxable account, you not only have to pay a trading fee, you also pay tax on the gain. If you held the stock for more than one year, that tax will be at capital gains rates, which max out at 15 percent; if you've held it for less than a year, the gain is taxed at your ordinary income tax rates, which are certain to be higher. Either way, to make up for the taxes you pay, you'll have to earn more than a 15 percent return on your next stock purchase just to break even. And few people pull that off.

SOLUTION: Once again, do the math.

> Read Brad Barber and Terrance Odean's paper titled: "Boys Will Be Boys." You can find it on the Web at http://faculty.haas.berkeley.edu/odean/papers/gender/BoysWillBeBoys.pdf.

Odean is a professor at Berkeley's Haas School of Business. He's done loads of research about investor behavior. This study chronicles the differences in how men and women trade stocks. The short version: By studying the account data for over 35,000 households, Odean found that men trade 45 percent more often than women.

What does that do to the value of their portfolios? It depresses their returns by an average of 2.65 percentage points per year. What does that mean in dollars and cents? If you started with $100,000, your tinkering would have cost you roughly $250,000 over a twenty-year period.

This may be one of those moments that you really ought to listen to your wife.

Do the math. Sell when an investment no longer makes sense—when its prospects are poor. Don't sell just because you can.

PROBLEM: Forgetting what the money is for.

> You invest every dime, often scrimping and saving to do it. And thanks to this superfrugality, you have a lot of money saved and invested. But it's not enough, you theorize. It's never enough. So you work extra hours; you skip vacations; you urge your spouse to do the same. All the while, your riches are growing bigger, and you are growing older.

Before you postpone one more vacation or miss one more baseball game, stop and consider what all this money is for. What are the things in life that you hold precious? Have you saved enough to buy those things? In fact, is your emphasis on saving robbing you of enjoying those things? Too many men work themselves into ulcers, heart attacks, or divorces in a quest to get something that they already had but were too busy working to notice.

SOLUTION: Slow down. Step back. Reevaluate.

> Figure out how much money you realistically need for your personal goals and how close you are to accumulating that amount of money. (You can answer that by completing the worksheets in Chapter 3.) Once you have enough, relax. Enjoy it. To be sure, you can be more successful at work, if you spend every waking hour there. But do you really want your kids to only remember you through the Jaguar that they bought with the money you left them when you died?

Put your wife and kids on your calendar. If that costs you money, take comfort in the fact that if they love you, they might take care of you in your old age. If they don't, your wife will divorce you and take half of your assets; and your kids will end up fighting with your second wife for whatever is left after you're gone.

As your mother used to say, "Be careful what you wish for."

QUICK TAKE

What You'll LEARN

Risk and reward go hand in hand in the world of investing. All investments carry some sort of risk, but investing smartly and safely can lead to consistent returns over the long term with minimal risk. In this chapter, you'll learn about:

- Understanding Market Risks
- Considering Rates of Return
- Why a Bad Market Could Be Good for You
- How Much Investment Risk Can You Tolerate?

What You'll DO

- Review average returns for different types of investments—taking note of the number of money-losing years and just how bad the bloodletting can get
- Take the Risk Quiz
- Calculate your score to determine how much risk you can handle

How You'll USE This

Whether you invest on your own or you use a financial planner, you'll need to know just how much risk you can take and still sleep at night. The Risk Quiz will help you figure out where you stand on the risk spectrum—from a person who can take almost no risk to a thrill-seeker ready to gamble for a potential pot of gold.

Later in the book, you'll be asked to estimate a return when calculating how much you need to save for your long-term goals. The lower your risk tolerance, the lower the return you should use in those charts. (Risk and reward go hand in hand.)

And, if you decide you want advice, your risk quiz will help you explain to a financial planner what you're comfortable with.