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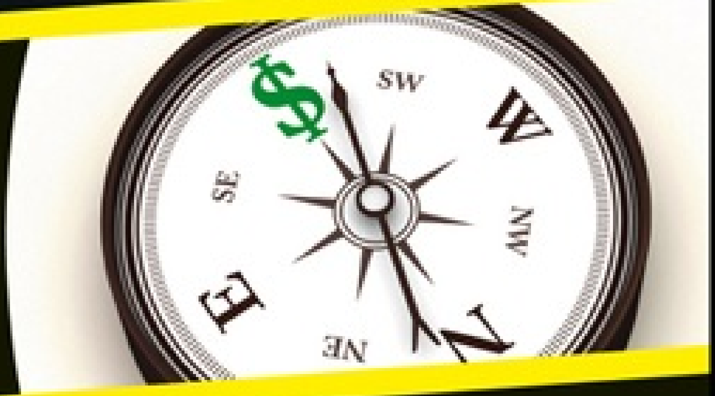

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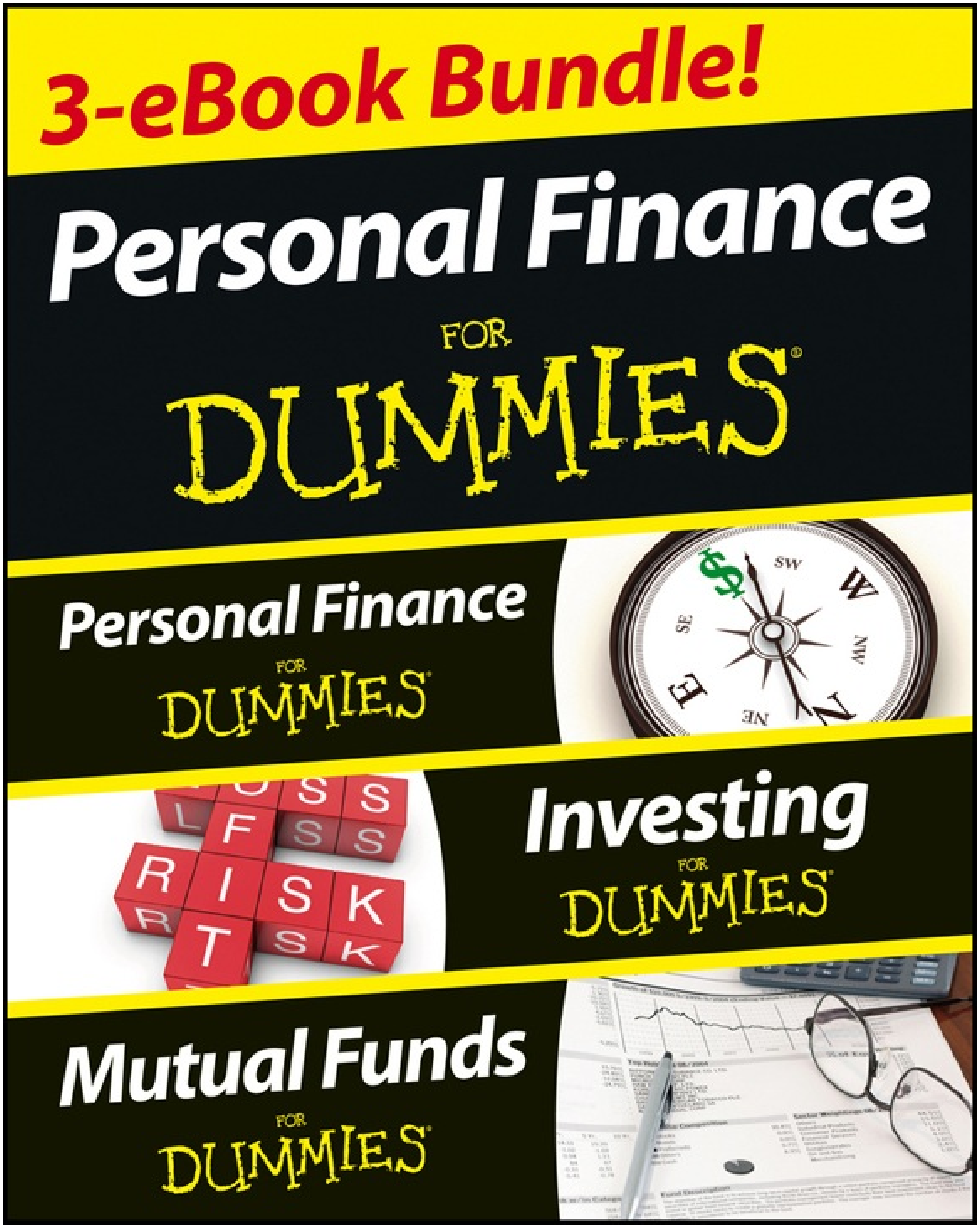
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Chapter 22: Ten Tactics to Thwart Identity Theft and Fraud

Making Everything Easier!™

7th Edition

Personal Finance FOR DUMMIES®

Learn to:

- Evaluate and manage your financial fitness
- Save more and spend less
- Assess your credit report and improve your score
- Make smart investments in any economic environment

Eric Tyson, MBA

Bestselling author, Investing For Dummies

Eric Tyson's Keys to Personal Financial Success

- **Take charge of your finances.** Procrastinating is detrimental to your long-term financial health. Don't wait for a crisis or major life event to get your act together. Read this book and start implementing a plan now!

- **Don't buy consumer items (cars, clothing, vacations, and so on) that lose value over time on credit.** Use debt only to make investments in things that gain value, such as real estate, a business, or an education.

- **Use credit cards only for convenience, not for carrying debt.** If you have a tendency to run up credit-card debt, then get rid of your cards and use only cash, checks, and debit cards.

- **Live within your means and don't try to keep up with your co-workers, neighbors, and peers.** Many who engage in conspicuous consumption are borrowing against their future; some end up bankrupt.

- **Save and invest at least 5 to 10 percent of your income.** Preferably, invest through a retirement savings account to reduce your taxes and ensure your future financial independence.

- **Understand and use your employee benefits.** If you're self-employed, find the best investment and insurance options available to you and use them.

- **Research before you buy.** Never purchase a financial product or service on the basis of an advertisement or salesperson's solicitation.

- **Avoid financial products that carry high commissions and expenses.** Companies that sell their products through aggressive sales techniques generally have the worst financial products and the highest commissions.

- **Don't purchase any financial product that you don't understand.** Ask questions and compare what you're being offered to what you can get from the best sources, which I recommend in this book.

- **Invest the majority of your long-term money in ownership vehicles that have appreciation potential, such as stocks, real estate, and your own business.** When you invest in bonds or bank accounts, you're simply lending your money to others, and the return you earn probably won't keep you ahead of inflation and taxes.

- **Avoid making emotionally based financial decisions.** For example, investors who panic and sell their stock holdings after a major market correction miss a buying opportunity. Be especially careful in making important financial decisions after a major life change, such as a divorce, job loss, or death in your family.

- **Make investing decisions based upon your needs and the long-term fundamentals of what you're buying.** Ignore the predictive advice offered by financial prognosticators — nobody has a working crystal ball. Don't make knee-jerk decisions based on news headlines.

- **Own your home.** In the long run, owning is more cost-effective than renting, unless you have a terrific rent-control deal. But don't buy until you can stay put for a number of years.

- **Purchase broad insurance coverage to protect against financial catastrophes.** Eliminate insurance for small potential losses.

- **If you're married, make time to discuss joint goals, issues, and concerns.** Be accepting of your partner's money personality; learn to compromise and manage as a team.

- **Prepare for life changes.** The better you are at living within your means and anticipating life changes, the better off you will be financially and emotionally.

- **Read publications that have high quality standards and that aren't afraid to take a stand and recommend what's in your best interests.** Avoid those that base their content on the hottest financial headlines or the whims of advertisers.

- **Prioritize your financial goals and start working toward them.** Be patient. Focus on your accomplishments and learn from your mistakes.

- **Hire yourself first.** You are the best financial person that you can hire. If you need help making a major decision, hire conflict-free advisors who charge a fee for their time. Work in partnership with advisors — don't abdicate control.

- **Invest in yourself and others.** Invest in your education, your health, and your relationships with family and friends. Having a lot of money isn't worth much if you don't have your health and people with whom to share your life. Give your time and money to causes that better our society and world.

Praise for Eric Tyson

> "Eric Tyson is doing something important — namely, helping people at all income levels to take control of their financial futures. This book is a natural outgrowth of Tyson's vision that he has nurtured for years. Like Henry Ford, he wants to make something that was previously accessible only to the wealthy accessible to middle-income Americans."
>
> — James C. Collins, coauthor of the national bestsellers *Built to Last and Good to Great*

> "*Personal Finance For Dummies* is the perfect book for people who feel guilty about inadequately managing their money but are intimidated by all of the publications out there. It's a painless way to learn how to take control."
>
> — Karen Tofte, producer, National Public Radio's *Sound Money*

> "Eric Tyson . . . seems the perfect writer for a …*For Dummies* book. He doesn't tell you what to do or consider doing without explaining the why's and how's — and the booby traps to avoid — in plain English. . . . It will lead you through the thickets of your own finances as painlessly as I can imagine."
>
> — *Chicago Tribune*

> "This book provides easy-to-understand personal financial information and advice for those without great wealth or knowledge in this area. Practitioners like Eric Tyson, who care about the well-being of middle-income people, are rare in today's society."
>
> — Joel Hyatt, founder of Hyatt Legal Services, one of the nation's largest general-practice personal legal service firms

> "Worth getting. Scores of all-purpose money-management books

reach bookstores every year, but only once every couple of years does a standout personal finance primer come along. *Personal Finance For Dummies,* by financial counselor and columnist Eric Tyson, provides detailed, action-oriented advice on everyday financial questions. . . . Tyson's style is readable and unintimidating."

— Kristin Davis, *Kiplinger's Personal Finance* magazine

"this is a great book. It's understandable. Other financial books are too technical and this one really is different."

— Business Radio Network

More Bestselling For Dummies Titles by Eric Tyson

Investing For Dummies®

A Wall Street Journal bestseller, this book walks you through how to build wealth in stocks, real estate, and small business as well as other investments.

Mutual Funds For Dummies®

This bestselling guide is now updated to include current fund and portfolio recommendations. Using the practical tips and techniques, you'll design a mutual fund investment plan suited to your income, lifestyle, and risky; preferences.

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This hands-on, friendly guide provides you with the targeted financial advice you need to establish firm financial footing in your 20s and to secure your finances for years to come. When it comes to protecting your financial future, starting sooner rather than later is the smartest thing you can do.

Home Buying For Dummies®

America’s #1 real-estate book includes coverage of online resources in addition to sound financial advice from Eric Tyson and frontline real-estate insights from industry veteran Ray Brown. Also available from America’s bestselling real-estate team of Tyson and Brown — *House Selling For Dummies* and *Mortgages For Dummies.*

Real Estate Investing For Dummies®

Real estate is a proven wealth-building investment, but many people don’t know how to go about making and managing rental property investments. Real-estate and property management expert Robert Griswold and Eric Tyson cover the gamut of property investment options, strategies, and techniques.

Personal Finance For Dummies®, 7th Edition

by Eric Tyson, MBA

WILEY

John Wiley & Sons, Inc.

Personal Finance For Dummies®

Published by
John Wiley & Sons, Inc.
111 River St.
Hoboken, NJ 07030-5774

www.wiley.com

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Published simultaneously in Canada

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Library of Congress Control Number is available from the publisher

ISBN 978-1-11811785-9 (pbk); ISBN 978-1-118-26261-0 (ebk); ISBN 978-1-118-22444-1 (ebk); ISBN 978-1-118-23817-2

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1

About the Author

Eric Tyson first became interested in money more than three decades ago. After his father was laid off during a recession and received some retirement money from his employer, Eric worked with his dad to make investing decisions with the money. A couple years later, Eric won his high school's science fair with a project on what influences the stock market. Dr. Martin Zweig, who provided some guidance, awarded Eric a one-year subscription to the *Zweig Forecast,* a famous investment newsletter. Of course, Eric's mom and dad share some credit with Martin for Eric's victory.

After toiling away for a number of years as a management consultant to Fortune 500 financial-service firms, Eric finally figured out how to pursue his dream. He took his inside knowledge of the banking, investment, and insurance industries and committed himself to making personal financial management accessible to all.

Today, Eric is an internationally acclaimed and bestselling personal finance book author, syndicated columnist, and speaker. He has worked with and taught people from all financial situations, so he knows the financial concerns and questions of real folks just like you. Despite being handicapped by an MBA from the Stanford Graduate School of Business and a BS in Economics and Biology from Yale University, Eric remains a master of "keeping it simple."

An accomplished personal finance writer, his "Investor's Guide" syndicated column, distributed by King Features, is read by millions nationally, and he is an award-winning columnist. He is the author of five national bestselling financial books in the *For Dummies* series, on personal finance, investing, mutual funds, home buying (coauthor), and taxes (coauthor). A prior edition of this book was awarded the Benjamin Franklin Award for best business book of the year.

Eric's work has been featured and quoted in hundreds of local and national publications, including *Newsweek,* the *Wall Street Journal,* the *Los Angeles Times,* the *Chicago Tribune, Forbes, Kiplinger's Personal Finance* magazine, *Parenting, Money, Family Money,* and *Bottom Line/Personal;* on NBC'S *Today Show,* ABC, CNBC, PBS *Nightly Business Report,* CNN, and FOX-TV; and on CBS national radio, NPR's *Sound Money,* Bloomberg Business Radio, and Business Radio Network.

Eric's website is www.erictyson.com.

Dedication

This book is hereby and irrevocably dedicated to my family and friends, as well as to my counseling clients and customers, who ultimately have taught me everything that I know about how to explain financial terms and strategies so that all of us may benefit.

Author's Acknowledgments

Being an entrepreneur involves endless challenges, and without the support and input of my good friends and mentors Peter Mazonson, Jim Collins, and my best friend and wife, Judy, I couldn't have accomplished what I have.

I hold many people accountable for my perverse and maniacal interest in figuring out the financial services industry and money matters, but most of the blame falls on my loving parents, Charles and Paulina, who taught me most of what I know that's been of use in the real world.

I'd also like to thank Michael Bloom, Chris Dominguez, Maggie McCall, David Ish, Paul Kozak, Chris Treadway, Sally St. Lawrence, K.T. Rabin, Will Hearst III, Ray Brown, Susan Wolf, Rich Caramella, Lisa Baker, Renn Vera, Maureen Taylor, Jerry Jacob, Robert Crum, Duc Nguyen, Maria Carmicino, and all the good folks at King

Duc Nguyen, Maria Carmicino, and all the good folks at King
Features for believing in and supporting my writing and teaching.

Many thanks to all the people who provided insightful comments on this edition and previous editions of this book, especially Bill Urban, Barton Francis, Mike van den Akker, Gretchen Morgenson, Craig Litman, Gerri Detweiler, Mark White, Alan Bush, Nancy Coolidge, and Chris Jensen.

And thanks to all the wonderful people at my publisher on the front line and behind the scenes, especially Erin Mooney and Elizabeth Rea.

Publisher's Acknowledgments

We're proud of this book; please send us your comments at http://dummies.custhelp.com. For other comments, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

Some of the people who helped bring this book to market include the following:

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Cover Photo: © iStockphoto.com / George Paul

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Personal Finance For Dummies®, 7th Edition

Visit www.dummies.com/cheatsheet/personalfinance to view this book's cheat sheet.

Table of Contents

Introduction

You're probably not a personal finance expert, for good reason. Personal Finance 101 isn't typically offered in our schools — not in high school and not even in the best colleges and graduate programs. It should be.

However, even if you got some financial education and acquired some financial knowledge over the years, you're likely a busy person who doesn't have enough hours in the day to get things done. Thus, you want to know how to diagnose your financial situation efficiently (and painlessly) to determine what you should do next. Unfortunately, after figuring out which financial strategies make sense for you, choosing specific financial products in the marketplace is often overwhelming. You have literally thousands of investment, insurance, and loan options to choose from. Talk about information overload!

To further complicate matters, you probably hear about most products through advertising that can be misleading, if not downright false. Of course, some ethical and outstanding firms advertise, but so do those that are more interested in converting your hard-earned income and savings into their profits. And they may not be here tomorrow when you need them.

Perhaps you've ventured online and been attracted to the promise of "free" advice. Unfortunately, discerning the expertise and background (and even identity) of those behind various blogs and websites is nearly impossible. And, as I discuss in this book, conflicts of interest (many of which aren't disclosed) abound online.

Despite the development of new media and new financial products and services, folks keep making the same common financial mistakes — procrastinating and lack of planning, wasteful spending, falling prey to financial salespeople and pitches, failing to do sufficient research before making important financial decisions, and so on. This book can keep you from falling into the same traps and get you going on the best paths.

As unfair as it may seem, numerous pitfalls await you when you seek help for your financial problems. The world is filled with biased and bad financial advice. As a former practicing financial counselor and now as a writer, I constantly see and hear about the consequences of poor advice. All too often, financial advice ignores the big picture and focuses narrowly on investing. Because money is not an end in itself but a part of your whole life, this book helps connect your financial goals and challenges to the rest of your life. You need a broad understanding of personal finance that includes all areas of your financial life: spending, taxes, saving and investing, insurance, and planning for major goals like education, buying a home, and retirement.

Even if you understand the financial basics, thinking about your finances in a holistic way can be difficult. Sometimes you're too close to the situation to be objective. Your finances may reflect the history of your life more than they reflect a comprehensive plan for your future.

You want to know the best places to go for your circumstances, so this book contains specific, tried-and-proven recommendations. I also suggest where to turn next if you need more information and help.

About This Book

You selected wisely in picking up a copy of *Personal Finance For Dummies,* 7th Edition! Over two million copies of prior editions of this book are in print, and as you can see from the quotes in the front of this edition, readers and reviewers alike have been pleased. This book also previously earned the prestigious Benjamin Franklin Award for best book of the year in business.

However, I never rest on my laurels. So the book you hold in your hands reflects more hard work and brings you the freshest material for addressing your personal financial quandaries. Here are some of the major updates you may notice as you peruse the pages of this book:

- Updated coverage of the best ways to reduce, minimize the cost of, and eliminate consumer debt
- Expanded information regarding smart ways to use credit and qualify for the best loan terms, as well as how to understand — and improve — your credit scores
- A complete discussion on making the most of Internet resources, including smart shopping online, the dangers of "free" money websites, and investing online
- Coverage of new and revised tax laws, pending and likely future tax law changes, and how to best take advantage of them
- The latest information on what's going on with government assistance programs, Social Security, and Medicare and what it means in terms of how you should prepare for and live in retirement
- Updated investment recommendations — especially in the areas of exchange-traded funds, mutual funds, and real estate
- Revised recommendations for where to get the best insurance deals, the impact of federal health insurance legislation, and expanded coverage on preparing for natural disasters
- Expanded and updated coverage of how to use and make sense of the news and financial resources (especially online resources)

Aside from being packed with updated information, another great feature of this book is that you can read it from cover to cover if you want, or you can read each chapter and part without having to read what comes before, which is useful if you have better things to do with your free time. Handy cross-references direct you to other places in the book for more details on a particular subject.

Conventions Used in This Book

To help you navigate the waters of this book, I've set up a few conventions:

- I use *italics* for emphasis and to highlight new words or terms that I define.
- I use **boldface** text to indicate the action part of numbered steps and to highlight key words or phrases in bulleted lists.
- I put all web addresses in `monofont` for easy identification.

What You Can Skip or Skim

I've written this book so you can find information easily and easily understand what you find. And although I'd like to believe that you want to pore over every last word between the two yellow and black covers, I actually make it easy for you to identify "skippable" material. This information is the stuff that, although interesting, isn't essential for you to know:

- **Text in sidebars:** The sidebars are the shaded boxes that appear here and there. They include helpful information and observations but aren't necessary reading.
- **Anything with a Technical Stuff icon attached:** This information is interesting but not critical to your understanding of the topic at hand.

Foolish Assumptions

In writing this book, I made some assumptions about you, dear reader:

- You want expert advice about important financial topics — such as paying off and reducing the cost of debt, planning for major goals, making wise investments — and you want answers quickly.
- Perhaps you want a crash course in personal finance and are looking for a book you can read cover-to-cover to help solidify major financial concepts and get you thinking about your finances in a more comprehensive way.

This book is basic enough to help novices get their arms around thorny financial issues. But advanced readers will be challenged, as well, to think about their finances in a new way and identify areas for improvement.

How This Book Is Organized

This book is organized into six parts, with each covering a major area of your personal finances. The chapters within each part cover specific topics in detail. Here's a summary of what you can find in each part.

Part I: Assessing Your Financial Fitness and Setting Goals

This part explains how to diagnose your current financial health and explores common reasons for any missing links in your personal finance knowledge. We all have dreams and goals, so in this part, I also encourage you to think about your financial (and personal) aspirations and figure out how much you should be saving if you want to retire someday or accomplish other important goals.

Part II: Spending Less, Saving More

Most people don’t have gobs of extra cash. Therefore, this part shows you how to figure out where all your dollars are going and tells you how to reduce your spending. Chapter 5 is devoted to helping you get out from under the burden of high-interest consumer debt (such as credit card debt). I also provide specifics for reducing your tax burden.

Part III: Building Wealth through Investing

Earning and saving money are hard work, so you should be careful when it comes to investing what you've worked so hard to save (or waited so long to inherit!). In this part, I assist you with picking investments wisely and help you understand investment risks, returns, and much more. I explain all the major — and best — investment options. I recommend specific strategies and investments to use both inside and outside of tax-sheltered retirement accounts. I also discuss buying, selling, and investing in real estate, as well as other wealth-building investments.

Part IV: Insurance: Protecting What You Have

Insurance is an important part of your financial life. Unfortunately, for most people, insurance is a thoroughly overwhelming and dreadfully boring subject. But perhaps I can pique your interest in this esoteric topic by telling you that you're probably paying more than you should for insurance and that you probably don't have the right coverage for your situation. This part tells you all you ever wanted to know (okay, fine — all you *never* wanted to know but probably should know anyway) about how to buy the right insurance at the best price.

Part V: Where to Go for More Help

As you build your financial knowledge, more questions and issues may arise. In this part, I discuss where to go and what to avoid when you seek financial information and advice. I also discuss hiring a financial planner as well as investigating resources in print, on the air, and online.

Part VI: The Part of Tens

The chapters in this part can help you manage major life changes and protect yourself from the increasingly common problem of identity theft. You also can find a glossary in this part. The world of money is filled with jargon, so you’ll be happy to know that this book includes a comprehensive glossary of financial terms that are often tossed around but seldom explained.

Icons Used in This Book

The icons in this book help you find particular kinds of information that may be of use to you.

This nerdy-looking guy appears beside discussions that aren’t critical if you just want to understand basic concepts and get answers to your financial questions. You can safely ignore these sections, but reading them can help deepen and enhance your personal financial knowledge.

This target flags strategy recommendations for making the most of your money.

This icon highlights the best financial products in the areas of investments, insurance, and so on. These products can help you implement my strategy recommendations.

This icon points out information that you'll definitely want to remember.

This icon marks things to avoid and points out common mistakes people make when managing their finances.

This icon alerts you to scams and scoundrels who prey on the unsuspecting.

This icon tells you when you should consider doing some additional research. I explain what to look for and what to look out for.

Where to Go from Here

This book is organized so you can go wherever you want to find complete information. Want advice on investing strategies, for example? Go to Part III for that. You can check out the table of contents to find broad categories of information and a chapter-by-chapter rundown of what this book offers, or you can look up a specific topic in the index.

If you're not sure where you want to go, you may want to turn a few pages and start at the beginning with Part I. It gives you all the basic info you need to assess your financial situation and points to places where you can find more detailed information for improving it.

Part I

Assessing Your Financial Fitness and Setting Goals

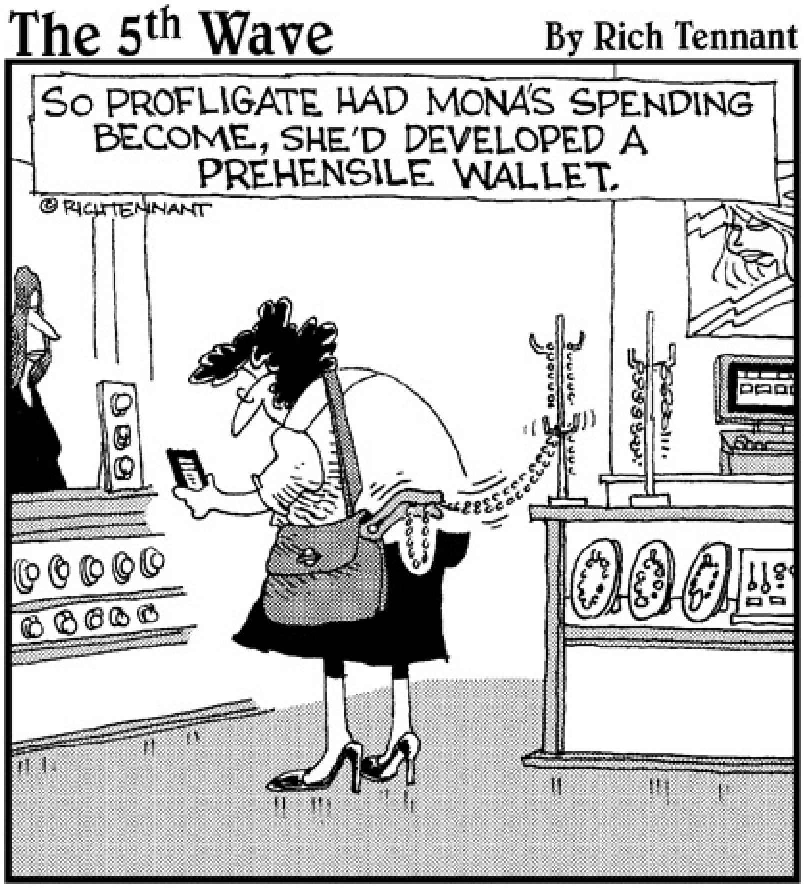
"I think I have a pretty good savings plan. I plan to save 15 percent on a Rolex watch this weekend."

In this part . . .

I discuss the concepts that underlie sensible personal financial management. You find out why you didn't know all these concepts before now (and whom to blame). Here, you undergo a (gentle) financial physical exam to diagnose your current fiscal health, and I show you how to identify where your hard-earned dollars are going. I also cover understanding and improving your credit report and scores and how to plan for and accomplish your financial goals.

Part II

Spending Less, Saving More



In this part . . .

I detail numerous ways to make your dollars go toward building up your savings rather than toward wasteful spending. Are you buried in debt with little to show for it? Well, it’s never too late to start digging out. Here you find out how to reduce your debt burden. I also devote an entire chapter to discussing taxes and how to legally minimize them.

Chapter 14

Investing in Real Estate: Your Home and Beyond

In This Chapter

- Choosing between buying and renting
- Determining how to finance your real-estate purchase
- Finding a great property
- Working successfully with real-estate agents
- Negotiating your best deal
- Handling money issues after you buy

Buying a home or investing in real estate can be financially and psychologically rewarding. On the other hand, owning real estate can be a real pain in the posterior, because purchasing and maintaining property can be quite costly, time-consuming, and emotionally draining. Perhaps you're looking to escape your rented apartment and buy your first home. Or maybe you're interested in becoming a local real-estate investing tycoon. In either case, you can learn many lessons from real-estate buyers who've traveled before you.

Note: Although this chapter focuses primarily on real estate in which you're going to live — otherwise known by those in the trade as *owner-occupied property* — much of what this chapter covers is relevant to real-estate investors. (For additional information on buying *investment real estate* — property that you rent out to others — see Chapter 9.)

Deciding Whether to Buy or Rent

You may be tired of moving from rental to rental. Perhaps your landlord doesn't adequately keep up the place, or you have to ask permission to hang a picture on the wall. You may desire the financial security and rewards that seem to come with home ownership. Or maybe you just want a place to call your own.

Any one of these reasons is good enough to *want* to buy a home. But before you commit to buy, you should take stock of your life and your financial health so you can decide whether you still want to buy a home and how much you can really afford to spend. You need to ask yourself some bigger questions.

Assessing your timeline

TIP

From a financial standpoint, you really shouldn't buy a place unless you can anticipate being there for at least three years (preferably five or more). Buying and selling a property entails a lot of expenses, including the cost of getting a mortgage (points, application, and appraisal fees), inspection expenses, moving costs, real-estate agents' commissions, and title insurance. *To cover these transaction costs plus the additional costs of ownership, a property needs to appreciate about 15 percent.*

If you need or want to move in a couple years, counting on 15 percent appreciation is risky. If you're fortunate and you happen to buy before a sharp upturn in housing prices, you may get it. If you're unlucky, you'll probably lose money on the deal.

Some people are willing to invest in real estate even when they don't expect to live in it for long and are open to turning their home into a rental. Doing so can work well financially in the long haul, but don't underestimate the responsibilities that come with being a landlord underestimate the responsibilities that come with being a landlord. Also, most people need to sell their current home in order to tap all the cash that they have in it so that they can buy the next one.

Determining what you can afford

Although buying and owning your own home can be a wise financial move in the long run, it’s a major purchase that can send shock waves through the rest of your personal finances. You’ll probably have to take out a 15-to 30-year mortgage to finance your purchase. The home you buy will need maintenance over the years. Owning a home is a bit like running a marathon: Just as you should be in good physical shape to successfully run a marathon, you should be in good financial health when you buy a home.

> I’ve seen too many people fall in love with a home and make a rushed decision without taking a hard look at the financial ramifications. Take stock of your overall financial health (especially where you stand in terms of retirement planning), *before* you buy property and agree to a particular mortgage. Don’t let the financial burdens of a home control your financial future.

Don’t trust a lender when he tells you what you can “afford” according to some formulas the bank uses to figure out what kind of a credit risk you are. To determine how much a potential home buyer can borrow, lenders look primarily at annual income; they pay no attention to some major aspects of a borrower’s overall financial situation. Even if you don’t have money tucked away into retirement savings, or you have several children to clothe, feed, and help put through college, you still qualify for the same size loan as other people with the same income (assuming equal outstanding debts). Only you can figure out how much you can afford, because only you know what your other financial goals are and how important they are to you.

Here are some important financial questions that no lender will ask or care about but that you should ask yourself before buying a home:

- Are you saving enough money monthly to reach your retirement goals?
- How much do you spend (and want to continue spending) on fun things such as travel and entertainment?
- How willing are you to budget your expenses in order to meet your monthly mortgage payments and other housing expenses?
- How much of your children's expected college educational expenses do you want to be able to pay for?

The other chapters in this book can help you answer these important questions. Chapter 4, in particular, helps you think through saving for important financial goals.

Since the first edition of this book was published nearly two decades ago, I have warned that many homeowners run into financial trouble because they don't know their spending needs and priorities or how to budget for them. For this reason, a surprisingly large percentage — some studies say about half — of people who borrow additional money against their home equity use the funds to pay consumer debts.

Calculating how much you can borrow

Mortgage lenders want to know your ability to repay the money you borrow. So you have to pass a few tests that calculate the maximum amount the lender is willing to lend you. For a home in which you'll reside, lenders total up your monthly housing expenses. They define reside, lenders total up your monthly housing expenses. They define your housing costs as

```
mortgage payment + property taxes + insurance
```

Lenders typically limit the amount they'll loan so that your total housing costs are no more than 35 percent of your monthly gross (before taxes) income for the housing expense. (If you're self-employed, take your net income from the bottom line of your federal tax form Schedule C and divide by 12 to get your monthly gross income.)

Lenders also consider your other debts when deciding how much to lend you. These other debts diminish the funds available to pay your housing expenses. Lenders add the amount you need to pay down your other consumer debts (for example, auto loans and credit cards) to your monthly housing expense. The monthly total costs of these debt payments plus your housing costs typically cannot exceed 40 percent.

One general rule says that you can borrow up to three times (or two and one-half times) your annual income when buying a home. But this rule is a really rough estimate. The maximum that a mortgage lender will loan you depends on interest rates. If rates fall, the monthly payment on a mortgage of a given size also drops. Thus, lower interest rates make real estate more affordable.

Table 14-1 gives you an estimate of the maximum amount you may be eligible to borrow. Multiply your gross annual income by the number in the second column to determine the approximate maximum you may be able to borrow. For example, if you're getting a mortgage with a rate around 7 percent and your annual income is $50,000, multiply 3.5 by $50,000 to get $175,000 — the approximate maximum mortgage allowed.

Table 14-1 The Approximate Maximum You Can Borrow

When Mortgage Rates Are	Multiply Your Gross Annual Income* by This Figure

When Mortgage Rates Are	Multiply Your Gross Annual Income* by This Figure
3%	**5.0**
4%	**4.6**
5%	**4.2**
6%	**3.8**
7%	**3.5**
8%	**3.2**
9%	**2.9**
10%	**2.7**
11%	**2.5**

**If you're self-employed, this is your net business income (before taxes).*

Comparing owning versus renting costs

The cost of owning a home is an important financial consideration for many renters. Some people assume that owning costs more. In fact, owning a home doesn't have to cost a truckload of money; it may even cost less than renting, especially with the decline in home prices in the late 2000s in many parts of the country.

On the surface, buying a place seems a lot more expensive than renting. You're probably comparing your monthly rent (measured in hundreds of dollars to more than $1,000, depending on where you live) to the purchase price of a property, which is usually a much larger number — perhaps $150,000 to $500,000 or more. When you consider a home purchase, you're forced to think about your housing expenses in one huge chunk rather than in small monthly installments (like a rent check).

Tallying up the costs of owning a place can be a useful and not-too-complicated exercise. To make a fair comparison between ownership and rental costs, you need to figure what it will cost on a *monthly basis* to buy a place you desire versus what it will cost to rent a *comparable* place. The worksheet in Table 14-2 enables you to do such a comparison. ***Note:*** In the interest of reducing the number of variables, all this "figuring" assumes a fixed-rate mortgage, *not* an adjustable-rate mortgage. (For more info on mortgages, see "Financing Your Home," later in this chapter.)

Also, I ignore what economists call the *opportunity cost of owning.* In other words, when you buy, the money you put into your home can't be invested elsewhere, and the foregone investment return on that money, say some economists, should be considered a cost of owning a home. I choose to ignore this concept because I don't agree with this line of thinking. When you buy a home, you're investing your money in real estate, which historically has offered solid returns over the decades (see Chapter 8). And second, I have you ignore opportunity cost because it greatly complicates the analysis.

Table 14-2 Monthly Expenses: Renting versus Owning

Figure Out This ($ per Month)	Write It Here

1. Monthly mortgage payment (see “Mortgage”)	$
2. Plus monthly property taxes (see “Property taxes”)	+ $
3. Equals total monthly mortgage plus property taxes	= $
4. Your income tax rate (refer to Table 7-1 in Chapter 7)	%
5. Minus tax benefits (line 3 multiplied by line 4)	– $
6. Equals after-tax cost of mortgage and property taxes (subtract line 5 from line 3)	= $
7. Plus insurance ($30 to $150/mo., depending on property value)	+ $
8. Plus maintenance (1% of property cost divided by 12 months)	+ $
9. Equals total cost of owning (add lines 6, 7, and 8)	= $

Now compare line 9 in Table 14-2 with the monthly rent on a comparable place to see which costs more — owning or renting.

Mortgage

To determine the monthly payment on your mortgage, simply multiply the relevant number (or multiplier) from Table 14-3 by the size of your mortgage expressed in thousands of dollars (divided by 1,000). For example, if you’re taking out a $100,000, 30-year mortgage at 6.5 percent, you multiply 100 by 6.32 for a $632 monthly payment.

Table 14-3 Your Monthly Mortgage Payment Multiplier

Interest Rate	15-Year Mortgage Multiplier	30-Year Mortgage Multiplier

3.0%	6.91	4.22
3.5%	7.15	4.49
4.0%	7.40	4.77
4.5%	7.65	5.07
5.0%	7.91	5.37
5.5%	8.17	5.68
6.0%	8.44	6.00
6.5%	8.71	6.32
7.0%	8.99	6.65
7.5%	9.27	6.99
8.0%	9.56	7.34
8.5%	9.85	7.69

9.0%	10.14	8.05
9.5%	10.44	8.41
10.0%	10.75	8.78

Property taxes

You can ask a real-estate person, mortgage lender, or your local assessor's office what your annual property tax bill would be for a house of similar value to the one you're considering buying (the average is about 1.5 percent of your property's value). Divide this amount by 12 to arrive at your monthly property tax bill.

Tax savings in home ownership

Generally speaking, mortgage interest and property tax payments for your home are tax-deductible on Schedule A of IRS Form 1040 (see Chapter 7). Here's a shortcut that works quite well in determining your tax savings in home ownership: Multiply your federal tax rate (see Table 7-1 in Chapter 7) by the total amount of your property taxes and mortgage payment. (Technically speaking, not all of your mortgage payment is tax-deductible — only the portion of the mortgage payment that goes toward interest. In the early years of your mortgage, nearly all of your payment goes toward interest. On the other hand, you may earn state tax benefits from your deductible mortgage interest and property taxes.)

If you want to more accurately determine how home ownership may affect your tax situation, get out your tax return and try plugging in some reasonable numbers to estimate how your taxes will change. You can also speak with a tax advisor.

Considering the long-term costs of renting

When you crunch the numbers to find out what owning rather than renting a comparable place may cost you on a monthly basis, you may discover that owning isn't as expensive as you thought. Or you may find that owning costs more than renting. This discovery may tempt you to think that, financially speaking, renting is cheaper than owning.

> Be careful not to jump to conclusions. Remember that you're looking at the cost of owning versus renting *today.* What about 5, 10, 20, or 30 years from now? As an owner, your biggest monthly expense — the mortgage payment — doesn't increase (assuming that you buy your home with a fixed-rate mortgage). Your property taxes, homeowner's insurance, and maintenance expenses — which are generally far less than your mortgage payment — will increase over time with the cost of living.

When you rent, however, your entire monthly rent is subject to the vagaries of inflation. Living in a rent-controlled unit, where the annual increase allowed in your rent is capped, is the exception to this rule. Rent control does not eliminate price hikes; it just limits them.

Suppose you're comparing the costs of owning a home that costs $240,000 to renting that same home for $1,200 a month. Table 14-4 compares the cost per month of owning the home (after factoring in tax benefits) to your rental costs over 30 years. This comparison assumes that you take out a mortgage loan equal to 80 percent of the cost of the property at a fixed rate of 7 percent and that the rate of inflation of your homeowner's insurance, property taxes, maintenance, and rent is 4 percent per year. I further assume that maintenance, and rent is 4 percent per year. Further assume that you're in a moderate, combined 35 percent federal and state tax bracket.

Table 14-4 Cost of Owning versus Renting over 30 Years

Year	Ownership Cost per Month	Rental Cost per Month
1	$1,380	$1,200
5	$1,470	$1,410
10	$1,620	$1,710
20	$2,040	$2,535
30	$2,700	$3,750

As you can see in Table 14-4, in the first few years, owning a home costs a little more than renting it. In the long run, however, owning is less expensive, because more of your rental expenses increase with inflation. And don't forget that as a homeowner you're building equity in your property; that equity will be quite substantial by the time you have your mortgage paid off.

Recognizing advantages to renting

Although owning a home and investing in real estate generally pay off handsomely over the long-term, to be fair and balanced, I must say that renting has its advantages. Some of the financially successful renters I've seen include people who pay low rent, either because they've made housing sacrifices or they live in a rent-controlled building. If you're consistently able to save 10 percent or more of your earnings, you're probably well on your way to achieving your future financial goals.

As a renter, you can avoid worrying about or being responsible for fixing up the property — that's your landlord's responsibility. You also have more financial and psychological flexibility as a renter. If you want to move, you can generally do so a lot easier as a renter than you can as a homeowner.

Having a lot of your money tied up in your home is another challenge that you don't face when renting over the long haul. Some people enter their retirement years with a substantial portion of their wealth in their homes. As a renter, you can have all your money in financial assets that you can tap in to more easily. Homeowners who have a major chunk of equity tied up in a home at retirement can downsize to a less costly property to free up cash and/or take out a reverse mortgage (which I discuss later in this chapter) on their home equity.

Financing Your Home

After you look at your financial health, figure out your timeline, and compare renting costs to owning costs, you need to confront the tough task of taking on debt to buy a home (unless you're independently wealthy). A mortgage loan from a bank or other source makes up the difference between the cash you intend to put into the purchase and the agreed-upon selling price of the real estate. This section reviews the different options you have for financing your home.

Understanding the two major types of mortgages

Like many other financial products, you have more mortgages to choose from than you could ever possibly investigate. The differences can be important or trivial, expensive or not. Two major types of mortgages exist — those with a fixed interest rate and those with a variable or adjustable rate.

- **Fixed-rate mortgages,** which are usually issued for a 15-or 30-year period, have interest rates that never, ever change. The interest rate you pay the first month is the same rate you pay the last month (and every month in between). Because the interest rate stays the same, your monthly mortgage payment amount doesn't change. With a fixed-rate mortgage, your monthly mortgage expense is certain.

Fixed-rate loans are not risk-free, however. If interest rates fall significantly after you obtain your mortgage, you face the danger of being stuck with your higher-cost mortgage if you're unable to refinance (see "Refinancing your mortgage," later in this chapter). You can be turned down for a refinance because of deterioration in your financial situation or a decline in the value of your property. Even if you're eligible to refinance, you may have to spend significant time and money to complete the process.

- **Adjustable-rate mortgages** (ARMs) carry an interest rate that varies over time. With an adjustable-rate mortgage, you can start with one interest rate and then have different rates for every year (or possibly every month) during a 30-year mortgage. Thus, the size of your monthly payment fluctuates. Because a mortgage payment makes an unusually large dent in most homeowners' checkbooks anyway, signing up for an ARM without understanding its risks is dangerous.

  The attraction of ARMs is the potential interest savings. For the first few years of an adjustable loan, the interest rate is typically lower than it is on a comparable fixed-rate loan. After that, the relative cost depends on the overall trends in interest rates. When interest rates drop, stay level, or rise just a little, you probably continue to pay less for your adjustable mortgage. On the other hand, when rates rise more than a percent or two and then stay elevated, the adjustable loan can cost you more than a fixed-rate loan.

Choosing between fixed-and adjustable-rate mortgages

You need to weigh the pros and cons of each mortgage type and decide what's best for your situation *before* you go out to purchase a piece of real estate or refinance a loan. In the real world, most people ignore this advice. The excitement of purchasing a home tends to cloud one's judgment. My experience has been that few people look at their entire financial picture before making major real-estate decisions. If you're one of them, you may end up with a mortgage that could someday seriously overshadow the delight you take in your little English herb garden out back.

Consider the issues I discuss in this section before you decide which kind of mortgage — fixed or adjustable — is right for you.

How willing and able are you to take on financial risk?

Take stock of how much risk you can handle with the size of your monthly mortgage payment. You can't afford much risk, for example, if your job and income are unstable and you need to borrow a lot. I define *a lot* as "close to the maximum a bank is willing to lend you." *A lot* can also mean that you have no slack in your monthly budget — in other words you're not regularly saving money. If you're in this situation, stick with a fixed-rate loan.

Don't take an adjustable loan simply because the initially lower interest rates allow you to afford the property you want to buy (unless you're absolutely certain that your income will rise to meet future payment increases). Try setting your sights on a property that you can afford with a fixed-rate mortgage.

If interest rates rise, a mushrooming adjustable mortgage payment may test the lower limits of your checking account balance. When you don't have emergency savings you can tap to make the higher payments, how can you afford the monthly payments — much less all the other expenses of home ownership?

And don't forget to factor in reasonably predictable future expenses that may affect your ability to make payments. For example, are you planning to start a family soon? If so, your income may fall while your expenses rise (as they surely will).

If you can't afford the highest allowed payment on an adjustable-rate mortgage, *don't take it.* You shouldn't accept the chance that the interest rate may not rise that high — it might, and then you could lose your home! Ask your lender to calculate the highest possible *maximum monthly payment* on your loan. That's the payment you'd face if the interest rate on your loan were to go to the highest level allowed (the *lifetime cap*).

You need to also consider your stress level. If you have to start following interest rate movements, it's probably not worth gambling on rates. On the other hand, maybe you're in a position to take the financial risks that come with an adjustable-rate mortgage. An adjustable loan places much of the risk of fluctuating rates on you (most adjustables, however, limit, or *cap,* the rise in the interest rate allowed on your loan). In return for your accepting some interest-rate risk, lenders cut you a deal — an adjustable mortgage's interest rate starts lower and stays lower if the overall level of interest rates doesn't rise substantially. Even if rates go up, they'll probably come back down over the life of your loan. So if you can stick with your adjustable for better and for worse, you may still come out ahead over the long term. Typical caps are 2 percent per year and 6 percent over the life of the loan.

You may feel financially secure in choosing an adjustable loan if you have a hefty financial cushion accessible in the event that rates go up, you take out a smaller loan than you're qualified for, or you're saving more than 10 percent of your income.

How long do you plan to keep the mortgage?

A mortgage lender takes extra risk when committing to a fixed interest rate for 15 to 30 years. Lenders don't know what may happen in the intervening years, so they charge you a premium for their risk.

> The savings on most adjustables is usually guaranteed in the first two or three years, because an adjustable-rate mortgage starts at a lower interest rate than a fixed one. If rates rise, you can end up giving back or losing the savings you achieve in the early years of the mortgage. In most cases, if you aren't going to keep your mortgage more than five to seven years, you're probably paying unnecessary interest costs to carry a fixed-rate mortgage.

Another mortgage option is a *hybrid loan,* which combines features of both the fixed-and adjustable-rate mortgages. For example, the initial rate may hold constant for a number of years — three to five years is common — and then adjust once a year or every six months thereafter. These hybrid loans may make sense for you if you foresee a high probability of keeping your loan seven to ten years or less but want some stability in your monthly payments. The longer the initial rate stays locked in, the higher the rate.

Shopping for fixed-rate mortgages

Of the two major types of mortgages I discuss earlier in this chapter, fixed-rate loans are generally easier to shop for and compare. The following sections cover what you need to know when shopping for fixed-rate mortgages.

Trading off interest rates and points

The *interest rate* is the annual amount a lender charges you for borrowing its money. The interest rate on a fixed-rate loan should always be quoted with the points on the loan.

Points are upfront fees paid to your lender when you close on your loan. Points are actually percentages: One point is equal to 1 percent of the loan amount. So when a lender tells you that 1.5 points are on a quoted loan, you pay 1.5 percent of the amount you borrow as points. On a $100,000 loan, for example, 1.5 points cost you $1,500. Points are actually prepaid interest, so they're tax deductible like the interest portion of regular monthly mortgage payments.

Home equity loans

Home equity loans, or home equity lines of credit (HELOCs) can be a useful source of financing to help buy or improve a home. HELOCs are second mortgages and best used by someone who already owns a home and wants to simply tap some of that equity without affecting the existing first mortgage (perhaps because of its attractive interest rate).

HELOCs of up to $100,000 are generally tax deductible. Once established, most HELOCs allow you to tap in to your credit line as you need or want to so you can use the money for many purposes, including a home remodel, college expenses for your kids, or as an emergency source of funds.

HELOCs have their downsides. The biggest negative in my experience is that they encourage homeowners to view their homes as piggy banks from which they can keep borrowing. The interest rate on a HELOC can increase instantaneously. Also beware that lenders can generally cancel your HELOC at their discretion, for example, if the value of your home falls too much or your credit score deteriorates.

For more complete and detailed information on HELOCs and all other home loans, please consult *Mortgages For Dummies* (Wiley), which I coauthored with Ray Brown.

If one lender offers 30-year mortgages at 5.75 percent and another lender offers them at 6 percent, the 6-percent loan isn't necessarily worse. You also need to consider how many points each lender charges.

The interest rate and points on a fixed-rate loan go together and move in opposite directions. If you're willing to pay more points on a given loan, the lender will often reduce the interest rate. Paying more in upfront points may save you a lot of money in interest, because the interest rate on your loan determines your payments over a long, long time — 15 to 30 years. If you pay fewer points, your interest rate increases. Paying less in points may appeal to you if you don't have much cash for closing on your loan.

Suppose Lender X quotes you 5.75 percent on a 30-year fixed-rate loan and charges one point (1 percent). Lender Y, who quotes 6 percent, doesn't charge any points. Which is better? The answer depends mostly on how long you plan to keep the loan.

The 5.75-percent loan is 0.25 percent less than the 6-percent loan. Year in and year out, the 5.75-percent loan saves you 0.25 percent. But because you have to pay 1 percent (one point) upfront on the 5.75-percent loan, it takes about four years to earn back the savings to cover the cost of that point. So if you expect to keep the loan less than four years, go with the 6-percent option.

To perform an apples-to-apples comparison of mortgages from different lenders, get interest rate quotes at the same point level for each mortgage. For example, ask each lender for the interest rate on a loan for which you pay one point.

Be wary of lenders who advertise no-point loans as though they're offering something for nothing. Remember, if a loan has no points, it's *guaranteed* to have a higher interest rate. That's not to say that the loan is better or worse than comparable loans from other lenders. But don’t get sucked in by a no-points sales pitch. Most lenders who spend big bucks advertising these types of loans rarely have the best deals.

Understanding other lender fees

In addition to charging you points and the ongoing interest rate, lenders tack on all sorts of other upfront fees when processing your loan. You need to know the total of all lender fees so that you can compare different mortgages and determine how much completing your home purchase is going to cost you.

Lenders can nickel and dime you with a number of fees other than points. Actually, you pay more than nickels and dimes — $300 here and $50 there add up in a hurry! Here are the main culprits:

- **Application and processing fees:** Most lenders charge several hundred dollars to complete your paperwork and process it through their *underwriting* (loan evaluation) department. The justification for this fee is that if your loan is rejected or you decide not to take it, the lender needs to cover the costs. Some lenders return this fee to you upon closing if you go with their loan (after you’re approved).

- **Credit report:** Many lenders charge a modest fee (about $50 to $75) for obtaining a copy of your credit report. This report tells the lender whether you’ve paid other loans you’ve taken in a timely manner. If you have problems on your credit report, clean them up before you apply (see “Increasing your approval chances,” later in this chapter; also check out Chapter 2 for info on checking your credit report).

- **Appraisal:** The property for which you’re borrowing money needs to be valued. If you default on your mortgage, your lender doesn’t want to get stuck with a property worth less than you owe. For most residential properties, the appraisal cost is typically several hundred dollars.

- **Title and escrow charges:** These not-so-inconsequential costs are discussed in the section, “Remembering title insurance and escrow fees,” later in this chapter.

Get a written itemization of charges from all lenders you are seriously considering so that you can more readily compare different lenders’ mortgages and so you have no surprises when you close on your loan. And to minimize your chances of throwing money away on a loan for which you may not qualify, ask the lender whether you may not be approved for some reason. Be sure to disclose any problems you’re aware of that are on your credit report or with the property.

Some lenders offer loans without points or other lender charges. If lenders don’t charge points or other fees, they have to make up the difference by charging a higher interest rate on your loan. Consider such loans only if you lack cash for closing or if you’re planning to use the loan for just a few years.

Shunning balloon loans

Be wary of balloon loans. They look like fixed-rate loans, but they really aren’t. With a *balloon loan,* the large remaining loan balance becomes fully due at a predetermined time — typically within three to ten years. Balloon loans are dangerous because you may not be able to refinance into a new loan to pay off the balloon loan when it comes due. What if you lose your job or your income drops? What if the value of your property drops and the appraisal comes in too low to qualify you for a new loan? What if interest rates rise and you can’t qualify for a new loan at the higher rate? Taking a balloon loan is a high-risk maneuver that can backfire.

Don't take a balloon loan unless all the following conditions apply:

- You really, really want a certain property.
- The balloon loan is your only financing option.
- You're positive that you're going to be able to refinance or pay off the loan entirely when the balloon loan comes due.

If you take a balloon loan, get one that allows for as much time as possible before coming due.

Inspecting adjustable-rate mortgages (ARMs)

Although sorting through myriad fixed-rate mortgage options is enough to give most people a headache, comparing the bells and whistles of ARMs can give you a mortgage migraine. Caps, indexes, margins, and adjustment periods — you can spend weeks figuring it all out. If you're clueless about personal finances — or just think that you are — shopping for adjustable mortgages scores a 9.9 degree of difficulty on the financial frustration scale.

Unfortunately, you have to wade through a number of details to understand and compare one adjustable to another. Bear with me. And remember throughout this discussion that calculating exactly which ARM is going to cost you the least is impossible, because the cost depends on so many variables. Selecting an ARM has a lot in common with selecting a home: You have to make trade-offs and compromises based on what's important to you.

Understanding the start rate

Just as the name implies, the *start rate* is the interest rate your ARM starts with. Don't judge a loan by this rate. You won't be paying this attractively low rate for long. The interest rate will rise as soon as the terms of the mortgage allow.

Start rates are probably one of the least important items to focus on when comparing adjustable loans. (You'd never know this from the way some lenders advertise them — you see ads with the start rate in 3-inch bold type and everything else in microscopic footnotes!)

Beware of prepayment penalties

Avoid loans with prepayment penalties. You pay this charge, usually 2 to 3 percent of the loan amount, when you pay off your loan before you're supposed to.

Prepayment penalties don't typically apply when you pay off a loan because you sell the property. But if you refinance such a loan in order to take advantage of lower interest rates, you almost always get hit by the prepayment penalties if the loan calls for such penalties.

The only way to know whether a loan has a prepayment penalty is to ask. If the answer is yes, find yourself another mortgage.

The formula (which includes index and margin) and rate caps are far more important for determining what a mortgage will cost you in the long run. Some people have labeled the start rate a *teaser rate,* because the initial rate on your loan is set artificially low to entice you. In other words, even if the market level of interest rates doesn't change, your adjustable is destined to increase — 1 to 2 percent is common.

Determining the future interest rate

You'd never (I hope) agree to a loan if your lender's whim and fancy determined your future interest rate. You need to know exactly how a lender figures out how much your interest rate is going to increase. All adjustables are based on the following formula, which specifies how the future interest rate on your loan is set:

```
index + margin = interest rate
```

Indexes are often (but not always) widely quoted in the financial press, and the specific one used on a given adjustable loan is chosen by the lender. The six-month Treasury bill rate is an example of an index that's used on some mortgages.

The *margin* is the amount added to the index to determine the interest rate you pay on your mortgage. Most loans have margins of around 2.5 percent.

So, for example, the interest rate of a mortgage could be driven by the following formula:

```
six-month Treasury bill rate + 2.5 percent = mortgage
  interest rate
```

In this situation, if six-month Treasuries are yielding 3 percent, the interest rate on your loan should be 5.5 percent. This figure is known as the *fully indexed rate.* If this loan starts at a 4.0-percent rate and the rate on six-month Treasuries stays the same, your loan should eventually increase to 5.5 percent.

TIP

The margin on a loan is hugely important. When you're comparing two loans that are tied to the same index and are otherwise equivalent, the loan with the lower margin is better. The margin determines the interest rate for every year you hold the mortgage.

Avoid negative amortization and interest-only loans if you're stretching

As you make mortgage payments over time, the loan balance you still owe is gradually reduced — this process is known as *amortizing* the loan. The reverse of this process — increasing your loan balance — is called *negative amortization.*

Negative amortization is allowed by some ARMs. Your outstanding loan balance can grow even though you're continuing to make mortgage payments when your mortgage payment is less than it really should be.

Some loans cap the increase of your monthly payment, but not the interest rate. The size of your mortgage payment may not reflect all the interest you owe on your loan. So rather than paying off the interest and some of your loan balance (or principal) every month, you're paying off some, but not all, of the interest you owe. Thus, the extra unpaid interest you still owe is added to your outstanding debt.

Using negative amortization is like paying only the minimum payment required on a credit card bill. You keep racking up greater interest charges on the balance as long as you make only the artificially low payment. Doing so defeats the whole purpose of borrowing an amount that fits your overall financial goals. And you may never get your mortgage paid off! Even worse, the increased interest you start to accrue on the unpaid interest added to your mortgage balance may not be tax deductible, because it doesn't qualify as interest incurred as part of the original purchase (what the IRS calls the *acquisition debt.*)

In prior editions of this book published in the early to mid-2000s, I warned that another type of potentially concerning loan, the interest-only mortgage, was being promoted heavily in higher cost housing markets that stretch buyers' budgets. In the early years of an interest-only loan, the monthly payment is kept lower because only interest is being paid; no payment is going to reduce the loan balance. What many folks don't realize is that at a set number of years into the mortgage (for instance, three, five, or seven), principal payments kick in as well, which dramatically increases the monthly payment.

Avoid negative-amortization mortgages. The only way to know for certain whether a loan includes negative amortization is to ask. Some lenders aren't forthcoming about telling you. You'll find it more frequently on loans that lenders consider risky. If you're having trouble finding lenders who are willing to deal with your financial situation, be especially careful.

Tread carefully with interest-only mortgages. Do not consider interest-only loans if you're stretching to be able to afford a home, and consider one only if you understand how they work and can afford the inevitable jump in payments.

Indexes differ mainly in how rapidly they respond to changes in interest rates. Following are the more common indexes:

- **Treasury bills (T-bills):** These indexes are based on government IOUs (Treasury bills), and a whole lot of them are out there. Most adjustables are tied to the interest rate on 6-month or 12-month T-bills.
- **Certificates of deposit (CDs):** Certificates of deposit are interest-bearing bank investments that lock you in for a specific period of time. ARMs are usually tied to the average interest rate banks are paying on six-month CDs. Like T-bills, CDs tend to respond quickly to changes in the market level of interest rates. Unlike T-bills, CD rates tend to move up a bit more slowly when rates rise and come down faster when rates decline.
- **11th District Cost of Funds:** This index tends to be among the slower-moving indexes. ARMs tied to 11th District Cost of Funds tend to start out at a higher interest rate. (The 11th District Cost of Funds Index is the weighted average of the cost of borrowings to member banking institutions of the Federal Home Loan Bank of San Francisco, the 11th District). A slower-moving index has the advantage of moving up less quickly when rates are on the rise. On the other hand, you need to be patient to realize the benefit of falling interest rates.

Adjustment period or frequency

Every so often, the mortgage-rate formula is applied to recalculate the interest rate on an adjustable-rate loan. Some loans adjust monthly. Others adjust every 6 or 12 months.

In advance of each rate change, the lender should send you a notice telling you what your new rate is. All things being equal, the less frequently your loan adjusts, the less financial uncertainty you have in your life. Less-frequent adjustments usually coincide with a loan starting at a higher interest rate.

Understanding rate caps

When the initial interest rate expires, the interest rate fluctuates based on the formula of the loan. Almost all adjustables come with rate caps. The *adjustment cap* limits the maximum rate change (up or down) allowed at each adjustment. On most loans that adjust every six months, the adjustment cap is 1 percent.

Loans that adjust more than once per year often limit the maximum rate change allowed over the entire year as well. On most such loans, the *annual rate cap* is 2 percent.

Almost all adjustables come with *lifetime caps,* which limit the highest rate allowed over the entire life of the loan. ARMs often have lifetime caps that are 5 to 6 percent higher than the start rate (though higher lifetime caps are increasingly common during the current low-interest-rate period). Before taking an adjustable, figure out the maximum possible payment at the lifetime cap to be sure that you can handle it.

Other ARM fees

Just as with fixed-rate mortgages, ARMs can carry all sorts of additional lender-levied charges. See the section “Understanding additional lender-levied charges. See the section "Understanding other lender fees," earlier in this chapter, for details.

Avoiding the down-payment blues

You can generally qualify for the most favorable mortgage terms by making a down payment of at least 20 percent of the purchase price of the property.

In addition to saving money on interest, you can avoid the added cost of private mortgage insurance (PMI) by putting down this much. (To protect against losing money in the event you default on your loan, lenders usually require PMI, which costs several hundred dollars per year on a typical mortgage.)

Many people don't have the equivalent of 20 percent or more of the purchase price of a home to avoid paying private mortgage insurance. Here are a number of solutions for coming up with that 20 percent faster or buying with less money down:

- **Go on a spending diet.** Take a tour through Chapter 6 to find strategies for cutting back on your spending.
- **Consider lower-priced properties.** Smaller properties and ones that need some work can help reduce the purchase price and, therefore, the required down payment.
- **Find partners.** You can often get more home for your money when you buy a building in partnership with one, two, or a few people. Prepare a legal contract to specify what's going to happen if a partner wants out, divorces, or passes away.
- **Seek reduced down-payment financing.** Some lenders will offer you a mortgage even though you may be able to put down only 10 percent (and perhaps even less) of the purchase price (typically at the cost of a much higher

interest rate). You must have solid credit to qualify for such loans, and you generally have to obtain and pay for the extra expense of private mortgage insurance (PMI), which protects the lender if you default on the loan. When the property value rises enough or you pay down the mortgage enough to have 20-percent equity in the property, you can drop the PMI. You have to apply to your lender to have the PMI dropped; it doesn't happen automatically.

Some property owners or developers may also be willing to finance your purchase with 10 percent or less down. You can't be as picky about properties, because not as many are available under these terms — many need work or haven't been sold yet for other reasons.

- **Get assistance from family.** If your relatives have money dozing away in a savings or CD account, they may be willing to lend (or even give) you the down payment. You can pay them an interest rate higher than the rate they're currently earning but lower than what you'd pay to borrow from a bank — a win/win situation for both of you. Lenders generally ask whether any portion of the down payment is borrowed and will reduce the maximum amount they're willing to loan you accordingly.

For more home-buying strategies, get a copy of the latest edition of *Home Buying For Dummies* (Wiley), which I coauthored with real-estate guru Ray Brown.

Comparing 15-year and 30-year mortgages

Many people don't have a choice between 15-and 30-year mortgages. To afford the monthly payments on their desired home, they need to spread the loan payments over a longer period of time, and a 30-year mortgage is the answer. A 15-year mortgage has higher monthly payments because you pay it off faster, meaning you pay off a larger amount of the loan balance each month and thus build equity in your home quicker. With fixed-rate mortgages at 6 percent, a 15-year mortgage comes with payments that are about 35 percent higher than those for a 30-year mortgage.

Even if you can afford these higher payments, taking the 15-year option isn't necessarily better. The money for making extra payments doesn't come out of thin air. You may have better uses (which I discuss later in this section) for your excess funds.

And if you opt for a 30-year mortgage, you maintain the flexibility to pay it off faster (except in those rare cases where you have to pay a prepayment penalty). By making additional payments on a 30-year mortgage, you can create your own 15-year mortgage. But if the need arises, you can fall back to making only the payments required on your 30-year schedule.

> Locking yourself into higher monthly payments with a 15-year mortgage comes with a risk. If money gets too tight in the future, you can fall behind in your mortgage payments. You may be able to refinance your way out of the predicament, but you can't count on it. If your finances worsen or your property declines in value, you may have trouble qualifying for a refinance.

Suppose you qualify for a 15-year mortgage and you're financially comfortable with the higher payments; the appeal of paying off your mortgage 15 years sooner is enticing. Besides, the interest rate is lower — generally up to 1⁄2 percent lower — on a 15-year mortgage. So if you can afford the higher payments on the 15-year mortgage, you'd be silly not to take it, right? Not so fast. You're really asking whether you should pay off your mortgage slowly or more quickly. And the answer isn't simple — it depends. Don't spend hours crunching numbers; you can make this decision by considering some qualitative issues.

First, think about *alternative uses* for the extra money you'd be throwing into paying down the mortgage. What's best for you depends on your overall financial situation and what else you can do with the money. If you would end up blowing the extra money at the racetrack or on an expensive car, pay down the mortgage. That's a no-brainer.

But suppose you take the extra $100 or $200 per month that you were planning to add to your mortgage payment and contribute it to a retirement account instead. This step may make financial sense. Why? Because contributions to 401(k)s, SEP-IRAs, Keoghs, and other types of retirement accounts (discussed in Chapter 11) are tax-deductible.

When you add an extra $200 to your mortgage payment to pay off your mortgage faster, you receive *no* tax benefits. When you dump that $200 into a retirement account, you get to subtract that $200 from the income on which you pay taxes. If you're paying 35 percent in federal and state income taxes, you shave $70 (that's $200 multiplied by 35 percent) off your tax bill.

In most cases, you get to deduct your mortgage interest on your tax return. So if you're paying 6 percent interest, your mortgage may really cost you only around 4 percent after you factor in the tax benefits. If you think you can do better (remember to consider the taxes on investment returns) by investing elsewhere (stocks, investment real estate, and so on), go for it. Investments such as stocks and real estate have generated better returns over the long haul. These investments carry risk, though, and they're not guaranteed to produce any return.

If you're uncomfortable investing and you'd otherwise leave the extra money sitting in a money market fund or savings account, you're better off paying down the mortgage. When you pay down the mortgage, you invest your money in a sure thing with a modest return. In fact, it’s equivalent to buying a risk-free bond that pays you a pretax interest rate equal to whatever your mortgage interest rate is.

With pre-college-age kids at home, you have an even better reason to fund retirement accounts before you consider paying down your mortgage quickly. Retirement account balances are generally not counted as an asset when determining financial aid for college expenses. By contrast, many schools still count equity in your home (the difference between its market value and your loan balance) as an asset. Your reward for paying down your mortgage balance may be less financial aid! (See Chapter 13 for more details about financing educational expenses.)

Paying down your mortgage faster, especially when you have children, is rarely a good financial decision if you haven’t exhausted contributions to your retirement accounts. Save in your retirement accounts first and get the tax benefits.

Finding the best lender

As with other financial purchases, you can save a lot of money by shopping around. It doesn’t matter whether you shop around on your own or hire someone to help you. Just do it!

On a 30-year, $180,000 mortgage, for example, getting a mortgage that costs 0.5 percent less per year saves you about $20,000 in interest over the life of the loan (given current interest rate levels). That’s enough to buy a decent car! On second thought, save it!

Shopping for a lender on your own

In most areas, you can find many mortgage lenders. Although having a large number of lenders to choose from is good for competition, it also makes shopping a chore.

Large banks whose names you recognize from their advertising usually don't offer the best rates. Make sure that you check out some of the smaller lending institutions in your area. Also, check out mortgage bankers, who, unlike banks, only do mortgages. The better mortgage bankers offer some of the most competitive rates.

Real-estate agents can also refer you to lenders with whom they've previously done business. These lenders may not necessarily offer the most competitive rates — the agent simply may have done business with them in the past.

TIP Web-surfers can head on over to E-Loan (`www.eloan.com`), Bankrate (`www.bankrate.com`), and Realtor.com (`www.realtor.com`). HSH Associates (phone 800-873-2837; website `www.hsh.com`) publishes mortgage information for each of the 50 states. For $10, the company will send you a list of dozens of lenders' rate quotes. You need to be a real data junkie to wade through these multipage reports full of numbers and abbreviations, though.

You can also look in the real-estate section of one of the larger Sunday newspapers (and associated websites) in your area for charts of selected lender interest rates. These tables are by no means comprehensive or reflective of the best rates available. In fact, many of them are sent to newspapers for free by firms that distribute mortgage information to mortgage brokers. Use the tables as a starting point by calling the lenders who list the best rates.

TIP One tactic that works well, especially in refinance situations, is to gather the best quotes from various sources, and then check with your current banking relationship last. Ask them to match or beat your best offer (waive or discount some fees, discount the interest rate, and so on). If you're a good client and they want to keep your business (or expand what they already have with you), they may give you the best deal.

Hiring a mortgage broker

Insurance agents peddle insurance, real-estate agents sell real estate, and mortgage brokers deal in mortgages. They buy mortgages at wholesale from lenders and then mark them up to retail before selling them to you. The mortgage brokers get their income from the difference, or *spread,* in the form of a commission. The terms of the loan obtained through a broker are generally the same as the terms you obtain from the lender directly.

Mortgage brokers get paid a percentage of the loan amount — typically 0.5 to 1 percent. This commission is negotiable, especially on larger loans that are more lucrative. Ask a mortgage broker what his cut is. Many people don't ask for this information, so some brokers may act taken aback when you inquire. Remember, it's your money!

The chief advantage of using a mortgage broker is that the broker can shop among lenders to get you a good deal. If you're too busy or disinterested to shop around for a good deal on a mortgage, a competent mortgage broker can probably save you money. A broker can also help you through the tedious process of filling out all those horrible documents lenders demand before giving you a loan. And if you have credit problems or an unusual property you're financing, a broker may be able to match you up with a hard-to-find lender who's willing to offer you a mortgage.

When evaluating a mortgage broker, be on guard for those who are lazy and don't continually shop the market looking for the best mortgage lenders. Some brokers place their business with the same lenders all the time, and those lenders don't necessarily offer the best rates. Also watch out for salespeople who earn big commissions pushing certain loan programs that aren't in your best interests. These brokers aren't interested in taking the time to understand your needs and discuss your options. Thoroughly check a broker's references before doing business.

Even if you plan to shop on your own, talking to a mortgage broker may still be worthwhile. At the very least, you can compare what you find with what brokers say they can get for you. Just be careful. Some brokers tell you what you want to hear and then aren't able to deliver when the time comes.

When a loan broker quotes you a really good deal, ask who the lender is. (Most brokers refuse to reveal this information until you pay the few hundred dollars to cover the appraisal and credit report.) You can check with the actual lender to verify the interest rate and points the broker quotes you and make sure that you're eligible for the loan.

Increasing your approval chances

A lender can take several weeks to complete your property appraisal and an evaluation of your loan package. When many people are trying to refinance their loans, typically after a large drop in interest rates, the process may even take upwards of six weeks. When you're under contract to buy a property, having your loan denied after waiting several weeks can mean that you lose the property as well as the money you spent applying for the loan and having the property inspected. Some property sellers may be willing to give you an extension, but others won't.

TIP

Here's how to increase your chances of having your mortgage approved:

- **Get your finances in shape before you shop.** You won't have a good handle on what you can afford to spend on a home until you whip your personal finances into shape. Do so before you begin to make offers on properties. This book can help you. If you have consumer debt, eliminate it — the more credit card, auto loan, and other consumer debt you rack up, the less mortgage you qualify for. In addition to the high interest rate and the fact that it encourages you to live beyond your means, you now have a third reason to get rid of consumer debt. Hang onto the dream of owning a home, and plug away at paying off consumer debts.

- **Clear up credit report problems.** Get a copy of your credit report before you apply for a mortgage. Chapter 2 explains how to obtain a free copy, as well as correct any mistakes or clear up blemishes.

- **Get preapproved or prequalified.** When you get *prequalified,* a lender speaks with you about your financial situation and then calculates the maximum amount he's willing to lend you based on what you tell him. *Preapproval* is much more in-depth and includes a lender's review of your financial statements. Don't waste your time and money getting preapproved if you're not really ready to buy.

- **Be upfront about problems.** Late payments, missed payments, or debts that you never bothered to pay can come back to haunt you. The best defense against loan rejection is to avoid it in the first place. You can sometimes head off potential rejection by disclosing to your lender anything that may cause a problem before you apply for the loan. That way, you have more time to correct problems and find alternate solutions. Mortgage brokers (see the preceding section) can also help you shop for lenders who are willing to offer you a loan despite credit problems.

- **Work around low/unstable income.** When you've been changing jobs or you're self-employed, your recent economic history may be as unstable as a country undergoing a regime change. Making a larger down payment is one way around this problem. You may try getting a cosigner, such as a relative or good friend. As long as he isn't borrowed up to his eyeballs, he can help you qualify for a larger loan than you can get on your own. Be sure that all parties understand the terms of the agreement, including who's responsible for monthly payments!
- **Consider a backup loan.** You certainly should shop among different lenders, and you may want to apply to more than one for a mortgage. Although applying for a second loan means additional fees and work, it can increase your chances of getting a mortgage if you're attempting to buy a difficult-to-finance property or if your financial situation makes some lenders leery. Be sure to disclose to each lender what you're doing — the second lender to pull your credit report will see that another lender has already done so.

Finding the Right Property

Shopping for a home can be fun. You get to peek inside other people's closets. But for most people, finding the right house at the right price can take a lot of time. When you're buying with partners or a spouse (or children, if you choose to share the decision-making with them), finding the right place can also entail a lot of compromise. A good agent (or several who specialize in different areas) can help with the legwork. The following sections cover the main things you need to consider when shopping for a home to call your own.

Condo, town house, co-op, or detached home?

Some people's image of a home is a single-family dwelling — a stand-alone house with a lawn and white picket fence. In some areas, however — particularly in higher-cost neighborhoods — you find *condominiums* (you own the unit and a share of everything else), *town homes* (attached or row houses), and *cooperatives,* also known as *co-ops* (you own a share of the entire building). The allure of such higher-density housing is that it's generally less expensive. In some cases, you don't have to worry about some of the general maintenance, because the owner's association (which you pay for, directly or indirectly) takes care of it.

TIP If you don't have the time, energy, or desire to keep up a property, shared housing may make sense for you. You generally get more living space for your dollars, and it may also provide you with more security than a stand-alone home.

As investments, however, single-family homes generally do better in the long run. Shared housing is easier to build and thus overbuild; on the other hand, single-family houses are harder to put up because more land is required. And most people, when they can afford it, still prefer a stand-alone home.

With that being said, you should remember that a rising tide raises all boats. In a good real-estate market, all types of housing appreciate, although single-family homes tend to do better. Shared housing values tend to increase the most in densely populated urban areas with little available land for new building.

TIP From an investment return perspective, if you can afford a smaller single-family home instead of a larger shared-housing unit, buy the single-family home. Be especially wary of buying shared housing in suburban areas with lots of developable land.

Casting a broad net

You may have an idea about the type of property and location you're interested in or think you can afford before you start your search. You may think, for example, that you can only afford a condominium in the neighborhood you're interested in. But if you take the time to check out other communities, you may be surprised to find one that meets most of your needs and also has affordable single-family homes. You'd never know about this community if you were to narrow your search too quickly.

Even if you've lived in an area for a while and you think you know it well, look at different types of properties in a number of communities before you narrow your search. Be open-minded and figure out which of your many criteria for a home you *really* care about.

Finding out actual sale prices

Don't look at just a few of the homes listed at a particular price and then get depressed because they're all dogs or you can't afford what you really want. Before you decide to renew your apartment lease, remember that properties often sell for less than the price at which they're listed.

Find out what the places you look at eventually sell for. Doing so gives you a better sense of what places are really worth and what properties you may be able to afford. Ask the agent or owner who sold the property what the sale price was, or contact the town's assessors' office for information on how to obtain property sale price information.

Researching the area

Even (and especially) if you fall in love with a house at first sight, go back to the neighborhood at various times of the day and on different days of the week. Travel to and from your prospective new home during commute hours to see how long your commute will really take. Knock on some doors and meet your potential neighbors. You may discover, for example, that a flock of chickens lives in the backyard next door or that the street and basements frequently flood.

Go visit the schools. Don't rely on statistics about test scores. Talk to parents and teachers. What's really going on at the school? Even if you don't have kids, the quality of the local school has direct bearing on the value of your property. Is crime a problem? Call the local police department. Will future development be allowed? If so, what type? Talk to the planning department. What are your property taxes going to be? Is the property located in an area susceptible to major risks, such as floods, mudslides, fires, or earthquakes? Consider these issues even if they're not important to you, because they can affect the resale value of your property. Make sure that you know what you're getting yourself into *before* you buy.

Working with Real-Estate Agents

When you buy (or sell) a home, you'll probably work with a real-estate agent. Real-estate agents earn their living on commission. As such, their incentives can be at odds with what's best for you. Real-estate agents usually don't hide the fact that they get a cut of the deal. Property buyers and sellers generally understand the real-estate commission system. I credit the real-estate profession for calling its practitioners "agents" instead of coming up with some silly obfuscating title such as "housing consultants."

A top-notch real-estate agent can be a significant help when you purchase or sell a property. On the other hand, a mediocre, incompetent, or greedy agent can be a real liability. The following sections help you sort the best from the rest.

Recognizing conflicts of interest

Real-estate agents, because they work on commission, face numerous conflicts of interest. Some agents may not even recognize the conflicts in what they're doing. The following list presents the most common conflicts of interest that you need to watch out for:

- Because agents work on commission, it costs them when they spend time with you and you don't buy or sell. They want you to complete a deal, and they want that deal as soon as possible — otherwise, they don't get paid. Don't expect an agent to give you objective advice about what you should do given your overall financial situation. Examine your overall financial situation *before* you decide to begin working with an agent.

- Because real-estate agents get a percentage of the sales price of a property, they have a built-in incentive to encourage you to spend more. Adjustable-rate mortgages (see "Financing Your Home," earlier in this chapter) allow you to spend more, because the interest rate starts at a lower level than that of a fixed-rate mortgage. Thus, real-estate agents are far more likely to encourage you to take an adjustable. But adjustables are a lot riskier — you need to understand these drawbacks before signing up for one.

- Agents often receive a higher commission when they sell listings that belong to other agents in their office. Beware. Sometimes the same agent represents both the property seller and the property buyer in the transaction — a real problem. Agents who hold open houses for sale may try to sell to an unrepresented buyer they meet at the open house. There's no way one person can represent the best interests of both sides.

- Because agents work on commission and get paid a percentage of the sales price of the property, many aren't interested in working with you if you can't or simply don't want to spend a lot. Some agents may reluctantly take you on as a customer and then give you little attention and time. Before you hire an agent, check references to make sure that he works well with buyers like you.

- Real-estate agents typically work a specific territory. As a result, they usually can't objectively tell you the pros and cons of the surrounding regions. Most won't admit that you may be better able to meet your needs by looking in another area where they don't normally work. Before you settle on an agent (or an area), spend time figuring out the pros and cons of different territories on your own. If you want to seriously look in more than one area, find agents who specialize in each area.

- Some agents may refer you to a more expensive lender who has the virtue of high approval rates. If you don't get approved for a mortgage loan, your entire real-estate deal may unravel. Be sure to shop around — you can probably get a loan more cheaply. Be especially wary of agents who refer you to mortgage lenders and mortgage brokers who pay agents referral fees. Such payments clearly bias a real-estate agent's "advice."

- Agents may encourage you to use a particular inspector with a reputation of being "easy" — meaning he may not "find" all the house's defects. Home inspectors are supposed to be objective third parties who are hired by prospective buyers to evaluate the condition of a property. Remember, it's in the agent’s best interest to seal the deal, and the discovery of problems may sidetrack those efforts.

- Under pressure to get a house listed for sale, some agents agree to be accomplices and avoid disclosing known defects or problems with the property. In most cover-up cases, it seems, the seller doesn’t explicitly ask an agent to help cover up a problem; the agent just looks the other way or avoids telling the whole truth. Never buy a home without having a home inspector look it over from top to bottom.

Looking for the right qualities in real-estate agents

When you hire a real-estate agent, you want to find someone who’s competent and with whom you can get along. Working with an agent costs a lot of money (which is built into the price of houses’ sold and generally deducted from the seller’s proceeds) — so make sure that you get your money’s worth.

INVESTIGATE

Interview several agents. Check references. Ask agents for the names and phone numbers of at least three clients they’ve worked with in the past six months (in the geographical area in which you’re looking). Look for the following traits in any agent you work with:

- **Full-time employment:** Some agents work in real estate as a second or even third job. Information in this field changes constantly. The best agents work at it full-time so that they can stay on top of the market.

- **Experience:** Hiring someone with experience doesn’t necessarily mean looking for an agent who’s been kicking around for decades. Many of the best agents come into the field from other occupations, such as business or teaching.

Some sales, marketing, negotiation, and communication skills can certainly be picked up in other fields, but experience in buying and selling real estate does count.

- **Honesty and integrity:** If your agent doesn't level with you about what a neighborhood or particular property is really like, you suffer the consequences.
- **Interpersonal skills:** An agent has to be able to get along not only with you but also with a whole host of other people who are typically involved in a real-estate deal: other agents, property sellers, inspectors, mortgage lenders, and so on.
- **Negotiation skills:** Is your agent going to exhaust all avenues to negotiate the best deal possible for you? Be sure to ask the agent's references how well the agent negotiated for them.
- **High-quality standards:** Sloppy work can lead to big legal or logistical problems down the road. If an agent neglects to recommend thorough and complete inspections, for example, you may be stuck with undiscovered problems after the deal is done.

INVESTIGATE

Agents sometimes market themselves as *top producers,* which means that they sell a relatively large volume of real estate. This title doesn't count for much for you, the buyer. It may be a red flag for an agent who focuses on completing as many deals as possible. When you're buying a home, you need an agent who has the following additional traits:

- **Patience:** You need an agent who's patient and willing to allow you the necessary time it takes to get educated and make the best decision for yourself.
- **Local market and community knowledge:** When you're looking to buy a home in an area in which you're not currently living, an informed agent can have a big impact on

your decision.

- **Financing knowledge:** As a buyer (especially a first-time buyer or someone with credit problems), you should look for an agent who knows which lenders can best handle your type of situation.

Buying real estate requires somewhat different skills than selling real estate. Few agents can do both equally well. No law or rule says that you must use the same agent when you sell a property as you do when you buy a property.

Buyer's agents/brokers

Increasing numbers of agents are marketing themselves as buyer's agents/brokers. Supposedly, these folks represent your interests as a property buyer exclusively. Legally speaking, buyer's agents may sign a contract saying that they represent your — and only your — interests. Before this enlightened era, all agents contractually worked for the property seller. The title "buyer's agent" is one of those things that sounds better than it really is. Agents who represent you as buyer's brokers still get paid only when you buy. And they still get a commission as a percentage of the purchase price. So they still have an incentive to sell you a piece of real estate; and the more expensive it is, the more commission they make.

Putting Your Deal Together

After you do your homework on your personal finances, discover how to choose a mortgage, and research neighborhoods and home prices, you'll hopefully be ready to close in on your goal. Eventually you'll find a home you want to buy. Before you make that first offer, though, you need to understand the importance of negotiations, inspections, and the other elements of a real-estate deal.

Negotiating 101

When you work with an agent, the agent usually handles the negotiation process. But you need to have a plan and strategy in mind; otherwise, you may end up overpaying for your home. Here are some recommendations for getting a good deal:

- **Never fall in love with a property.** If you have money to burn and can't imagine life without the home you just discovered, pay what you will. Otherwise, remind yourself that other good properties are out there. Having a backup property in mind can help.

- **Find out about the property and owner before you make your offer.** How long has the property been on the market? What are its flaws? Why is the owner selling? The more you understand about the property and the seller's motivations, the better able you'll be to draft an offer that meets both parties' needs.

- **Get comparable sales data to support your price.** Too often, home buyers and their agents pick a number out of the air when making an offer. But if the offer has no substance behind it, the seller will hardly be persuaded to lower his asking price. Pointing to recent and comparable home sales to justify your offer price strengthens your case.

- **Remember that price is only one of several negotiable items.** Sometimes sellers get fixated on selling their homes for a certain amount. Perhaps they want to get at least what they paid for it years ago. You may be able to get a seller to pay for certain repairs or improvements, to pay some of your closing costs, or to offer you an attractive loan without the extra loan fees that a bank would charge. Likewise, the real-estate agent's commission is negotiable.

Inspecting before you buy

When you buy a home, you may be making one of the biggest (if not *the* biggest) purchases of your life. Unless you build homes and do contracting work, you probably have no idea what you're getting yourself into when it comes to furnaces and termites.

Spend the time and money to locate and hire good inspectors and other experts to evaluate the major systems and potential problem areas of the home. Areas that you want to check include

- Overall condition of the property
- Electrical, heating, and plumbing systems
- Foundation
- Roof
- Pest control and dry rot
- Seismic/slide/flood risk

Inspection fees often pay for themselves. When problems that you weren't aware of are uncovered, the inspection reports give you the information you need to go back and ask the property seller to fix the problems or reduce the purchase price of the property to compensate you for correcting the deficiencies yourself.

As with other professionals whose services you retain, interview several inspection companies. Ask which systems they inspect and how detailed a report they're going to prepare for you (ask for a sample copy). Request names and phone numbers of three people who have used their service within the past six months.

Never accept a seller's inspection report as your only source of information. When a seller hires an inspector, he may hire someone who won't be as diligent and critical of the property. What if the inspector is a buddy of the seller or his agent? By all means, review the seller's inspection reports if available, but get your own as well.

And here's one more inspection for you to do: The day before you close on the purchase, do a brief walk-through of the property. Make sure that everything is still in good order and that all the fixtures, appliances, curtains, and other items that were to be left per the contract are still there. Sometimes sellers (and their movers) "forget" what they're supposed to leave or try to test your powers of observation.

Remembering title insurance and escrow fees

Mortgage lenders require *title insurance* to protect against someone else claiming legal title to your property. This claim can happen, for example, when a husband and wife split up and the one who remains in the home decides to sell and take off with the money. If both spouses are listed as owners on the title, the spouse who sells the property (possibly by forging the other's signature) has no legal right to do so. Both you and the lender can get stuck holding the bag if you buy the home that the one spouse of this divided couple is selling. But title insurance acts as the salvation for you and your lender. Title insurance protects you against the risk that the spouse whose name was forged will come back and reclaim rights to the home after it's sold.

If you're in the enviable position of paying cash for a property, you should still buy title insurance, even though a mortgage lender won't prod you to do so. You need to protect your investment.

Escrow charges pay for neutral third-party services to ensure that the instructions of the purchase contract or refinance are fulfilled and that everyone gets paid.

Many people don't seem to understand that title insurance and escrow fees vary from company to company. As a result, they don't bother to comparison shop; they simply use the company that their real-estate agent or mortgage lender suggests.

When you call around for title insurance and escrow fee quotes, make sure that you understand all the fees. Many companies tack on all sorts of charges for things such as courier fees and express mail. If you find a company with lower prices and want to use it, ask for an itemization in writing so that you don't have any surprises. Real-estate agents and mortgage lenders can be a good starting point for referrals because they usually have a broader perspective on the cost and service quality of different companies. Call other companies as well. Agents and lenders may be biased toward a company simply because they're in the habit of using it or they've referred clients to it before.

After You Buy

After you buy a home, you'll make a number of important decisions over the months and years ahead. This section discusses the key issues you need to deal with as a homeowner and tells what you need to know to make the best decision for each of them.

Refinancing your mortgage

Three reasons motivate people to *refinance,* or obtain a new mortgage to replace an old one. One is obvious: to save money because interest rates have dropped. Refinancing can also be a way to raise capital for some other purpose. You can use refinancing to get out of one type of loan and into another. The following sections can help you decide on the best option in each case.

Spending money to save money

If your current loan has a higher rate of interest than comparable new loans, you may be able to save money by refinancing. Because refinancing costs money, whether you can save enough to justify the cost is open to question. If you can recover the expenses of the refinance within a few years, go for it. If recovering the costs will take longer, refinancing may still make sense if you anticipate keeping the property and mortgage that long.

Be wary of mortgage lenders or brokers who tout how soon your refinance will pay for itself; they usually oversimplify their calculations. For example, if the refinance costs you $2,000 to complete (for appraisals, loan fees and points, title insurance, and so on) and reduces your monthly payment by $100, lenders or brokers typically say that it's going to take 20 months for you to recoup the refinance costs. This estimate isn't accurate, however, because you lose some tax write-offs if your mortgage interest rate and payment are reduced. You can't simply look at the reduced amount of your monthly payment. (Mortgage lenders like to look at it, however, because it makes refinancing more attractive.) And your new mortgage will be reset to a different term than the number of years remaining on your old one.

If you want a better estimate of your likely cost savings but don't want to spend hours crunching numbers, take your tax rate — for example, 27 percent — and reduce your monthly payment savings on the refinance by this amount (see Chapter 7). Continuing with the example in the preceding paragraph, if your monthly payment drops by $100, you're really saving about $73 a month after factoring in the lost tax benefits. So it takes about 28 months ($2,000 divided by $73) — not 20 — to recoup the refinance costs.

Note that not all refinances cost big money. So-called no-cost refinances or no-point loans minimize your out-of-pocket expenses, but as I discuss earlier in this chapter, they may not be your best long-term options. Such loans usually come with higher interest rates.

Using money for another purpose

Refinancing to pull out cash from your home for some other purpose can make good financial sense because under most circumstances, mortgage interest is tax-deductible. Paying off other higher-interest consumer debt — such as on credit cards or on an auto loan — is a common reason for borrowing against a home. The interest on consumer debt is not tax-deductible and is generally at a much higher interest rate than what mortgages charge you.

TIP If you're starting a business, consider borrowing against your home to finance the launch of your business. You can usually do so at a lower cost than with a business loan.

You need to find out whether a lender is willing to lend you more money against the equity in your home (which is the difference between the market value of your house and the loan balance). You can use Table 14-1, earlier in this chapter, to estimate the maximum loan for which you may qualify.

Changing loans

You may want to refinance even though you aren't forced to raise cash or you're able to save money. Perhaps you're not comfortable with your current loan — holders of adjustable-rate mortgages often face this problem. You may find out that a fluctuating mortgage payment makes you anxious and wreaks havoc on your budget.

payment makes you anxious and wreaks havoc on your budget.

Paying money to go from an adjustable to a fixed rate is a lot like buying insurance. The cost of the refinance is “insuring” you a level mortgage payment. Consider this option only if you want peace of mind and you plan to stay with the property for a number of years.

Sometimes jumping from one adjustable to another makes sense. Suppose that you can lower the maximum lifetime interest rate cap and the refinance won’t cost much. Your new loan should have a lower initial interest rate than the one you’re paying on your current loan. Even if you don’t save megabucks, the peace of mind of a lower ceiling can make refinancing worth your while.

Mortgage life insurance

Shortly after you buy a home or close on a mortgage, you start getting mail from all kinds of organizations that keep track of publicly available information about mortgages. Most of these organizations want to sell you something, and they don’t tend to beat around the bush. “What will your dependents do if you meet with an untimely demise and they’re left with a gargantuan mortgage?” these organizations ask. In fact, this is a good financial-planning question. If your family is dependent on your income, can it survive financially if you pass away?

> Don’t waste your money on mortgage life insurance. You may need life insurance to provide for your family and help meet large obligations such as mortgage payments or educational expenses for your children, but mortgage life insurance is typically grossly overpriced. (Check out the life insurance section in Chapter 16 for advice about term life insurance.) Consider mortgage life insurance only if you have a health problem and the mortgage life insurer doesn’t require a physical examination. Be sure to compare it with term life

options.

Is a reverse mortgage a good idea?

An increasing number of homeowners are finding, particularly in their later years of retirement, that they lack cash. The home in which they live is usually their largest asset. Unlike other investments, such as bank accounts, bonds, or stocks, a home does not provide any income to the owner unless he decides to rent out a room or two.

A *reverse mortgage* allows a homeowner who is low on cash to tap home equity. For an elderly homeowner, using home equity can be a difficult thing to do psychologically. Most people work hard to pay a mortgage month after month, year after year, until it's finally all paid off. What a feat and what a relief after all those years!

Taking out a reverse mortgage reverses this process. Each month, the reverse mortgage lender sends you a check that you can spend on food, clothing, travel, or whatever you want. The money you receive each month is really a loan from the bank against the value of your home, which makes the monthly check free from taxation. A reverse mortgage also allows you to stay in your home and use its equity to supplement your monthly income.

The main drawback of a reverse mortgage is that it can diminish the estate that you may want to pass on to your heirs or use for some other purpose. Also, some loans require repayment within a certain number of years. The fees and the effective interest rate you're charged to borrow the money can be quite high.

Because some loans require the lender to make monthly payments to you as long as you live in the home, lenders assume that you'll live many years in your home so that they won't lose money when making these loans. If you end up keeping the loan for only a few years because you move, for example, the cost of the loan is extremely high.

TIP You may be able to create a reverse mortgage with your relatives. This technique can work if you have family members who are financially able to provide you with monthly income in exchange for ownership of the home when you pass away.

You have other alternatives to tapping the equity in your home. Simply selling your home and buying a less expensive property (or renting) is one option. Under current tax laws, qualifying house sellers can exclude a sizable portion of their profits from capital gains tax: up to $250,000 for single taxpayers and $500,000 for married couples.

Selling your house

The day may come when you want to sell your house. If you're going to sell, make sure you can afford to buy the next home you desire. Be especially careful if you're a trade-up buyer — that is, if you're going to buy an even more expensive home. All the affordability issues discussed at the beginning of this chapter apply. You also need to consider the following issues.

Selling through an agent

When you're selling a property, you want an agent who can get the job done efficiently and sell your house for as much as possible. As a seller, you need to seek an agent who has marketing and sales expertise and is willing to put in the time and money necessary to sell your house. Don't necessarily be impressed by an agent who works for a large company. What matters more is what the agent will do to market your property.

When you list your house for sale, the contract you sign with the listing agent includes specification of the commission to be paid if the agent is successful in selling your house. In most areas of the country, agents usually ask for a 6-percent commission. In an area that has lower-cost housing, they may ask for 7 percent.

Remember that commissions are *always* negotiable. Because the commission is a percentage, you have a much greater possibility of getting a lower commission on a higher-priced house. If an agent makes 6 percent selling both a $200,000 house and a $100,000 house, the agent makes twice as much on the $200,000 house. Yet selling the higher-priced house does not take twice as much work. (Selling a $400,000 house certainly doesn't take four times the effort of selling a $100,000 house.)

TIP

If you're selling a higher-priced home (above $250,000), you have no reason to pay more than a 5-percent commission. For expensive properties ($500,000 and up), a 4-percent commission may be reasonable. You may find, however, that your ability to negotiate a lower commission is greatest when an offer is on the table. Because you don't want to give other agents (working with buyers) a reason not to sell your house, have your listing agent cut his take rather than reduce the commission that you advertise you're willing to pay to an agent who brings you a buyer.

In terms of the length of the listing sales agreement you make with an agent, three months is reasonable. When you give an agent a listing that's too long (6 to 12 months) in duration, the agent may simply toss your listing into the multiple listing book and expend little effort to sell your property. Practically speaking, if your home hasn't sold, you can fire your agent whenever you want, regardless of the length of the listing agreement. However, a shorter listing may be more motivating for your agent.

Selling without a real-estate agent

You may be tempted to sell without an agent so that you can save the commission that's deducted from your house's sale price. If you have the time, energy, and marketing experience and you can take the time to properly value your home, you can sell your house without an agent and possibly save some money.

The major problem with attempting to sell your house on your own is that agents who are working with buyers don’t generally look for or show their clients properties that are for sale by owner. Besides saving you time, a good agent can help ensure that you’re not sued for failing to disclose the known defects of your property. If you decide to sell your house on your own, make sure you have access to a legal advisor who can review the contracts. Whether you sell through an agent or not, be sure to read the latest edition of *House Selling For Dummies* (Wiley), which I co-wrote with real-estate expert Ray Brown.

Should you keep your home until prices go up?

Many homeowners are tempted to hold on to their properties (when they need to move) if the property is worth less than when they bought it or if the real-estate market is soft. Renting out your property probably isn’t worth the hassle, and holding on to it probably isn’t worth the financial gamble. If you need to move, you’re better off, in most cases, selling your house.

You may reason that, in a few years (during which you’d rent the property), the real-estate storm clouds will clear, and you’ll be able to sell your property at a much higher price. Here are three risks associated with this line of thinking:

- You can’t know whether property prices in the next few years are going to rebound, stay the same, or drop even further. A property generally needs to appreciate at least a few percent per year just to make up for all the costs of holding and maintaining it.
- You may be unprepared for legal issues and dealings with your tenants. If you’ve never been a landlord, don’t

underestimate the hassle and headaches associated with this job.

- If you convert your home into a rental property in the meantime and it appreciates in value, you're going to pay capital gains tax on your profit when you sell it (and the taxable profit will be higher if you have taken tax deductions for depreciation during the rental period). This capital gains tax wipes out much of the advantage of having held on to the property until prices recovered. (If you want to be a long-term rental property owner, you can do a *tax-free exchange* into another rental property when you sell.)

However, if you would realize little cash from selling *and* you lack other money for the down payment to purchase your next property, you have good reason for holding on to a home that has dropped in value.

Should you keep your home as investment property after you move?

TIP: Converting your home into rental property is worth considering if you need or want to move. Don't consider doing so unless it really is a long-term proposition (ten years or more). As discussed in the preceding section, selling rental property has tax consequences.

If you want to convert your home into an investment property, you have an advantage over someone who's looking to buy an investment property, because you already own your home. Locating and buying investment property takes time and money. You also know what you have with your current home. If you go out and purchase a property to rent, you're starting from scratch.

If your property is in good condition, consider what damage renters may do to it; few renters will take care of your home the way that you would. Also consider whether you’re cut out to be a landlord. For more information, see the section on real estate as an investment in Chapter 9.

Chapter 15

Insurance: Getting What You Need at the Best Price

In This Chapter

- Buying the right insurance at the best price
- Overcoming roadblocks to getting the coverage you need
- Getting your claim money when you've suffered a loss

Unless you work in the industry, you may find insurance to be a dreadfully boring topic. Most people associate insurance with disease, death, and disaster and would rather do just about anything other than review their policies or spend money on insurance. But because you won't want to deal with money hassles when you're coping with catastrophes — illness, disability, death, fires, floods, earthquakes, and so on — you should secure insurance well before you need it.

Insurance is probably the most misunderstood and least monitored area of personal finance. Studies show that more than 90 percent of Americans purchase and carry the wrong types and amounts of insurance coverage. My own experience as a financial counselor confirms this statistic. Most people are overwhelmed by all the jargon in sales and policy statements. Thus, they pay more than necessary for their policies and fail to get coverage through the best companies.

In this chapter, I tell you how to determine what kinds of insurance you need, explain what you can do if you're denied coverage, and give you advice on getting your claims paid. Later chapters discuss types of insurance in detail, including insurance on people (Chapter 16) and possessions (Chapter 17).

Discovering My Three Laws of Buying Insurance

I know your patience and interest in finding out about insurance is surely limited, so in this section I boil the subject down to three fairly simple but powerful concepts that can easily save you big bucks. And while you're saving money, you can still get the quality coverage you need in order to avoid a financial catastrophe.

Law I: Insure for the big stuff; don't sweat the small stuff

Imagine, for a moment, that you're offered a chance to buy insurance that reimburses you for the cost of your cellphone if you lose or damage it. Because most cellphones don't cost much, I don't think you'd buy that insurance. (This coverage really does exist, and about 20 percent of mobile phone owners plunk down about $50 to $150 annually to insure their phones.)

What if you could buy insurance that would pay for the cost of a restaurant meal if you got food poisoning? Even if you were splurging at a fancy restaurant, you wouldn't have a lot of money at stake, so you'd probably decline that coverage as well.

> The point of insurance is to protect against losses that would be financially catastrophic to you, not to smooth out the bumps of everyday life. The preceding example about restaurant insurance is silly, but some people buy equally foolish policies without knowing it. In the following sections, I tell you how to get the most appropriate insurance coverage for your money. I start off with the "biggies" that are worth your money, and then I work down to some insurance options that are less worthy of your dollars.

Buy insurance to cover financial catastrophes

You want to insure against what could be a huge financial loss for you or your dependents. The price of insurance isn't cheap, but it's relatively small in comparison to the potential total loss from a financial catastrophe.

The beauty of insurance is that it spreads risks over millions of other people. If your home were to burn to the ground, paying the rebuilding cost out of your own pocket probably would be a financial catastrophe. If you have insurance, the premiums paid by you and all the other homeowners collectively can easily pay the bills.

Think for a moment about what your most valuable assets are. Also consider potential large expenses. Perhaps they include the following:

- **Future income:** During your working years, your most valuable asset is probably your future earnings. If you were disabled and unable to work, what would you live on? Long-term disability insurance exists to help you handle this type of situation. If you have a family that's financially dependent on your earnings, how would your family manage if you died? Life insurance can fill the monetary void left by your death.
- **Business:** If you're a business owner, what would happen if you were sued for hundreds of thousands of dollars or a million dollars or more for negligence in some work that you messed up? Liability insurance can protect you.
- **Health:** In this age of soaring medical costs, you can easily rack up a $100,000 hospital bill in short order. Major medical health insurance helps pay such expenses. And yet, a surprising number of people don't carry any health insurance — particularly those who work in small businesses. (See Chapter 16 for more on health insurance.)

Psychologically, buying insurance coverage for the little things that are more likely to occur is tempting. You don't want to feel like you're wasting your insurance dollars. You want to get some of your money back, darn it! You're more *likely* to get into a fender bender with your car or have a package lost in the mail than you are to lose your home to fire or suffer a long-term disability. But if the fender bender costs $500 (which you end up paying out of your pocket because you took my advice to take a high deductible; see the next section) or the postal service loses your package worth $50 or $100, you won't be facing a financial disaster.

On the other hand, if you lose your ability to earn an income because of a disability, or if you're sued for $1 million and you're not insured against such catastrophes, not only will you be extremely unhappy, but you'll also face financial ruin. "Yes, but what are the odds," I hear people rationalize, "that I'll suffer a long-term disability or that I'll be sued for $1 million?" I agree that the odds are quite low, but the risk is there. The problem is that you just don't know what, or when, bad luck may befall you.

And don't make the mistake of thinking that you can figure the odds better than the insurance companies can. The insurance companies predict the probability of your making a claim, large or small, with a great deal of accuracy. They employ armies of number-crunching actuaries to calculate the odds that bad things will happen and the frequency of current policyholders' making particular types of claims. The companies then price their policies accordingly.

REMEMBER

So buying (or not buying) insurance based on your perception of the likelihood of needing the coverage is foolish. Insurance companies aren't stupid; in fact, they're ruthlessly smart! When insurance companies price policies, they look at a number of factors to determine the likelihood of your filing a claim. Take the example of auto insurance. Who do you think will pay more for auto insurance — a single male who's age 20, lives the fast life in a high-crime city, drives a macho, turbo sports car, and has received two speeding tickets in the past year? Or a couple in their 40s, living in a low-crime area, driving a four-door sedan, and having a clean driving record?

Take the highest deductible you can afford

Most insurance policies have *deductibles* — the maximum amount you must pay in the event of a loss, before your insurance coverage kicks in and begins paying out. On many policies, such as auto and homeowner's/renter's coverage, most folks opt for a $100 to $250 deductible.

Here are some benefits of taking a higher deductible:

- **You save premium dollars.** Year in and year out, you can enjoy the lower cost of an insurance policy with a high deductible. You may be able to shave 15 to 20 percent off the cost of your policy. Suppose, for example, that you can reduce the cost of your policy by $150 per year by raising your deductible from $250 to $1,000. That $750 worth of coverage is costing you $150 per year. Thus, you'd need to have a claim of $1,000 or more every five years — highly unlikely — to come out ahead. If you're that accident-prone, guess what? The insurance company will raise your premiums.

- **You don't have the hassles of filing small claims.** If you have a $300 loss on a policy with a $100 deductible, you need to file a claim to get your $200 (the amount you're covered for after your deductible). Filing an insurance claim can be an aggravating experience that takes hours of time. In some cases, you may even have your claim denied after jumping through all the necessary hoops. Getting your due may require prolonged haggling.

When you have low deductibles, you may file more claims (although this doesn't necessarily mean that you'll get more money). After filing more claims, you may be "rewarded" with higher premiums —

filing more claims, you may be "rewarded" with higher premiums — in addition to the headache you get from preparing all those blasted forms! Filing more claims may even cause cancellation of your coverage!

Avoid small-potato policies

A good insurance policy can seem expensive. A policy that doesn't cost much, on the other hand, can fool you into thinking that you're getting something for next to nothing. Policies that cost little also cover little — they're priced low because they don't cover large potential losses.

WARNING!

Following are examples of common "small-potato" insurance policies that are generally a waste of your hard-earned dollars. As you read through this list, you may find examples of policies that you bought and that you feel paid for themselves. I can hear you saying, "But I collected on that policy you're telling me not to buy!" Sure, getting "reimbursed" for the hassle of having something go wrong is comforting. But consider all such policies that you bought or may buy over the course of your life. You're not going to come out ahead in the aggregate — if you did, insurance companies would lose money! These policies aren't worth the cost relative to the small potential benefit. On average, insurance companies pay out just 60 cents in benefits on every dollar collected. Many of the following policies pay back even less — around 20 cents in benefits (claims) for every insurance premium dollar spent:

- **Extended warranty and repair plans:** Isn't it ironic that right after the salesperson persuades you to buy a television, computer, or car — in part by saying how reliable the product is — she tries to convince you to spend more money to insure against the failure of the item? If the product is so good, why do you need such insurance?

  Extended warranty and repair plans are expensive and unnecessary insurance policies. Product manufacturers' warranties typically cover any problems that occur in the first year or even several years. After that, paying for a repair out of your own pocket isn't a financial catastrophe. (Some credit-card issuers automatically double the manufacturer's warranty without additional charge on items purchased with their card. However, the cards that do this typically are higher-cost premium cards, so this is no free lunch — you're paying for this protection in terms of higher fees.)

- **Home warranty plans:** If your real-estate agent or the seller of a home wants to pay the cost of a home warranty plan for you, turning down the offer would be ungracious. (As Grandma would say, you shouldn't look a gift horse in the mouth.) But don't buy this type of plan for yourself. In addition to requiring some sort of fee (around $50 to $100), home warranty plans limit how much they'll pay for problems.

  Your money is best spent hiring a competent inspector to uncover problems and fix them *before* you purchase the home. If you buy a house, you should expect to spend money on repairs and maintenance; don't waste money purchasing insurance for such expenses.

- **Dental insurance:** If your employer pays for dental insurance, take advantage of it. But don't pay for this coverage on your own. Dental insurance generally covers a couple teeth cleanings each year and limits payments for more expensive work.

- **Credit life and credit disability policies:** *Credit life policies* pay a small benefit if you die with an outstanding loan. *Credit disability policies* pay a small monthly income in the event of a disability. Banks and their credit-card divisions usually sell these policies. Some companies sell insurance to pay off your credit-card bill in the event of your death or disability, or to cover minimum monthly payments for a temporary period during specified life transition events (such as loss of a job, divorce, and so on).

The cost of such insurance seems low, but that's because the potential benefits are relatively small. In fact, given what little insurance you're buying, these policies are expensive. If you need life or disability insurance, purchase it. But get enough coverage, and buy it in a separate, cost-effective policy (see Chapter 16 for more details).

If you're in poor health and you can buy these insurance policies without a medical evaluation, you represent an exception to the "don't buy it" rule. In this case, these policies may be the only ones to which you have access — another reason these policies are expensive. If you're in good health, you're paying for the people with poor health who can enroll without a medical examination and who undoubtedly file more claims.

- **Daily hospitalization insurance:** Hospitalization insurance policies that pay a certain amount per day, such as $100, prey on people's fears of running up big hospital bills. Health care is expensive — there's no doubt about that.

  But what you really need is a comprehensive (major medical) health insurance policy. One day in the hospital can lead to thousands, even tens of thousands, of dollars in charges, so that $100-per-day policy may pay for less than an hour of your 24-hour day! Daily hospitalization policies don't cover the big-ticket expenses. If you lack a comprehensive health insurance policy, make sure you get one (see Chapter 16)!

- **Insuring packages in the mail:** You buy a $40 gift for a friend, and when you go to the post office to ship it, the friendly postal clerk asks whether you want to insure it. For a few bucks, you think, "Why not?" The U.S. Postal Service may have a bad reputation for many reasons, but it rarely loses or damages things. Go spend your money on something else — or better yet, invest it.

- **Contact lens insurance:** The things that people in this country come up with to waste money on just astound me. Contact lens insurance really does exist! The money goes to replace your contacts if you lose or tear them. Lenses are cheap. Don't waste your money on this kind of insurance.

- **Little stuff riders:** Many policies that are worth buying, such as auto and disability insurance, can have all sorts of riders added on. These *riders* are extra bells and whistles that insurance agents and companies like to sell because of the high profit margin they provide (for *them*). On auto insurance policies, for example, you can buy a rider for a few bucks per year that pays you $25 each time your car needs to be towed. Having your vehicle towed isn't going to bankrupt you, so it isn't worth insuring against.

  Likewise, small insurance policies that are sold as add-ons to bigger insurance policies are usually unnecessary and overpriced. For example, you can buy some disability insurance policies with a small amount of life insurance added on. If you need life insurance, purchasing a sufficient amount in a separate policy is less costly.

Law II: Buy broad coverage

Purchasing coverage that's too narrow is another major mistake people make when buying insurance. Such policies often seem like cheap ways to put your fears to rest. For example, instead of buying life insurance, some folks buy flight insurance at an airport self-service kiosk. They seem to worry more about their mortality when getting on an airplane than they do when getting into a car. If they die on the flight, their beneficiaries collect. But should they die the next day in an auto accident or get some dreaded disease — which is statistically far more likely than going down in a jumbo jet — the beneficiaries get nothing from flight insurance. Buy life insurance (broad coverage to protect your loved ones financially in the event of your death no matter how you die), not flight insurance (narrow coverage).

The medical equivalent of flight insurance is cancer insurance. Older people, who are fearful of having their life savings depleted by a long battle with this dreaded disease, are easy prey for this narrow insurance. If you get cancer, cancer insurance pays the bills. But what if you get heart disease, diabetes, or some other disease? Cancer insurance won’t pay these costs. Purchase major medical coverage, not cancer insurance.

Recognizing fears

Fears, such as getting cancer, are natural and inescapable. Although you may not have control over the emotions that your fears invoke, you must often ignore those emotions in order to make rational insurance decisions. In other words, getting shaky in the knees and sweaty in the palms when boarding an airplane is okay, but letting your fear of flying cause you to make poor insurance decisions is not okay, especially when those decisions affect the financial security of your loved ones.

Preparing for natural disasters — insurance and otherwise

In the chapters following this one, in which I discuss specific types of insurance such as disability insurance and homeowner's insurance, I highlight the fact that you'll find it nearly impossible to get coverage that includes every possibility of catastrophe. For example, when purchasing homeowner's coverage, you find that losses from floods and earthquakes are excluded. You can secure such coverage in separate policies, which you should do if you live in an area subject to such risks (see more on this in Chapter 17). Many people don't understand these risks, and insurers don't always educate customers about such gaping holes in their policies.

Examining misperceptions of risks

How high do you think your risks are for expiring prematurely if you're exposed to toxic wastes or pesticides, or if you live in a dangerous area that has a high murder rate? Well, actually, these risks are quite small when compared to the risks you subject yourself to when you get behind the wheel of a car or light up yet another cigarette.

Reporter John Stossel was kind enough to share with me the results of a study done for him by physicist Bernard Cohen. In the study, Cohen compared different risks. Cohen's study showed that people's riskiest behaviors are smoking and driving. Smoking whacks an average of seven years off a person's life, whereas driving a car results in a bit more than half a year of life lost, on average. Toxic waste shaves an average of one week off an American's life span.

Unfortunately, you can't buy a formal insurance policy to protect yourself against all of life's great dangers and risks. But that doesn't mean that you must face these dangers as a helpless victim; simple changes in behavior can help you improve your security.

Personal health habits are a good example of the types of behavior you can change. If you're overweight and you eat unhealthy, highly processed foods, drink alcohol excessively, and don't exercise, you're asking for trouble, especially during post-middle age. Engage in these habits, and you dramatically increase your risk of heart disease and cancer.

You can buy all the types of traditional insurance that I recommend in this book and still not be well protected for the simple reason that you're overlooking uninsurable risks. However, not being able to buy formal insurance to protect against some dangers doesn't mean that you can't drastically reduce your exposure to such risks by modifying your behavior. For example, you can't buy an auto insurance policy that protects your personal safety against drunk drivers, who are responsible for about 11,000 American deaths annually. However, you can choose to drive a safe car, practice safe driving habits, and minimize driving on the roads during the late evening hours and on major holidays when drinking is prevalent (such as New Year's Eve, July 4th, and so on).

In addition to filling those voids, also think about and plan for the nonfinancial issues that inevitably arise in a catastrophe. For example, make sure you have

- A meeting place for you and your loved ones if you're separated during a disaster (and an out-of-area person to serve as a common point of contact).
- An escape plan in the event that your area is hit with flooding or some other natural disaster (tornado, hurricane, earthquake, fire, or mudslide)
- The security of having taken steps to make your home safer in the event of an earthquake or fire (for instance, securing shelving and heavy objects from falling and tipping, and installing smoke detectors and fire extinguishers)
- A plan for what you'll do for food, clothing, and shelter should your home become uninhabitable

You get the idea. Although you can't possibly predict what's going to happen and when, you can find out about the risks of your area. In addition to buying the broadest possible coverage, you should also make contingency plans for disasters.

Law III: Shop around and buy direct

Whether you're looking at auto, home, life, disability, or other types of coverage, some companies may charge double or triple the rates that other companies charge for the same coverage. Insurers that charge the higher rates may not be better about paying claims, however. You may even end up with the worst of both possible worlds — high prices *and* lousy service.

Most insurance is sold through agents and brokers who earn commissions based on what they sell. The commissions, of course, can bias what they recommend.

can bias what they recommend.

Not surprisingly, policies that pay agents the biggest commissions also tend to be more costly. In fact, insurance companies compete for the attention of agents by offering bigger commissions. When I browse publications targeted to insurance agents, I often see ads in which the largest text is the commission percentage offered to agents who sell the advertiser’s products.

Besides the attraction of policies that pay higher commissions, agents also get hooked, financially speaking, on companies whose policies they sell frequently. After an agent sells a certain amount of a company’s insurance policies, she is rewarded with higher commission percentages (and other perks) on any future sales. Just as airlines bribe frequent fliers with mileage bonuses, insurers bribe agents with fatter commissions and awards such as trips and costly goods.

Shopping around is a challenge not only because most insurance is sold by agents working on commission, but also because insurers set their rates in mysterious ways. Every company has a different way of analyzing how much of a risk you are; one company may offer low rates to me but not to you, and vice versa.

Despite the obstacles, several strategies exist for obtaining low-cost, high-quality policies. The following sections offer smart ways to shop for insurance. (Chapters 16 and 17 recommend how and where to get the best deals on specific types of policies.)

Choosing financially stable insurers

In addition to the price of the policy and the insurer's reputation and track record for paying claims, an insurer's financial health is important to consider when choosing a company. If you faithfully pay your premium dollars year after year, you're going to be upset if the insurer goes bankrupt right before you have a major claim.

Insurance companies can fail just like any other company, and dozens do in a typical year. A number of organizations evaluate and rate, with some sort of letter grade, the financial viability and stability of insurance companies. The major rating agencies include A. M. Best, Fitch, Moody's, Standard & Poor's, and Weiss.

The rating agencies' letter-grade system works just the way it does in high school: A is better than B or C. Each company uses a different scale. Some companies have AAA as their highest rating, and then AA, A, BBB, BB, and so on. Others use A+, A, A–, B+, B, B–, and so on.

Just as getting more than one medical opinion is a good idea, getting two or three financial ratings can give you a better sense of the safety of an insurance company. Stick with companies that are in the top two — or, at worst, three — levels on the different rating scales.

You can obtain current rating information about insurance companies, free of charge, by asking your agent for a listing of the current ratings. If you're interested in a policy sold without the involvement of an agent, you can request the current ratings from the insurer itself.

Although the financial health of an insurance company is important, it's not as big a deal as some insurers (usually those with the highest ratings) and agents make it out to be. Just as financially unhealthy banks are taken over and merged into viable ones, sickly insurers usually follow a similar path under the direction of state insurance regulators.

With most insurance company failures, claims still get paid. The people who had money invested in life insurance or annuities with the failed insurer are the ones who usually lose out. Even then, you typically get back 80 to 90 cents on the dollar of your account value with the insurer, but you may have to wait years to get it.

Looking at employer and other group plans

When you buy insurance as part of a larger group, you generally get a lower price because of the purchasing power of the group. Most of the health and disability policies that you can access through your employer are less costly than equivalent coverage you can buy on your own.

INVESTIGATE

Likewise, many occupations have professional associations through which you may be able to obtain lower-cost policies. Not all associations offer better deals on insurance — compare their policy features and costs with other options.

Life insurance is an exception to the rule that states that group policies offer better value than individual policies. Group life insurance plans usually aren't cheaper than the best life insurance policies that you can buy individually. However, group policies may have the attraction of convenience (ease of enrollment and avoidance of lengthy sales pitches from life insurance salespeople). Group life insurance policies that allow you to enroll without a medical evaluation are usually more expensive, because such plans attract more people with health problems who can't get coverage on their own. If you're in good health, you should definitely shop around for life insurance (see Chapter 16 to find out how).

BEWARE

Insurance agents who want to sell you an individual policy can come up with 101 reasons why buying from them is preferable to buying through your employer or some other group. In most cases, agents' arguments for buying an individual policy from them include self-serving hype.

One valid issue that agents raise is that if you leave your job, you'll lose your group coverage. Sometimes that may be true. For example, if you know that you're going to be leaving your job to become self-employed, securing an individual disability policy before you leave your job makes sense. However, your employer's health insurer may allow you to buy an individual policy when you leave.

In Chapter16, I explain what you need in the policies you're looking for so that you can determine whether a group plan meets your needs. In most cases, group plans, especially through an employer, offer good benefits. So as long as the group policy is cheaper than a comparable individual policy, you'll save money overall buying through the group plan.

Buying insurance without paying sales commissions

Buying policies from the increasing number of companies that are selling their policies directly to the public without the insurance agent and the agent's commission is your best bet for getting a good insurance value. Just as you can purchase no-load mutual funds directly from an investment company without paying any sales commission (see Chapter 10), you also can buy no-load insurance. Be sure to read Chapters 16 and 17 for more specifics on how to buy insurance directly from insurance companies.

Annuities, investment/insurance products traditionally sold through insurance agents, are also now available directly to the customer, without commission. Simply contact some of the leading no-load mutual fund companies (see Chapter 11).

The straight scoop on commissions

The commission paid to an insurance agent is never disclosed through any of the documents or materials that you receive when buying insurance. The only way you can know what the commission is and how it compares with other policies is to ask the agent. Nothing is wrong or impolite about asking. After all, your money pays the commission. You need to know whether a particular policy is being pitched harder because of its higher commission.

Commissions are typically paid as a percentage of the first year's premium on the insurance policy. (Many policies pay smaller commissions on subsequent years' premiums.) With life and disability insurance policies, for example, a 50-percent commission on the first year's premium is not unusual. With life insurance policies that have a cash value, commissions of 80 to 100 percent of your first year's premium are possible. Commissions on health insurance are lower but generally not as low as commissions on auto and homeowner's insurance.

Dealing with Insurance Problems

When you seek out insurance or have insurance policies, sooner or later you’re bound to hit a roadblock. Although insurance problems can be among the more frustrating in life, in the following sections, I explain how to successfully deal with the more common obstacles.

Knowing what to do if you’re denied coverage

Just as you can be turned down when you apply for a loan, you can also be turned down when applying for insurance. With medical, life, or disability insurance, a company may reject you if you have an existing medical problem (a preexisting condition) and are therefore more likely to file a claim. When it comes to insuring assets such as a home, you may have difficulty getting coverage if the property is deemed to be in a high-risk area.

TIP

Here are some strategies to employ if you’re denied coverage:

- **Ask the insurer why you were denied.** Perhaps the company made a mistake or misinterpreted some information that you provided in your application. If you’re denied coverage because of a medical condition, find out what information the company has on you and determine whether it’s accurate.
- **Request a copy of your medical information file.** Just as you have a credit report file that details your use (and misuse) of credit, you also have a medical information report. Once per year, you can request a free copy of your

medical information file (which typically highlights only the more significant problems over the past seven years, not your entire medical file or history) by calling 866-692-6901 or visiting the website at www.mib.com (click on the link on the homepage for "Consumers"). If you find a mistake on your report, you have the right to request that it be fixed. However, the burden is on you to prove that the information in your file is incorrect. Proving that your file contains errors can be a major hassle — you may even need to contact physicians you saw in the past, because their medical records may be the source of the incorrect information.

- **Shop other companies.** Just because one company denies you coverage, that doesn't mean all insurance companies will do the same. Some insurers better understand certain medical conditions and are more comfortable accepting applicants with those conditions. While most insurers charge higher rates to people with blemished medical histories than they do to people with perfect health records, some companies penalize them less than others. An agent who sells policies from multiple insurers, called an *independent agent,* can be helpful, because she can shop among a number of different companies.

- **Find out about state high-risk pools.** A number of states act as the insurer of last resort and provide basic insurance for those who can't get it from insurance companies. The Health Insurance Resource Center website at www.healthinsurance.org/risk_pools provides links to all state health coverage high-risk pool websites. Alternatively, you can check with your state department of insurance (see the "Government" section of your local white pages) for high-risk pools for other types of insurance, such as property coverage.

- **Check for coverage availability before you buy.** If you're considering buying a home, for example, and you can't get coverage, the insurance companies are trying to tell you something. What they’re effectively saying is “We think that property is so high-risk, we’re not willing to insure it even if you pay a high premium.”

Getting your due on claims

In the event that you suffer a loss and file an insurance claim, you naturally hope that your insurance company will cheerfully and expeditiously pay your claims. Given all the money that you shelled out for coverage and all the hoops you jumped through to get approved for coverage in the first place, that’s a reasonable expectation.

Insurance companies may refuse to pay you what you think they owe you for many reasons, however. In some cases, your claim may not be covered under the terms of the policy. At a minimum, the insurer wants documentation and proof of your loss. Other people who have come before you have been known to cheat, so insurers won’t simply take your word, no matter how honest and ethical you are.

Some insurers view paying claims as an adversarial situation and take a “negotiate tough” stance. Thinking that all insurance companies are going to pay you a fair and reasonable amount even if you don’t make your voice heard is a mistake.

The tips that I discuss in this section can help you ensure that you get paid what your policy entitles you to.

Documenting your assets and case

When you're insuring assets, such as your home and its contents, having a record of what you own can be helpful if you need to file a claim. The best defense is a good offense. If you keep records of valuables and can document their cost, you should be in good shape.

A video is the most efficient record for documenting your assets, but a handwritten list detailing your possessions works, too. Just remember to keep this record someplace away from your home — if your home burns to the ground, you'll lose your documentation, too!

If you're robbed or are the victim of an accident, get the names, addresses, and phone numbers of witnesses. Take pictures of property damage and solicit estimates for the cost of repairing or replacing whatever has been lost or damaged. File police reports when appropriate, if for no other reason than to bolster your documentation for the insurance claim.

Preparing your case

Filing a claim should be viewed the same way as preparing for a court trial or an IRS audit. Any information you provide verbally or in writing can and will be used against you to deny your claim. First, you should understand whether your policy covers your claim (this is why getting the broadest possible coverage helps). Unfortunately, the only way to find out whether the policy covers your claim is to read it. Policies are hard to read because they use legal language in non-user-friendly ways.

TIP A possible alternative to reading your policy is to call the claims department and, *without* providing your name (and using caller ID blocking on your phone if you're calling from home), ask a representative whether a particular loss (such as the one that you just suffered) is covered under its policy. You have no need to lie to the company, but you don't have to tell the representative who you are and that you're about to file a claim, either. Your call is so you can understand what your policy covers. However, some companies aren't willing to provide detailed information unless a specific case is cited.

After you initiate the claims process, keep records of all conversations and copies of all the documents you give to the insurer's claims department. If you have problems down the road, this "evidence" may bail you out.

For property damage, get at least a couple of reputable contractors' estimates. Demonstrate to the insurance company that you're trying to shop for a low price, but don't agree to use a low-cost contractor without knowing that she can do quality work.

Approaching your claim as a negotiation

To get what you're owed on an insurance claim, you must approach most claims' filings for what they are — a negotiation with a party that's often uncooperative. And the bigger the claim, the more your insurer will play the part of adversary.

A number of years ago, when I filed a homeowner's insurance claim after a major rain and wind storm significantly damaged my backyard fence, I was greeted on a weekday by a perky, smiley adjuster. When the adjuster entered my yard and started to peruse the damage, her demeanor changed dramatically. She had a combative, hard-bargainer type attitude that I last witnessed when I worked on some labor-management negotiations during my days as a consultant.

The adjuster stood on my back porch, a good distance away from the fences that had been blown over by wind and crushed by two large trees, and said that my insurer preferred to repair damaged fences rather than replace them. "With your deductible of $1,000, I doubt this will be worth filing a claim for," she said.

The fence that had blown over, she reasoned, could have new posts set in concrete. Because we had already begun to clean up some of the damage for safety reasons, I presented to her some pictures of what the yard looked like right after the storm; she refused to take them. She took some measurements and said that she'd have her settlement check to us in a couple of days. The settlement she faxed was for $1,119 — nowhere near what it would cost me to fix the damage that was done.

Practicing persistency

When you take an insurance company's first offer and don't fight for what you're due, you may be leaving a lot of money on the table. To make my long fence-repair story somewhat shorter, after *five* rounds of haggling with the adjusters, supervisors, and finally managers, I was awarded payment to replace the fences and clean up most of the damage. Even though all the contractors I contacted recommended that the work be done this way, the insurance adjuster discredited their recommendations by saying, "Contractors try to jack up the price and recommended work once they know an insurer is involved."

My final total settlement came to $4,888, more than $3,700 higher than the insurer's first offer. Interestingly, my insurer backed off its preference for repairing the fence when the contractor's estimates for doing that work exceeded the cost of a new fence.

I was disappointed with the behavior of that insurance company. I know from conversations with others that my homeowner's insurance company (at that time) was not unusual in its adversarial strategy, especially with larger claims. And to think that this insurer at the time had one of the better track records for paying claims!

Enlisting support

If you're doing your homework and you're not making progress with the insurer's adjuster, ask to speak with supervisors and managers. This is the strategy I used to get the additional $3,700 needed to get things back to where they were before the storm.

The agent who sold you the policy may be helpful in preparing and filing the claim. A good agent can help increase your chances of getting paid — and getting paid sooner. If you're having difficulty with a claim for a policy obtained through your employer or other group, speak with the benefits department or a person responsible for interacting with the insurer. These folks have a lot of clout, because the agent and/or insurer doesn't want to lose the entire account.

> If you're having problems getting a fair settlement from the insurer of a policy you bought on your own, try contacting the state department of insurance. You can find the phone number in the "Government" section of the white pages of your phone book or possibly in your insurance policy, or you can peruse the list at the National Association of Insurance Commissioners website at www.naic.org (click on the link for "States and Jurisdictions" on its home page to find links to department of insurance websites for each state).

When insurers (and government) move slowly

In 2005, when two hurricanes caused unprecedented damage and loss along the Gulf Coast, I received many complaints from folks in that region. Typical is the following note I received from a New Orleans family in December 2005, more than three months after hurricane Katrina:

"We had substantial damage to our home in New Orleans due to hurricane Katrina. We had roof damage on August 29th and three feet of water August 31st. Our flood insurance is through an insurance company acting as an agent for FEMA's program. Our adjuster has still not turned in the necessary paperwork for our claim. Our home insurer made no allowance for proper removal and disposal of asbestos shingles and we have gotten just $2,000 for living expenses out of the $21,000 we're now owed. We have just gotten a first partial payment ($40,000 out of $160,000) on the flood insurance, but it was made out to the wrong mortgage company so we had to send the check back.

"It is shocking that it has gone on this long. It has been all over the papers about the delay of some flood insurance payments being due to FEMA not having adequate money in the till. There's no doubt the insurers are overwhelmed, but why is this taking so long? I called the Louisiana Department of Insurance and was told that insurers normally have 30 days for claims according to the insurance department (who has said they can have 45 days in this case). It's been over 60 days since the adjuster came out to our home."

Stories like this make me disappointed and mad. There's simply no excuse for large insurance companies who are in the business of insuring for such events not to bring the proper resources to bear to make timely payments. The fact that they did not do so for Gulf Coast victims is even more reprehensible given the widespread problems in that area. In addition to home losses, many people also had job losses to deal with and could ill afford to be without money. Large insurers that have written flood policies for which FEMA temporarily lacks money should pay their policyholders. Although the federal government and FEMA officials should be taken to task for allowing FEMA's accounts to run dry, customer-service-oriented insurers can step up and advance money that they know will soon be coming from FEMA.

In situations like this, if you do your homework and you're not making progress with the insurer's adjuster, ask to speak with supervisors and managers. If you're having problems getting a fair and timely settlement from the insurer, try contacting your state's department of insurance. This person who wrote me was from Louisiana, where the state department of insurance had more than 1,600 hurricane-related complaints in the first three months after hurricane Katrina. To my surprise when I spoke with them, the department's Director of Public Information told me that no insurance companies had been fined and penalized for delaying payments. It's no wonder these companies weren't getting on the stick!

Hiring a public adjuster who, for a percentage of the payment (typically 5 to 10 percent), can negotiate with insurers on your behalf is another option.

When all else fails and you have a major claim at stake, try contacting an attorney who specializes in insurance matters. You can find these specialists in the yellow pages under “Attorneys — Insurance Law.” Expect to pay $100+ per hour. Look for a lawyer who’s willing to negotiate on your behalf, help draft letters, and perform other necessary tasks on an hourly basis without filing a lawsuit. Your state department of insurance, the local bar association, or other legal, accounting, or financial practitioners also may be able to refer you to someone.

Chapter 16

Insurance on You: Life, Disability, and Health

In This Chapter

- Looking into life insurance
- Debating disability insurance
- Selecting the best health insurance

During your working years, multiplying your typical annual income by the number of years you plan to continue working produces a pretty big number. That dollar amount equals what is probably your most valuable asset — your ability to earn an income. You need to protect this asset by purchasing some insurance on *you*.

This chapter explains the ins and outs of buying insurance to protect your income: life insurance in case of death, and disability insurance in case of an accident or severe medical condition that prevents you from working. I tell you what coverage you should have, where to look for it, and what to avoid.

In addition to protecting your income, you also need to insure against financially catastrophic expenses. I'm not talking about January's credit-card bill — you're on your own with that one. I'm talking about the type of bills that are racked up from a major surgery and a multi-week stay in the hospital. To protect yourself from potentially astronomical medical bills, you need to have comprehensive health insurance.

Providing for Your Loved Ones: Life Insurance

You generally need life insurance only when other people depend on your income. The following folks don't need life insurance to protect their incomes:

- Single people with no children
- Working couples who could maintain a lifestyle acceptable to them on one of their incomes
- Independently wealthy people who don't need to work
- Retired people who are living off their retirement nest egg
- Minor children (are you financially dependent upon your children?)

If others are either fully or partly dependent on your paycheck (usually a spouse and/or child), you need life insurance, especially if you have major financial commitments such as a mortgage or years of child-rearing ahead. You may also want to consider life insurance if an extended family member is currently or likely to be dependent on your future income.

Determining how much life insurance to buy

Determining how much life insurance to buy is as much a subjective decision as it is a quantitative decision. I've seen some worksheets that are incredibly long and tedious (some are worse than your tax returns). There's no need to get fancy. If you're like me, your eyes start to glaze over if you have to complete 20-plus lines of calculations. Figuring out how much life insurance you need doesn't have to be that complicated.

The main purpose of life insurance is to provide a lump sum payment to replace the deceased person's income. Ask yourself how many years of income you want to replace. Table 16-1 provides a simple way to figure how much life insurance to consider purchasing. To replace a certain number of years' worth of income, simply multiply the appropriate number in the table by your annual after-tax income.

Table 16-1 Life Insurance Calculation

Years of Income to Replace	Multiply Annual After-Tax Income* By
5	4.5
10	8.5
20	15
30	20

**Roughly determine your annual after-tax income in one of two ways: Get out last year's tax return (and Form W-2) and subtract the federal, state, and Social Security taxes you paid from your gross employment income; or multiply your gross income by 80 percent if you're a low-income earner, 70 percent if you're a moderate-income earner, or 60 percent if you're a high-income earner.*

Another way to determine the amount of life insurance to buy is to think about how much would be needed to pay for major debts or expenditures, such as your mortgage, other loans, and college for your children. For example, suppose you want your spouse to have enough of a life insurance death benefit to pay off your mortgage and half of your children's college education. Simply add your mortgage amount to half of your children's estimated college costs (see Chapter 13 for approximate numbers) and then buy that amount of life insurance.

Social Security, if you're covered, can provide survivors benefits to your spouse and children. However, if your surviving spouse is working and earning even a modest amount of money, he or she is going to get few, if any, survivors benefits. Prior to reaching Social Security's "full retirement age" (see Chapter 4), your survivors benefits get reduced by $1 for every $2 you earn above $14,640 (in 2012).

This income threshold is higher if you reach full retirement age during the year. For example, the Social Security benefits for those reaching full retirement age during 2012 are reduced by $1 for each $3 they earn above $38,880 until the month in which they reach full retirement age. Beginning the month you reach your full retirement age, there's no limit on your earnings if you're collecting survivors benefits.

If either you or your spouse anticipates earning a low enough income to qualify for survivors benefits, you may want to factor your Social Security survivors benefits into how much life insurance to buy. Contact the Social Security Administration by phone at 800-772-1213 or visit its website at www.ssa.gov to estimate your benefits.

Examining "other" life insurance

Contemplating the possibility of your untimely demise is surely depressing. You'll likely feel some peace of mind when purchasing a life insurance policy to provide for your dependents. However, I suggest you take things a step further. Suppose you (or your spouse) pass away. Do you think that simply buying a life insurance policy will be sufficient "help" for the loved ones you leave behind? Surely your contribution to your household involves far more than being a breadwinner.

Do you have a will? See Chapter 17 for more details on wills and other estate-planning documents. Make sure that all your important financial documents — investment account statements, insurance policies, employee benefits materials, small-business accounting records, and so on — are kept in one place (such as a file drawer) that your loved ones know about. You may also want to consider providing a list of key contacts — such as who you recommend calling (or what you recommend reading) in the event of legal, financial, or tax quandaries.

So, in addition to trying to provide financially for your dependents, you also need to take some time to reflect on what else you can do to help point them in the right direction on matters you normally handle. With most couples, it's natural for one spouse to take more responsibility for money management. That's fine; just make sure to talk about what's being done so that in the event that the responsible spouse dies, the surviving person knows how to jump into the driver's seat.

If you have kids (and even if you don't), you may want to give some thought to sentimental leave-behinds for your loved ones. These leave-behinds can be something like a short note telling them how much they meant to you and what you'd like them to remember about you.

The Social Security Administration can tell you how much your survivors would receive per month in the event of your death. You should factor this benefit into the amount of life insurance that you calculate in Table 16-1. For example, suppose your annual after-tax income is $25,000 and Social Security provides a survivors benefit of $10,000 annually. Therefore, for the purposes of Table 16-1, you should determine the amount of life insurance needed to replace $15,000 annually ($25,000 – $10,000), not $25,000.

Comparing term life insurance to cash value life insurance

I'm going to tell you how you can save hours of time and thousands of dollars. Ready? *Buy term life insurance.* (An exception is if you have a high net worth — several million bucks or more — in which case you may want to *consider* other options. See the estate-planning section in Chapter 17.) If you've already figured out how much life insurance to purchase and this is all the advice you need, you can jump to the "Buying term insurance" section that follows.

If you want the details behind my recommendation for term insurance, the following information is for you. Or maybe you've heard (and have already fallen prey to) the sales pitches from life insurance agents, most of whom love selling cash value life insurance because of its huge commissions.

Despite the variety of names that life insurance marketing departments have cooked up for policies, life insurance comes in two basic flavors:

- **Term insurance:** This insurance is pure life insurance. You pay an annual premium for which you receive a particular amount of life insurance coverage. If you, the insured person, pass away, your beneficiaries collect; otherwise, the premium is gone, but you're grateful to be alive!

- **Cash value insurance:** All other life insurance policies (whole, universal, variable, and so on) combine life insurance with a supposed savings feature. Not only do your premiums pay for life insurance, but some of your dollars are also credited to an account that grows in value over time, assuming you keep paying your premiums. On the surface, this type of insurance sounds potentially attractive. People don't like to feel that their premium dollars are getting tossed away.

BEWARE

But cash value insurance has a big catch. For the same amount of coverage (for example, for $100,000 of life insurance benefits), cash value policies cost you about eight times (800 percent) more than comparable term policies.

Insurance salespeople know the buttons to push to interest you in buying the wrong kind of life insurance. In the following sections, I give you some of the typical arguments they make for purchasing cash value polices, followed by my perspective on each one.

"Cash value policies are all paid up after X years. You don't want to be paying life insurance premiums for the rest of your life, do you?"

Agents who pitch cash value life insurance present projections that imply that after the first ten or so years of paying your premiums, you don't need to pay more premiums to keep the life insurance in force. The only reason you may be able to stop paying premiums is because you poured a lot of extra money into the policy in the early years. Remember that cash value life insurance costs about eight times as much as term insurance.

Imagine that you're currently paying $500 a year for auto insurance and that an insurance company comes along and offers you a policy for $4,000 per year. The representative tells you that after ten years, you can stop paying and still keep your same coverage. I'm sure that you wouldn't fall for this sales tactic, but many people do when they buy cash value life insurance.

You also need to be wary of the projections, because they often include unrealistic and lofty assumptions about the investment return that your cash balance can earn. When you stop paying into a cash value policy, the cost of each year's life insurance is deducted from the remaining cash value. If the rate of return on the cash balance is not sufficient to pay the insurance cost, the cash balance declines, and eventually you receive notices saying that your policy needs more funding to keep the life insurance in force.

"You won't be able to afford term insurance when you're older."

As you get older, the cost of term insurance increases because the risk of dying rises. But life insurance is not something you need all your life! It's typically bought in a person's younger years when financial commitments and obligations outweigh financial assets. Twenty or thirty years later, the reverse should be true — if you use the principles in this book!

When you retire, you don't need life insurance to protect your employment income, because there isn't any to protect! You may need life insurance when you're raising a family and/or you have a substantial mortgage to pay off, but by the time you retire, the kids should be out on their own (you hope!), and the mortgage should be paid down.

In the meantime, term insurance saves you a tremendous amount of money. For most people, it takes 20 to 30 years for the premium they're paying on a term insurance policy to finally catch up to (equal) the premium they've been paying all along on a comparable amount of cash value life insurance.

"You can borrow against the cash value at a low interest rate."

Such a deal! It's your money in the policy, remember? If you deposited money in a savings or money market account, how would you like to pay for the privilege of borrowing your own money back? Borrowing on your cash value policy is potentially dangerous: You increase the chances that the policy will lapse — leaving you with nothing to show for your premiums.

“Your cash value grows tax-deferred.”

Ah, a glimmer of truth at last. The cash value portion of your policy grows without taxation until you withdraw it, but if you want tax-deferral of your investment balances, you should first take advantage of funding 401(k)s, 403(b)s, SEP-IRAs, and Keoghs. Such accounts give you an immediate tax deduction for your current contributions in addition to growth without taxation until withdrawal.

The money you pay into a cash value life policy gives you no upfront tax deductions. If you exhaust the tax-deductible plans, consider a Roth IRA and then variable annuities, which provide access to better investment options and tax-deferred compounding of your investment dollars. Roth IRAs have the added bonus of tax-free withdrawal of your investment earnings. (See Chapter 11 for details on retirement accounts.)

> Life insurance tends to be a mediocre investment at best. The insurance company generally quotes you an interest rate for the first year; after that, the company changes the rate annually. If you don’t like the future interest rates, you can be penalized for quitting the policy. Would you ever invest your money in a bank account that quoted an interest rate for the first year and then penalized you for moving your money within the next seven to ten years?

“Cash value policies are forced savings.”

Many agents argue that a cash value plan is better than nothing —

at least it's forcing you to save. This line of thinking is silly because so many people drop cash value life insurance policies after just a few years of paying into them. You can accomplish "forced savings" without using life insurance. Any of the retirement savings accounts mentioned in Chapter 11 can be set up for automatic monthly transfers. Employers offering such a plan can deduct contributions from your paycheck — and they don't take a commission! You can also set up monthly electronic transfers from your bank checking account to contribute to mutual funds (see Chapter 10).

"Life insurance is not part of your taxable estate."

If the ownership of a life insurance policy is properly structured, the death benefit is free of estate taxes. This part of the sales pitch is about the only sound reasoning that exists for buying cash value life insurance. Under current federal laws, you can pass on $5 million free of federal estate taxes. But even if you have that large of a nest egg, you have numerous other ways to reduce your taxable estate (see Chapter 17).

Making your decision

Insurance salespeople aggressively push cash value policies because of the high commissions that insurance companies pay them. Commissions on cash value life insurance range from 50 to 100 percent of your first year's premium. An insurance salesperson, therefore, can make *eight to ten times more money* (yes, you read that right) selling you a cash value policy than he can selling you term insurance.

Ultimately, when you purchase cash value life insurance, you pay the high commissions that are built into these policies. As you can see in the policy's cash value table, you don't get back any of the money that you dump into the policy if you quit the policy in the first few years. The insurance company can't afford to give you any of your money back in those early years because so much of it has been paid to the selling agent as commission. That's why these policies explicitly penalize you for withdrawing your cash balance within the first seven to ten years.

Because of the high cost of cash value policies relative to the cost of term, you're more likely to buy less life insurance coverage than you need — that's the sad part of the insurance industry's pushing of this stuff. *The vast majority of life insurance buyers need more protection than they can afford to buy with cash value coverage.*

Cash value life insurance is the most oversold insurance and financial product in the history of the financial services industry. Cash value life insurance makes sense for a small percentage of people, such as small-business owners who own a business worth at least several million dollars and don't want their heirs to be forced to sell their business to pay estate taxes in the event of their death. (See "Considering the purchase of cash value life insurance," later in this chapter.)

Purchase low-cost term insurance and do your investing separately. Life insurance is rarely a permanent need; over time, you can reduce

Life insurance is rarely a permanent need; over time, you can reduce the amount of term insurance you carry as your financial obligations lessen and you accumulate more assets.

Buying term insurance

Term insurance policies have several features from which to choose. I cover the important elements of term insurance in this section so you can make an informed decision about purchasing it.

Selecting how often your premium adjusts

Term insurance can be purchased so that your premium adjusts (increases) annually or after 5, 10, 15, or 20 years. The less frequently your premium adjusts, the higher the initial premium and its incremental increases will be. (Remember, as you get older, the risk of dying increases, so the cost of your insurance goes up.)

The advantage of a premium that locks in for, say, 15 years is that you have the security of knowing how much you'll be paying annually for the next 15 years. You also don't need to go through medical evaluations as frequently to qualify for the lowest rate possible. The disadvantage of a policy with a long-term rate lock is that you pay more in the early years than you do on a policy that adjusts more frequently. In addition, you may want to change the amount of insurance you carry as your circumstances change. Thus, you may throw money away when you dump a policy with a long-term premium guarantee before its rate is set to change.

Policies that adjust the premium every five to ten years offer a happy medium between price and predictability.

Ensuring guaranteed renewability

Guaranteed renewability, which is standard practice on the better policies, assures that the policy can't be canceled because of poor health. Don't buy a life insurance policy without this feature unless you expect that your life insurance needs will disappear when the policy is up for renewal.

Deciding where to buy term insurance

A number of sound ways to obtain high-quality, low-cost term insurance are available. You may choose to buy through a local agent because you know him or prefer to buy from someone close to home. However, you should invest a few minutes of your time getting quotes from one or two of the following sources to get a sense of what's available in the insurance market. Gaining familiarity with the market can prevent an agent from selling you an overpriced, high-commission policy.

Here are some sources for high-quality, low-cost term insurance:

- **USAA:** This company sells low-cost term insurance directly to the public. Contact USAA by phone at 800-531-8722 or visit `www.usaa.com/inet/pages/insurance_life_main`.
- **Insurance agency quotation services:** These services provide proposals from the highest-rated, lowest-cost companies available. Like other agencies, the services receive a commission if you buy a policy from them, which you're under no obligation to do. They ask questions such as your date of birth, whether you smoke, some basic health questions, and how much coverage you want. Services that are worth considering include
  - **AccuQuote:** Phone 800-442-9899; website `www.accuquote.com`
  - **ReliaQuote:** Phone 800-940-3002; website

www.reliaquote.com

- **Term4Sale:** Phone 888-798-3488; website www.term4sale.com (this company doesn't sell life insurance but can refer you to agents who do)

See Chapter 19 for information on how to use your computer when making life insurance decisions.

Considering the purchase of cash value life insurance

Don't expect to get objective information from anyone who sells cash value life insurance. Beware of insurance salespeople masquerading under the guise of self-anointed titles, such as estate-planning specialists or financial planners.

As I discuss earlier in the chapter, purchasing cash value life insurance may make sense if you expect to have an estate-tax "problem." However, cash value life insurance is just one of many ways to reduce your estate taxes (see the section on estate planning in Chapter 17).

Among the best places to shop for cash value life insurance policies are

- **USAA:** Phone 800-531-8722; website www.usaa.com/inet/pages/insurance_life_main
- **Ameritas Direct:** Phone 800-555-4655; website www.ameritasdirect.com

If you want to obtain some cash value life insurance, tread carefully with local insurance agents. Most agents aren't as interested in educating as they are in selling. Besides, the best cash value policies can be obtained commission-free when you buy them from the sources I provide in the preceding list. The money saved on commissions (which can easily be thousands of dollars) is reflected in a much higher cash value for you.

Getting rid of cash value life insurance

If you were snookered into buying a cash value life insurance policy and you want to part ways with it, go ahead and do so. *But don't cancel the coverage until you first secure new term coverage.* When you need life insurance, you don't want to have a period when you're not covered (Murphy's Law says *that's* when disaster will strike).

Ending a cash value life insurance policy has tax consequences. You generally must pay federal income tax on the amount you receive in excess of the premiums you paid over the life of the policy. Because some life insurance policies feature tax-deferred retirement savings, you may incur a 10-percent federal income tax penalty on earnings withdrawn before age 59½, just as you would with an IRA. Before withdrawing the cash balance in your life insurance policy, consider checking with the insurer or a tax advisor to clarify what the tax consequences may be.

You can avoid federal income tax early withdrawal penalties and sidestep taxation on accumulated interest in a life insurance policy by doing a tax-free exchange (also known as a section 1035 exchange) into a no-load (commission-free) variable annuity. The no-load mutual fund company through which you buy the annuity takes care of transferring your existing balance. (See Chapter 12 for more information about annuities.)

Preparing for the Unpredictable: Disability Insurance

As with life insurance, the purpose of disability insurance is to protect your income. The only difference is that with disability insurance, you're protecting the income for yourself (and perhaps also your dependents). If you're completely disabled, you still have living expenses, but you probably can't earn employment income.

I'm referring to long-term disabilities. If you throw out your back while reliving your athletic glory days and you wind up in bed for a couple weeks, it likely won't be a financial disaster. But, what if you were disabled in such a way that you couldn't work for several years? This section helps you figure out whether you need disability insurance, how much to get, and where to find it.

Deciding whether you need coverage

Most large employers offer disability insurance to their employees. Many small-company employees and all self-employed people are left to fend for themselves without disability coverage. Being without disability insurance is a risky proposition, especially if, like most working people, you need your employment income to live on.

If you're married and your spouse earns a large enough income that you can make do without yours, consider skipping disability coverage. The same is true if you've already accumulated enough money for your future years (in other words, you're financially independent). Keep in mind, though, that your expenses may go up if you become disabled and require specialized care.

For most people, dismissing the need for disability coverage is easy. The odds of suffering a long-term disability seem so remote — and they are. But if you suffer bad luck, disability coverage can relieve you (and possibly your family) of a major financial burden.

Most disabilities are caused by medical problems, such as arthritis, heart conditions, hypertension, and back/spine or hip/leg impairments. Some of these ailments occur with advancing age, but more than one-third of all disabilities are suffered by people under the age of 45. The vast majority of these medical problems cannot be predicted in advance, particularly those caused by random accidents.

If you think you have good disability coverage through government programs, you'd better think again:

- **Social Security disability:** Social Security pays long-term benefits only if you're not able to perform any substantial, gainful activity for more than a year or if your disability is expected to result in death. Furthermore, Social Security disability payments are quite low because they're intended to provide only for basic, subsistence-level living expenses.

- **Workers' compensation:** Workers' compensation (if you have such coverage through your employer) pays you benefits if you're injured on the job, but it doesn't pay any benefits if you get disabled away from your job. You need coverage that pays regardless of where and how you're disabled.
- **State disability programs:** Some states have disability insurance programs, but the coverage is typically bare bones. State programs are also generally not a good value because of the cost for the small amount of coverage they provide. Benefits are paid over a short period of time (rarely more than a year).

Determining how much disability insurance you need

You need enough disability coverage to provide you with sufficient income to live on until other financial resources become available. If you don't have much saved in the way of financial assets and you want to continue with the lifestyle supported by your current income if you suffer a disability, get disability coverage to replace your entire monthly take-home (after-tax) pay.

The benefits you purchase on a disability policy are quoted as the dollars per month you receive if disabled. So if your job provides you with a $3,000-per-month income after payment of taxes, seek a policy that provides a $3,000-per-month benefit.

If you pay for your disability insurance, the benefits are tax-free (but hopefully you won't ever have to collect them). If your employer picks up the tab, your benefits are taxable, so you need a larger benefit amount.

In addition to the monthly coverage amount, you also need to select the duration for which you want a policy to pay you benefits. You need a policy that pays benefits until you reach an age at which you become financially self-sufficient. For most people, that's around age 65, when their Social Security benefits kick in. If you anticipate needing your employment income past your mid-60s, you may want to obtain disability coverage that pays you until a later age.

On the other hand, if you crunch some numbers (see Chapter 3) and you expect to be financially independent by age 55, shop for a policy that pays benefits up to that age — it'll cost you less than one that pays benefits to you until age 65. If you're within five years of being financially independent or able to retire, five-year disability policies are available, too. You may also consider such short-term policies when you're sure that someone (for example, a family member) can support you financially over the long-term.

Identifying other features you need in disability insurance

Disability insurance policies have many confusing features. Here's what to look for — and look out for — when purchasing disability insurance:

- **Definition of disability:** An *own-occupation* disability policy provides benefit payments if you can't perform the work you normally do. Some policies pay you only if you're unable to perform a job for which you are *reasonably trained.* Other policies revert to this definition after a few years of being own-occupation. Own-occupation policies are the most expensive because there's a greater chance that the insurer will have to pay you. The extra cost may not be worth it unless you're in a high-income or specialized occupation and you'd have to take a significant pay cut to do something else (and you wouldn't be happy about a reduced income and the required lifestyle changes).

- **Noncancelable and guaranteed renewable:** These features ensure that your policy can't be canceled because of your falling into poor health. With policies that require periodic physical exams, you can lose your coverage just when you're most likely to need it.

- **Waiting period:** This is the "deductible" on disability insurance — the time between the onset of your disability and the time you begin collecting benefits. As with other types of insurance, you should take the highest deductible (longest waiting period) that your financial circumstances allow. The waiting period significantly reduces the cost of the insurance and eliminates the hassle of filing a claim for a short-term disability. The minimum waiting period on most policies is 30 days. The maximum waiting period can be up to one to two years. Try a waiting period of three to six months if you have sufficient emergency reserves.

- **Residual benefits:** This option pays you a partial benefit if you have a disability that prevents you from working full-time.

- **Cost-of-living adjustments (COLAs):** This feature automatically increases your benefit payment by a set percentage annually or in accordance with changes in inflation. The advantage of a COLA is that it retains the purchasing power of your benefits. A modest COLA, such as 3 to 4 percent, is worth having.

- **Future insurability:** A clause that many agents encourage you to buy, future insurability allows you to buy additional coverage regardless of health. For most people, paying for the privilege of buying more coverage later is not worth it if the income you earn today fairly reflects your likely long-term earnings (except for cost-of-living increases). You may benefit from the future insurability option if your income is artificially low now and you're confident that it will rise significantly in the future. (For example, you just got out of medical school and you're earning a low salary while being enslaved as a resident.)

- **Insurer's financial stability:** As I discuss in Chapter 15, you should choose insurers that'll be here tomorrow to pay your claim. But don't get too hung up on the stability of the company; benefits are paid even if the insurer fails, because the state or another insurer will almost always bail out the unstable insurer.

Deciding where to buy disability insurance

The place to buy disability insurance with the best value is through your employer or professional association. Unless these groups have done a lousy job shopping for coverage, group plans offer a better value than disability insurance you can purchase on your own. Just make sure that the group plan meets the specifications discussed in the preceding section, especially any limitations of benefit amounts or stricter qualification terms, which are found on some group plans.

Don't trust an insurance agent to be enthusiastic about the quality of a disability policy your employer or other group is offering. Agents have a conflict of interest when they criticize these options, because they won't make a commission if you buy through a group.

If you don't have access to a group policy, check with your agent or a company you already do business with. But tread carefully when purchasing disability insurance through an agent. Some agents try to load down your policy with all sorts of extra bells and whistles to pump up the premium along with their commission.

If you buy disability insurance through an agent, consider *list billing,* where you sign up with several other people for coverage at the same time and are invoiced together for your coverage. It can knock up to 15 percent off an insurer’s standard prices. Ask your insurance agent how list billing works.

Getting the Care You Need: Health Insurance

Almost everyone needs health insurance, but not everyone has it. Some people who can afford health insurance choose not to buy it because they believe that they’re healthy and they’re not going to need it. Others who opt not to buy health insurance figure that if they ever really need healthcare, they’ll get it even if they can’t pay. To a large extent, they’re right. People without health insurance generally put off getting routine care, which can lead to small problems turning into bigger and costlier ones.

Choosing the best health plan

Before Medicare (the government-run insurance program for the elderly) kicks in at age 65+, odds are that you'll obtain your health insurance through your employer. Be thankful if you do. Employer-provided coverage eliminates the headache of having to shop for coverage, and it's usually cheaper than coverage you buy on your own.

Whether you have options through your employer or you have to hunt for a plan on your own, the following sections cover the major issues to consider when selecting among the health insurance offerings in the marketplace.

Major medical coverage

You need a plan that covers the *big* potential expenses: hospitalization, physician, and ancillary charges, such as X-rays and laboratory work. If you're a woman and you think that you may want to have children, make sure that your plan has maternity benefits.

Choice of healthcare providers

Plans that allow you to use any healthcare provider you want are becoming less common and more expensive in most areas. Health maintenance organizations (HMOs) and preferred provider organizations (PPOs) are the main plans that restrict your choices. They keep costs down because they negotiate lower rates with selected providers.

HMOs and PPOs are more similar than they are different. The main difference is that PPOs still pay the majority of your expenses if you use a provider outside their approved list. If you use a provider outside the approved list with an HMO, you typically aren’t covered at all.

If you have your heart set on particular physicians or hospitals, find out which health insurance plans they accept as payment. Ask yourself whether the extra cost of an open-choice plan is worth being able to use their services if they’re not part of a restricted-choice plan. Also be aware that some plans allow you to go outside their network of providers as long as you pay a bigger portion of the incurred medical costs. If you’re interested in being able to use alternative types of providers, such as acupuncturists, find out whether the plans you’re considering cover these services.

Don’t let stories of how hard it is to get an appointment with a doctor or other logistical hassles deter you from going with an HMO or PPO plan. These things can happen in plans with open choice, too. The idea that doctors who can’t get patients on their own are the only ones who sign up with restricted-choice plans is a myth. Although HMO and PPO plans do offer fewer choices when it comes to providers, surveys show that customer satisfaction with these plans is as high as it is for plans that offer more choices.

Lifetime maximum benefits

Health insurance plans specify the maximum total benefits they'll pay over the course of time you're insured by their plan. Although a million dollars may be more money than you could ever imagine being spent on your healthcare, it's the minimum acceptable level of total benefits. With the cost of healthcare today, you can quickly blow through that if you develop major health problems. Ideally, choose a plan that has no maximum or that has a maximum of at least 5 million dollars.

Deductibles and co-payments

> To reduce your health insurance premiums, choose a plan with the highest deductible and co-payment you can afford. As with other insurance policies, the more you're willing to share in the payment of your claims, the less you have to pay in premiums. Most policies have annual deductible options (such as $250, $500, $1,000, and so on) as well as co-payment options, which are typically 20 percent or so.

When choosing a co-payment percentage, don't let your imagination run wild and unnecessarily scare you. A 20-percent co-payment doesn't mean that you have to come up with $20,000 for a $100,000 claim. Insurance plans generally set a maximum out-of-pocket limit on your annual co-payments (such as $1,000, $2,000, and so on); the insurer covers 100 percent of any medical expenses that go over that cap.

> For insurance provided by your employer, consider plans with low out-of-pocket expenses if you know that you have health problems. Because you're part of a group, the insurer

won’t increase your individual rates just because you’re filing more claims.

Saving on taxes when spending on healthcare

If you expect to have out-of-pocket medical expenses, find out whether your employer offers a flexible spending or healthcare reimbursement account. These accounts enable you to pay for uncovered medical expenses with pretax dollars. If, for example, you’re in a combined 35-percent federal and state income tax bracket, these accounts allow you to pay for necessary healthcare at a 35-percent discount. These accounts can also be used to pay for vision and dental care.

Be forewarned of the major stumbling blocks you face when saving through medical reimbursement accounts. First, you need to elect to save money from your paycheck prior to the beginning of each plan year. The only exception is at the time of a “life change,” such as a family member’s death, marriage, spouse’s job change, divorce, or the birth of a child. You also need to use the money within the year you save it, because these accounts contain a “use it or lose it” feature.

Health savings accounts (HSAs) are another option, especially for the self-employed and people who work for smaller firms. To qualify, you must have a high-deductible (at least $1,200 for individuals; $2,400 for families) health insurance policy; then you can put money earmarked for medical expenses into an investment account that offers the tax benefits — deductible contributions and tax-deferred compounding — of a retirement account (see Chapter 4). And unlike a flexible spending account, you don’t have to deplete the HSA by the end of the year: Money can compound tax-deferred inside the HSA for years. Begin to investigate an HSA through insurers offering health plans you’re interested in or with the company you currently have coverage through (also see my website, www.erictyson.com, for the latest information on the best HSA plans).

You may also be able to save on taxes if you have a substantial amount of healthcare expenditures in a year. You can deduct medical and dental expenses as an itemized deduction on Schedule A to the extent that they exceed 7.5 percent of your adjusted gross income (refer to Chapter 7). Unless you’re a low-income earner, you need to have substantial expenses, usually caused by an accident or major illness, to take advantage of this tax break.

Most HMO plans don't have deductible and co-payment options. Most just charge a set amount — such as $25 — for a physician's office visit.

Guaranteed renewability

You want a health insurance plan that keeps renewing your coverage without you having to prove continued good health. If good health could be guaranteed, you wouldn't need health insurance in the first place.

Buying health insurance

You can buy many health plans through agents, and you can also buy some directly from the insurer. When health insurance is sold both ways, buying through an agent usually doesn’t cost more.

If you’re self-employed or you work for a small employer that doesn’t offer health insurance as a benefit, get proposals from the larger and older health insurers in your area. Larger plans can negotiate better rates from providers, and older plans are more likely to be here tomorrow.

Many insurers operate in a bunch of different insurance businesses. You want those that are the biggest in the health insurance arena and are committed to that business. Nationally, Blue Cross, Blue Shield, Kaiser Permanente, Aetna, UnitedHealth Group, CIGNA, Assurant, Golden Rule, and Anthem are among the older and bigger health insurers. If your coverage is canceled, you may have to search for coverage that allows an existing medical problem. Other health insurers won’t want to insure you. (Find out whether your state department of insurance offers a plan for people unable to get coverage.)

Also check with professional or other associations that you belong to, because plans offered by these groups sometimes offer decent benefits at a competitive price due to the purchasing power clout that they possess. A competent independent insurance agent who specializes in health insurance can help you find insurers who are willing to offer you coverage.

Health insurance agents have a conflict of interest that’s common to all financial salespeople working on commission: The higher the premium plan they sell you, the bigger the commission they earn. So an agent may try to steer you into higher-cost plans and avoid suggesting some of the strategies I discuss in the preceding section for reducing your cost of coverage. (Good agents can help guide you to the best plans that cover preexisting conditions and offer the to the best plans that cover preexisting conditions and offer the lowest costs for your medications. Be sure to provide them with this information and compare options carefully.)

Dealing with insurance denial

When you try to enroll in a particular health insurance plan, you may be turned down because of current or previous health problems. Your *medical information file* (the medical equivalent of a credit report) may contain information explaining why you were turned down. (See Chapter 15 for more about medical information files.)

If you have a so-called *preexisting condition* (current or prior medical problems), you have several options to pursue when trying to secure health insurance:

- **Try health insurance plans that don't discriminate.** A few plans — typically Blue Cross, Blue Shield, and some HMO plans, such as Kaiser Permanente — will sometimes take you regardless of your condition.
- **Find a job with an employer whose health insurer doesn't require a medical exam.** This shouldn't be your only reason for seeking new employment, but it can be an important factor. If you're married, you may also be able to get into an employer group plan if your spouse takes a new job.
- **Find out whether your state offers a plan.** A number of states maintain "high-risk" pools that insure people who have preexisting conditions and are unable to find coverage elsewhere (see Chapter 15 for how to find out which states offer such plans). If your state doesn't offer one of these plans, I suppose that, in a drastic situation, you could move to a nearby state that does.

Understanding Obamacare

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act. Together, these two laws enacted comprehensive health care reform in the United States.

This is mammoth legislation comprising thousands of pages of rule and regulations, the constitutionality of which is going to be evaluated by the U.S. Supreme Court, likely before the 2012 election. Also, depending upon the outcome of the 2012 elections, much — if not all — of Obamacare may be repealed. In the meantime, this section highlights the most important portions of the legislation that you need to understand.

Dealing with medical claims headaches

If you sign up for a health plan that has deductibles and co-payments, make sure that you review the benefits statements your insurer sends you. Errors often pop up on these statements and during the claims filing process. Not surprisingly, the errors are usually at your expense.

Make sure that your insurer has kept accurate track of your contributions toward meeting your plan's annual deductible and maximum out-of-pocket charges. Also, don't pay any healthcare providers who send you bills until you receive proper notification from the insurance company detailing what you are obligated to pay those providers according to the terms of your plan. Because most insurance companies have negotiated discounted fee schedules with healthcare providers, the amount that a provider bills you is often higher than the amount they're legally due as per the terms of their contract with your insurer. Your insurer's benefits statement should detail the approved and negotiated rate once the claim is processed. And don't let providers try to bully you into paying them the difference between what they billed you for and what the insurer says they are due. Providers are due only the discounted fees they agreed to with your insurer.

Haggling with your health insurer is a real pain, and it usually happens after you rack up significant medical expenses and may still not be feeling well. But if you don't stay on top of your insurer, you can end up paying thousands of dollars in overpayments. If you're overwhelmed with an avalanche of claims and benefits statements, you may want to consider using a health insurance claims processing service. You can get a referral to firms that engage in this line of work by visiting the Alliance of Claims Assistance Professionals website at `www.claims.org`.

Effective in 2011, employer group health plans

- Must offer coverage to adult children up to age 26 who are not eligible for coverage under another employer's health plan (this latter requirement is dropped effective 2014). The coverage is not taxable to the employee or dependent.

- May not impose lifetime limits.
- May not impose preexisting condition exclusions on children under age 19.
- Must provide preventive care without cost sharing, and must cover certain child preventive care services as recommended by government. This rule applies only to new group health plans.

In 2013, higher income taxpayers will get hit with higher tax rates on their investments as well as higher Medicare tax rates to help pay for Obamacare. Taxpayers with total taxable income above $200,000 (for a single return) or $250,000 (for a joint return) from any source will be subject to a 3.8 percent tax on the *lesser* of the following:

- Their net investment income (for example, interest, dividends, and capital gains)
- The amount, if any, by which their modified adjusted gross income exceeds the dollar thresholds

Taxpayers with earned income above $200,000 (for a single return) or $250,000 (for a joint return) will be subject to an additional 0.9 percent Medicare tax (in other words, rising from 1.45 percent to 2.35 percent) on wages in excess of those amounts. Employers will not be required to match the payment of this incremental increase, which is applicable only to the employee.

Also in 2013, individual taxpayers seeking to claim an itemized income tax deduction for medical expenses will be able to deduct only the portion of such expenses in excess of 10 percent of their adjusted gross income, up from the current level of 7.5 percent of income. (This change is deferred to 2017 for those people age 65 and over.)

In 2014, the following additional provisions of Obamacare kick in:

- Employer "pay or play" responsibility begins. Employers must offer minimum essential coverage to full-time employees or make nondeductible payments to government.

- Group health plans must remove all annual dollar limits on participants' benefit payments.
- Group health plans must limit cost-sharing and deductibles to levels that don't exceed those applicable to a health-savings-account-eligible, high-deductible health plan. (Such plans currently have a $1,200 individual and $2,400 family minimum deductible.)
- Group health plans must remove all preexisting condition exclusions on all participants.
- Group health plans may not have waiting periods of longer than 90 days.

Looking at retiree medical care insurance

Medicare, the government-run health insurance plan for the elderly, is a multi-part major medical plan. Enrollment in Part A (hospital expenses) is automatic. Part B, which covers physician expenses and other charges, including home healthcare coverage; Part C, supplemental Medicare coverage (sold through private insurers); and Part D, for prescription drugs (provided through private insurers), are optional. Supplemental insurance policies, also known as Medigap coverage, may be of interest to you if you want help paying for the costs that Medicare doesn't pay.

Closing Medicare's gaps

Medigap coverage generally pays the deductibles and co-payments that Medicare charges. For the first 60 days of hospitalization, you pay $1,156 total out of your own pocket. If you have an unusually long hospital stay, you pay $289 per day for the 61st through the 90th day, $578 per day for the 91st through the 150th day, and all costs beyond 150 days. Clearly, if you stay in a hospital for many months, your out-of-pocket expenses can escalate; however, the longest hospitalizations tend not to last for many months. Also note that Medicare's hospitalization benefits refresh when you're out of the hospital for 60 consecutive days.

If you're unable to pay for the deductibles and co-payments because your income is low, making a long hospital stay a financial catastrophe for you, *Medicaid* (the state-run medical insurance program for low-income people) may help pay your bills. Alternatively, Medigap insurance can help close the gap.

Check with your physician(s) to see if he charges a fee higher than the one listed on Medicare's fee schedule. If your physician does charge a higher fee, you may want to consider going to another physician if you can't afford the fee or if you want to save some money. (But don't drop your current doctor before finding another who accepts Medicare and you as a patient. Many doctors are not accepting Medicare patients.) Medicare often pays only 80 percent of the physician charges that the program allows on its fee schedule.

The biggest reason that elderly people consider extra health insurance is that Medicare pays only for the first 100 days in a skilled nursing facility. Anything over that is your responsibility. Unfortunately, Medigap policies don't address this issue, either.

Long-term care insurance

Insurance agents who are eager to earn a hefty commission will often tell you that long-term care (LTC) insurance is the solution to your concerns about an extended stay in a nursing home. Don't get your hopes up. Policies are complicated and filled with all sorts of exclusions and limitations. On top of all that, they're expensive, too.

The decision to purchase LTC insurance is a trade-off. Do you want to pay thousands of dollars annually, beginning at age 60, to guard against the possibility of a long-term stay in a nursing home? If you live into or past your mid-80s, you can end up paying $100,000 or more on an LTC policy (not to mention the lost investment earnings on these insurance premiums).

People who end up in a nursing home for years on end may come out ahead financially when buying LTC insurance. The majority of people who stay in a nursing home are there for less than a year, though, because they either pass away or move out. Medicare pays for the bulk of the cost of the first 100 days in a nursing home as long as certain conditions are satisfied. Medicare pays for all basic services (telephone, television, and private room charges excluded) for the first 20 days and then requires a co-payment of $144.50 per day for the next 80 days. First, the nursing-home stay must follow hospitalization within 30 days, and the nursing-home stay must be for the same medical condition that caused the hospitalization. When you're discharged from the nursing home, you can qualify for an additional 100-day benefit period as long as you haven't been hospitalized or in a nursing home in the 60 days prior to your readmission.

If you have relatives or a spouse who will likely care for you in the event of a major illness, you definitely should *not* waste your money on nursing-home insurance. You can also bypass this coverage if you have and don't mind using retirement assets to help pay nursing-home costs.

Even if you do deplete your assets, remember that you have a backup: Medicaid (state-provided medical insurance) can pick up the cost if you can't. However, be aware of a number of potential drawbacks to getting coverage for nursing-home stays under Medicaid:

- **Medicaid patients are at the bottom of the priority list.** Most nursing homes are interested in the bottom line, so the patients who bring in the least revenue — namely Medicaid patients — get the lowest priority on nursing-home waiting lists.
- **Some nursing homes don't take Medicaid patients.** Check

with your preferred nursing homes in your area to see whether they accept Medicaid.

- **The states may squeeze Medicaid further.** Deciding which medical conditions warrant coverage is up to your state. With the budget noose tightening, some states are disallowing certain types of coverage (for example, mental problems for elderly people who are otherwise in good physical health).

If you're concerned about having your stash of money wiped out by an extended nursing-home stay and you have a strong desire to pass money to your family or a favorite charity, you can start giving your money away while you're still healthy. (If you're already in poor health, legal experts can strategize to preserve your assets and keep them from being used to pay nursing-home costs.)

TIP

Consider buying nursing-home insurance if you want to retain and protect your assets and it gives you peace of mind to know that a long-term nursing-home stay is covered. But do some comparison shopping, and make sure that you buy a policy that pays benefits for the long term. A year's worth (or even a few years' worth) of benefits won't protect your assets if your stay lasts longer. Also be sure to get a policy that adjusts the daily benefit amount for increases in the cost of living. Get a policy that covers care in your home or other settings if you don't need to be in a high-cost nursing home, and make sure that it doesn't require prior hospitalization for benefits to kick in. To keep premiums down, also consider a longer exclusion or waiting period — three to six months or a year before coverage starts.

You may also want to consider retirement communities if you're willing to live as a younger retiree in such a setting. After paying an entrance fee, you pay a monthly fee, which usually covers your rent, care, and meals. Make sure that any such facility you're considering guarantees care for life and preferably has a continuum of care guarantees care for life and preferably has a continuum of care levels available. Also verify that it accepts Medicaid in case you deplete your assets.

Making sense of Medicare's prescription drug program

As if there weren't enough confusing government programs, Uncle Sam had to create yet another that began in 2006 — the Medicare (Part D) prescription drug plan. Here are some key facts you need to know about these somewhat complicated plans, which are offered through private insurers:

- Plans make the most sense for those who expect to spend more than $5,000 annually on prescription drugs.
- If you choose not to enroll when you're first eligible and then later enroll, you'll be charged a penalty equal to 1 percent of the national average Part D premium for each month that has elapsed since you were first eligible to participate. You will pay this penalty for as long as you're in the plan.
- If you're on the fence about enrolling, consider starting with a low-premium plan that then gives you the right to transfer into a higher-cost and better-coverage plan without paying the late enrollment penalty.
- Visit www.medicare.gov for helpful information on drug plans and how to select one. For example, click on the Formulary (drug) Finder to identify specific insurer plans that cover your current medications or your anticipated future medications. AARP's website, www.aarp.org, also has plenty of information and resources to find out more about these confusing plans.

Part V

Where to Go for More Help

"I bought a software program that should help us monitor and control our spending habits, and while I was there, I picked up a few new games, a couple of screensavers, four new mousepads, this nifty pullout keyboard cradle..."

In this part . . .

I help you sift through the morass of financial resources competing for your attention and dollars. Many people who call themselves financial planners claim to be able to make you rich, but I show you how you may end up poorer if you don't choose an advisor wisely. I also cover software and Internet resources and name the best of the bunch and the pitfalls of financial websites. Finally, I discuss how to benefit from the financial coverage in print and on the air, as well as how to sidestep the sometimes-problematic advice in these media.

Chapter 19

Using a Computer to Manage Your Money

In This Chapter

- Evaluating money management software and websites
- Performing financial tasks with your computer

Although a computer may be able to assist you with your personal finances, it simply represents one of many tools. Computers are best for performing routine tasks (such as processing lots of bills or performing many calculations) quickly and for aiding you with research.

This chapter gives you an overview of how to use software and cyberspace with your finances. I tell you how to use this technology to pay your bills, prepare taxes, research investments, plan for retirement, trade securities, buy insurance, and plan your estate, and I suggest the best software and websites.

Surveying Software and Websites

You can access two major repositories of personal finance information through your computer. Although the lines are blurring between these two categories, they're roughly defined as software and the Internet:

- *Software* refers to computer programs that are either packaged in a box or DVD case or are available to be downloaded online. Most of the mass-marketed financial software packages sell for under $100. If you've ever used a word-processing program such as Word or WordPerfect or a spreadsheet program such as Excel, then you've used software.

- *The Internet* is a vast ocean of information that you can generally access via a modem, cable modem, or DSL (digital subscriber line). These devices allow your computer to talk with other computers. To access the Internet, you need a web browser, which you can obtain through your Internet service provider (ISP). Most of the financial stuff on the Internet is supplied by companies marketing their wares and, hence, is available for free. Some sites sell their content for a fee.

Adding up financial software benefits

Although the number of personal-finance software packages and websites is large and growing, quality is lagging behind quantity, especially among the free Internet sites. The best software can

- Guide you to better organization and management of your personal finances
- Help you complete mundane tasks or complex calculations quickly and easily and provide basic advice in unfamiliar territory
- Make you feel in control of your financial life

Mediocre and bad software, on the other hand, can make you feel stupid or, at the very least, make you want to scream. Lousy packages usually end up in the software graveyard.

Having reviewed many of the packages available, I can assure you that if you're having a hard time with some of the programs out there (and sometimes even with the more useful programs), you're not at fault. Too many packages assume that you already know not at fault. Too many packages assume that you already know things such as your tax rate, your mortgage options, and the difference between stock and bond mutual funds. Much of what's out there is too technically oriented and isn't user-friendly. Some of it is even flawed in its financial accuracy.

A good software package, like a good tax or financial advisor, helps you better manage your finances. It simply and concisely explains financial terminology, and it helps you make decisions by offering choices and recommendations, allowing you to "play" with alternatives before following a particular course of action. With increasing regularity, financial software packages are being designed to perform more than one task or to address more than one area of personal finances. But remember that no software package covers the whole range of issues in your financial life. Later in this chapter, I recommend some of my favorite financial software.

Surfing hazards online

Like the information you receive from any medium, you have to sift out the good from the bad when you surf the Internet. If you blindly navigate the Internet and naively think that what's out there is useful "information," "research," or "objective advice," you're in for a rude awakening.

Most personal-finance sites on the Internet are free, which — guess what — means that these sites are basically advertising or are dominated and driven by advertising. If you're looking for material written by unbiased experts or writers, well, finding it on the web may seem like searching for the proverbial needle in the haystack because the vast majority of what's online is biased and uninformed.

Considering the source so you can recognize bias

A report on the Internet published by a leading investment-banking firm provides a list of the "coolest finance" sites. On the list is the website of a major bank. Because it has been a long time since I was in junior high school, I'm not quite sure what "cool" means anymore. If cool can be used to describe a well-organized and graphically pleasing website, then I guess I can say that the bank's site is cool.

However, if you're looking for sound information and advice, then the bank's site is decidedly "uncool." It steers you in a financial direction that benefits (not surprisingly) the bank and not you. For example, in the real-estate section, users are asked to plug in their gross monthly income and down payment. The information is then used to spit out the supposed amount that users can "afford" to spend on a home. No mention is given to the other financial goals and concerns — such as saving for retirement — that affect one's ability to spend a particular amount of money on a home.

Consider this advice in the lending area of the site: "When you don't have the cash on hand for important purchases, we can help you borrow what you need. From a new car, to that vacation you've been longing for, to new kitchen appliances, you can make these dreams real now." Click on a button at the bottom of this screen — and presto, you're on your way to racking up credit-card and auto debt. Why bother practicing delayed gratification, living within your means, or buying something used if getting a loan is "easy" and comes with "special privileges"?

Watching out for "sponsored" content

Sponsored content, a euphemism for advertising under the guise of editorial content (known in the print media as *advertorials*), is another big problem to watch out for on websites. You may find a disclaimer or note, which is often buried in small print in an obscure part of the website, saying that an article is sponsored by (in other words, paid advertising by) the "author."

A mutual-fund "education" site, for example, states that its "primary purpose is to provide viewers with an independent guide that contains information and articles they can't get anywhere else." The content of the site suggests otherwise. In the "Expert's Corner" section of the site, material is reprinted from a newsletter that advocates frequent trading in and out of mutual funds to try and guess and time market moves. Turns out that the article is “sponsored by the featured expert”: In other words, it’s a paid advertisement. (The track record of the newsletter’s past recommendations, which isn’t discussed on the site, is poor.)

Even more troubling is the increasing number of websites that fail to disclose (even cryptically) that their content comes from advertisers. Print publications generally have a tradition of disclosing when an article is paid advertising, but in the Wild West online, many sites fail to make this important disclosure. Mind you, I’m not saying that disclosure makes paid-for content okay — I’m simply stating that a lack of disclosure makes an already bad situation even worse.

Also, beware of websites, especially those that are “free,” that are making money in a clandestine way from two sources: companies whose products they praise and affiliates to whom they direct mouse clicks/web traffic. In perusing the web, I noticed, for example, that many “free” financial websites were singing the praises of the software You Need A Budget (YNAB). I test-drove the product (which is like a slimmed-down version of Quicken or Microsoft Money), and it’s a decent but not exceptional product. My research uncovered the fact that the makers of YNAB pay a whopping 35-percent commission to website affiliates who pitch and direct users to buy the product. YNAB Pro is their most popular product and sells for $60, so a website flogging it for them pockets $21 for each copy it sells. Does that taint a site’s recommendation of YNAB? Of course it does.

Increasingly, companies are paying websites outright to simply mention and praise their products; doing so is incredibly sleazy even if it’s disclosed, but to do so without disclosure is unethical. Also beware of links to recommended product and service providers to do business with — more often than not, the referring website gets paid an affiliate fee. Look for sites that post policies against receiving such referral fees from companies whose products and services they recommend. (As an example, see the disclosure I use on my own site, www.erictyson.com.)

Steering clear of biased financial-planning advice

I also suggest skipping the financial-planning advice offered by financial service companies that are out to sell you something. Such companies can't take the necessary objective, holistic view required to render useful advice.

For example, on one major investment company's website, you find a good deal of material on the firm's mutual funds. The site's college-planning advice is off the mark because it urges parents to put money in a custodial account in the child's name. Ignored is the fact that doing so will undermine your child's ability to qualify for financial aid (see Chapter 13), that your child will have control of the money at either age 18 or 21 depending upon your state, and that you're likely better off funding your employer's retirement plan. If you did that, though, you couldn't set up a college savings-plan account at the fund company, which this area of the site prods you to do.

Shunning short-term thinking

> Many financial websites provide real-time stock quotes as a hook to a site that is cluttered with advertising. My experience working with individual investors is that the more short-term they think, the worse they do. And checking your portfolio during the trading day certainly promotes short-term thinking.

Another way that sites create an addictive environment for you to return to multiple times daily is to constantly provide news and other rapidly changing content. Do you really need "Breaking News" updates that gasoline prices jumped 19 cents per gallon over the past two weeks or that Larry King is having a contest with a

Hollywood celebrity on Twitter to see who can sign up more followers in the next week?

Also, beware of tips offered around the electronic water cooler — message boards. As in the real world, chatting with strangers and exchanging ideas are sometimes fine. However, if you don't know the identity and competence of message-board posters or chat-room participants, why would you follow their financial advice or stock tips? Getting ideas from various sources is okay, but educate yourself and do your homework before making personal financial decisions.

If you want to best manage your personal finances and find out more, remember that the old expression "You get what you pay for" contains a grain of truth. Free information on the Internet, especially information provided by companies in the financial-services industry, is largely self-serving. Stick with information providers who have proven themselves offline or who don't have anything to sell except objective information and advice.

Accomplishing Money Tasks on Your Computer

In the remainder of this chapter, I detail important personal financial tasks that your computer can assist you with. I also provide my recommendations for the best software and websites to help you accomplish these chores.

Paying your bills and tracking your money

Plenty of folks have trouble saving money and reducing their spending. Thus, it’s no surprise that in the increasingly crowded universe of free websites, plenty are devoted to supposedly helping you to reduce your spending. More of these sites keep springing up, but among those you may have heard of and stumbled upon are Geezeo, Mint, Wesabe, and Yodlee. As you can already see, attracting attention online starts with having a quirky name!

I’ve kicked the tires and checked out these sites and frankly have mixed to negative feelings about them. The biggest problems I have with these sites are that they’re loaded with advertising and/or have affiliate relationships with companies. What does this mean? The site gets paid if you click on a link to one of its recommended service providers and buy what it’s selling.

I will give credit to Mint for at least admitting in black and white that it is soliciting and receiving affiliate payments when it states on its site:

> *“How can Mint be free? We give you personalized ideas on how to save money by showing you the best way to save among thousands of financial products. If you decide to make a change that saves you some cash, we sometimes earn a small fee from the bank or company you switch to.”*

This, of course, creates an enormous conflict of interest and thoroughly taints any recommendation made by Mint and similar sites that profit from affiliate referrals. For starters, they have no incentive or reason to recommend companies that won’t pay them an affiliate fee. And, there’s little — if any — screening of companies for quality service levels that are important to you as a consumer.

Also, be forewarned that after registering you as a site user, the first thing most of these sites want you to do is connect directly to your financial institutions (banks, brokerages, investment companies) and download your investment account and spending data. If your instincts tell you this might not be a good idea, you should trust your instincts. Yes, there are security concerns, but those pale in comparison to privacy concerns and concerns about the endless pitching to you of products and services.

pitching to you of products and services.

Another problem that I have with these websites is the incredibly simplistic calculators that they have. One that purported to help with retirement planning didn't allow users to choose a retirement age younger than 62 and had no provisions for part-time work. When it asked about your assets, it made no distinction between equity in your home and financial assets (stocks, bonds, mutual funds, and so on). Finally, if you encounter a problem using these sites, they generally offer no phone support, so you're relegated to ping-ponging e-mails in the hopes of getting your questions answered.

Quicken is a good software program that I've reviewed that helps with expense tracking and bill paying. In addition to offering printed checks and electronic bill-payment, Quicken is a financial organizer. The program allows you to list your investments and other assets, along with your loans and other financial liabilities. Quicken automates the process of paying your bills, and it can track your check-writing and prepare reports that detail your spending by category so you can find the fat in your budget. (For a complete discussion on how to track your spending, see Chapter 3.)

In addition to the significant investment of time necessary to figure out how to use Quicken, another drawback is the cost of computer checks if you buy them from the software company. You can chop those costs by ordering from other companies, such as Checks Tomorrow (website www.checkstomorrow.com).

You can avoid dealing with paper checks — written or printed — by signing up for *online bill payment.* With such services, you save on checks, stamps, and envelopes. These services are available to anyone with a checking account through an increasing number of banks, credit unions, and brokerage firms, as well as through Quicken. Another option is to sign up through CheckFree's website: www.mycheckfree.com.

Planning for retirement

Good retirement-planning software and online tools can help you plan for retirement by crunching the numbers for you. But they can also teach you how particular changes — such as your investment returns, the rate of inflation, or your savings rate — can affect when and in what style you can retire. The biggest time-saving aspect of retirement-planning software and websites is that they let you more quickly play with and see the consequences of changing the assumptions.

Some of the major investment companies I profile in Part III of this book are sources for some high-quality, low-cost retirement-planning tools. Here are some good ones to consider:

- **T. Rowe Price's website** (www.troweprice.com) has several tools that can help you determine where you stand in terms of reaching a given retirement goal. T. Rowe Price (phone 800-225-5132) also offers some excellent workbooklets for helping you plan for retirement. Expect some marketing of T. Rowe Price's mutual funds in its booklets and software.

- **Vanguard's website** (www.vanguard.com) can help with figuring savings goals to reach retirement goals as well as with managing your budget and assets in retirement.

Preparing your taxes

Good, properly-used tax-preparation software can save you time and money. The best programs "interview" you to gather the necessary information and select the appropriate forms based on your responses. Of course, you're still the one responsible for locating all the information needed to complete your return. More-experienced taxpayers can bypass the interview and jump directly to the forms they know they need to complete. These programs also help flag overlooked deductions and identify other tax-reducing strategies.

TurboTax and H&R Block at Home are among the better tax-preparation programs I've reviewed.

In addition to the federal tax packages, tax-preparation programs are available for state income taxes, too. Many state tax forms are fairly easy to complete because they're based on information from your federal form. If your state tax forms are based on your federal form, you may want to skip buying the state income-tax preparation packages and prepare your state return by hand.

If you're mainly looking for tax forms, you can get them at no charge in tax-preparation books or through the IRS's website (`www.irs.gov`).

Researching investments

Instead of schlepping off to the library and fighting over the favorite investing reference manuals, ponying up hundreds of dollars to buy print versions for your own use, or slogging through voice-mail hell when you call government agencies, you can access a variety of materials on your computer. You can also often pay for just what you need:

- **The SEC:** The Securities and Exchange Commission (SEC) allows unlimited, free access to its documents at `www.sec.gov`. All public corporations, as well as mutual funds, file their reports with the agency. Be aware, however, that navigating this site takes patience.
- **Morningstar:** You can access Morningstar's individual stock and mutual fund reports at `www.morningstar.com`. The reports are free, but they're watered-down versions of the company's

comprehensive software and paper products. If you want to buy Morningstar's unabridged fund reports online, you can do so for a fee.

- **Vanguard:** Although I'm leery of financial service company "educational" materials because of bias and self-serving advice, some companies do a worthy job on these materials. The investor-friendly, thrifty Vanguard Group of mutual funds has an online university on its website (www.vanguard.com), where investors can learn the basics of fund investing. Additionally, investors in Vanguard's funds can access up-to-date personal account information through the site.

Trading online

If you do your investing homework, trading securities online may save you money and perhaps some time. For years, discount brokers (which I discuss in Chapter 8) were heralded as the low-cost source for trading. Now, online brokers such as E*TRADE Financial (phone 800-387-2331; website www.etrade.com) and Scottrade (phone 800-619-7283; website www.scottrade.com) have set a new, lower-cost standard. The major mutual fund companies, such as T. Rowe Price and Vanguard, also offer competitive online services.

A number of the newer discount brokers have built their securities brokerage business around online trading. By eliminating the overhead of branch offices and by accepting and processing trades by computer, online brokers keep their costs and brokerage charges to a minimum. Cut-rate electronic brokerage firms are for people who want to direct their own financial affairs and don't want or need to work with a personal broker. However, some of these brokers have limited products and services. For example, some don't offer many of the best mutual funds. And my own experience with reaching live people at some online brokers has been trying — I've had to wait on hold for more than ten minutes before a customer service representative answered the call.

Although online trading may save you on transaction costs, it can also encourage you to trade more than you should, resulting in higher total trading costs, lower investment returns, and higher income tax bills. Following investments on a daily basis encourages you to think short-term. Remember that the best investments are bought and held for the long haul (see Part III for more information).

Reading and searching periodicals

Many business and financial publications are online, offering investors news and financial market data. *The Wall Street Journal* provides an online, personalized edition of the paper (`http://online.wsj.com`) that allows you to tailor the content to meet your specific needs. The cost is $21.62 per month.

Leading business publications such as *Forbes* (`www.forbes.com`) and *BusinessWeek* (`www.bloombergbusinessweek.com`) put their current magazines' content on the Internet. Some publications are charging for archived articles and for some current content for nonsubscribers to their print magazine. Be careful to take what you read and hear in the mass media with many grains of salt (see Chapter 20 for more on mass media). Much of the content revolves around tweaking people's anxieties and dwelling on the latest crises and fads.

My website (`www.erictyson.com`) includes analysis of current news and highlights and summarizes the best content from many sources and sites, including leading newsletters.

Buying life insurance

If loved ones are financially dependent on you, you probably know that you need some life insurance. But add together the dread of life-insurance salespeople and a fear of death, and you have a recipe for procrastination. Although your computer can't stave off the Grim Reaper, it can help you find a quality, low-cost policy that can be more than 80 percent less costly than the most expensive options, all without having you deal with high-pressure sales tactics.

The best way to shop for term life insurance online is through one of the quotation services that I discuss in Chapter 16. At each of these sites, you fill in your date of birth, whether you smoke, how much coverage you'd like, and for how long you'd like to lock in the initial premium. When you're done filling in this information, a new web page pops up with a list of low-cost quotes (based on assumed good health) from highly rated (for financial stability) insurance companies.

Invariably, the quotes are ranked by how cheap they are. Although cost is certainly an important factor, many of these services don't do as good of a job explaining other important factors to consider when doing your comparison shopping. For example, the services sometimes don't cover the projected and maximum rates after the initial term has expired. Be sure to ask about these other future rates before you agree to a specific policy.

If you decide to buy a policy from one of the online agencies, you can fill out an online application form. The quotation agency will then mail you a detailed description of the policy and insurer, along with your completed application. In addition to having to deal with snail mail, you'll also have to deal with a *medical technician,* who will drop by your home to check on your health status . . . at least until some computer genius figures out a way for you to give blood and urine samples online!

Preparing legal documents

Just as you can prepare a tax return with the advice of a software

Just as you can prepare a tax return with the advice of a software program, you can also prepare common legal documents. This type of software may save you from the often difficult task of finding a competent and affordable attorney.

Using legal software is generally preferable to using fill-in-the-blank documents. Software has the built-in virtues of directing and limiting your choices and preventing you from making common mistakes. Quality software also incorporates the knowledge and insights of the legal eagles who developed the software. And it can save you money.

If your situation isn't unusual, legal software may work well for you. As to the legality of documents that you create with legal software, remember that a will, for example, is made legal and valid by your witnesses; the fact that an attorney prepares the document is *not* what makes it legal.

An excellent package for preparing your own will is Quicken WillMaker Plus, which is published by Nolo, a name synonymous with high quality and user-friendliness in the legal publishing world. In addition to allowing you to prepare wills, WillMaker can also help you prepare a living will and medical power of attorney document. The software also allows you to create a living trust that serves to keep property out of probate in the event of your death (see Chapter 17). Like wills, living trusts are fairly standard legal documents that you can properly create with the guidance of a top-notch software package. The package advises you to seek professional guidance for your situation, if necessary.

Part VI

The Part of Tens

"It's an interesting financial plan that should get us through the 'sandwich years,' but I should mention that neither my wife nor I know much about hijacking an oil tanker."

In this part . . .

You find some fun and useful chapters that can help you with financial strategies for ten life changes and guide you with ten tips for avoiding identity theft and fraud. Why “tens”? Why not?

Chapter 21

Survival Guide for Ten Life Changes

In This Chapter

- Handling the financial challenges that arise during life changes
- Minimizing money worries so you can focus on what matters most

Some of life's changes come unexpectedly, like earthquakes. Others you can see coming when they're still far off, like a big storm moving in off the horizon. Whether a life change is predictable or not, your ability to navigate successfully through its challenges and adjust quickly to new circumstances depends largely on your degree of preparedness.

Perhaps you find my comparison of life changes to natural disasters to be a bit negative. After all, some of the changes I discuss in this chapter should be occasions for joy. But understand that what one defines as a "disaster" has everything to do with preparedness. To the person who has stored no emergency rations in her basement, the big snowstorm that traps her in her home can lead to problems. But to the prepared person with plenty of food and water, that same storm may mean a vacation from work and some relaxing days in the midst of a winter wonderland.

First, here are some general tips that apply to all types of life changes:

- **Stay in financial shape.** An athlete is best able to withstand physical adversities during competition by training and eating well in advance. Likewise, the sounder your finances are to begin with, the better you'll be able to deal with life changes.

- **Changes require change.** Even if your financial house is in order, a major life change — starting a family, buying a home, starting a business, divorcing, retiring — should prompt you to review your personal financial strategies. Life changes affect your income, spending, insurance needs, and ability to take financial risk.
- **Don't procrastinate.** With a major life change on the horizon, procrastination can be costly. You (and your family) may overspend and accumulate high-cost debts, lack proper insurance coverage, or take other unnecessary risks. Early preparation can save you from these pitfalls.
- **Manage stress and your emotions.** Life changes often are accompanied by stress and other emotional upheavals. Don't make knee-jerk decisions during these changes. Take the time to become fully informed and recognize and acknowledge your feelings. Educating yourself is key. You may want to hire experts to help (see Chapter 18), but don't abdicate decisions and responsibilities to advisors — the advisors may not have your best interests at heart or fully appreciate your needs.

Here, then, are the major changes you may have to deal with at some point in your life. I wish you more of the good changes than the bad.

Starting Out: Your First Job

If you just graduated from college or some other program, or you're otherwise entering the workforce, your increased income and reduction in educational expenses are probably a welcome relief. You'd think, then, that more young adults would be able to avoid financial trouble and challenges. But they face these challenges largely because of poor financial habits picked up at home or from the world at large. Here's how to get on the path to financial success:

- **Don't use consumer credit.** The use and abuse of consumer credit can cause long-term financial pain and hardship. To get off on the right financial foot, young workers need to shun the habit of making purchases on credit cards that they can't pay for in full when the bill arrives in the mail. Here's the simple solution for running up outstanding credit-card balances: Don't carry a credit card. If you need the convenience of making purchases with a piece of plastic, get a debit card (see Chapter 5).

- **Get in the habit of saving and investing.** Ideally, your savings should be directed into retirement accounts that offer tax benefits unless you want to accumulate down-payment money for a home or small-business purchase (see Chapter 4). Thinking about a home purchase or retirement is usually not in the active thought patterns of first-time job seekers. I'm often asked, "At what age should a person start saving?" To me, that's similar to asking at what age you should start brushing your teeth. Well, when you have teeth to brush! So I say you should start saving and investing money from your first paycheck. Try saving 5 percent of every paycheck and then eventually increase your saving to 10 percent. If you're having trouble saving money, track your spending and make cutbacks as needed (refer to Chapters 3 and 6).

- **Get insured.** When you're young and healthy, imagining yourself feeling otherwise is hard. Many twenty-somethings give little thought to the potential for healthcare expenses. But because accidents and unexpected illnesses can strike at any age, forgoing coverage can be financially devastating. When you're in your first full-time job with more-limited benefits, buying disability coverage, which replaces income lost due to a long-term disability, is also wise. And as you begin to build your assets, consider making out a will so that your assets go where you want them to in the event of your untimely passing.

- **Continue your education.** After you get out in the workforce, you (like many other people) may realize how little you learned in formal schooling that can actually be used in the real world and, conversely, how much you need to learn that school never taught you. Read, learn, and continue to grow. Continuing education can help you advance in your career and enjoy the world around you.

Changing Jobs or Careers

During your adult life, you'll almost surely change jobs — perhaps several times a decade. I hope that most of the time you'll be changing by your own choice. But let's face it: Job security is not what it used to be. Downsizing has impacted even the most talented workers.

Always be prepared for a job change. No matter how happy you are in your current job, knowing that your world won't fall apart if you're not working tomorrow can give you an added sense of security and encourage openness to possibility. Whether you're changing your job by choice or necessity, the following financial maneuvers can help ease the transition:

- **Structure your finances to afford an income dip.** Spending less than you earn always makes good financial sense, but if you're approaching a possible job change, spending less is even more important, particularly if you're entering a new field or starting your own company and you expect a short-term income dip. Many people view a lifestyle of thriftiness as restrictive, but ultimately those thrifty habits can give you more freedom to do what you want to do. Be sure to keep an emergency reserve fund (see Chapter 8).

If you lose your job, batten down the hatches. You normally get little advance warning when you lose your job through no choice of your own. It doesn't mean, however, that you can't do anything financially. Evaluating and slashing your current level of spending may be necessary. Everything should be fair game, from how much you spend on housing to how often you eat out to where you do your grocery shopping. Avoid at all costs the temptation to maintain your level of spending by accumulating consumer debt.

- **Evaluate the total financial picture when relocating.** At some point in your career, you may have the option of relocating. But don't call the moving company until you understand the financial consequences of such a move. You can't simply compare salaries and benefits between the two jobs. You also need to compare the cost of living between the two areas: housing, commuting, state income and property taxes, food, utilities, and all the other major expenditure categories that I cover in Chapter 3.
- **Track your job search expenses for tax purposes.** If you're seeking a new job in your current (or recently current) field of work, your job search expenses may be tax-deductible, even if you don't get a specific job you desire. Remember, however, that if you're moving into a new career, your job search expenses are not tax-deductible.

Getting Married

Ready to tie the knot with the one you love? Congratulations — I hope that you'll have a long, healthy, and happy life together. In addition to the emotional and moral commitments that you and your spouse will make to one another, you're probably going to be merging many of your financial decisions and resources. Even if you're largely in agreement about your financial goals and strategies, managing as two is far different than managing as one. Here's how to prepare:

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- **Take a compatibility test.** Many couples never talk about their goals and plans before marriage, and failing to do so breaks up way too many marriages. Finances are just one of the many issues you need to discuss. Ensuring that you know what you're getting yourself into is a good way to minimize your chances for heartache. Ministers, priests, and rabbis sometimes offer premarital counseling to help bring issues and differences to the surface.
- **Discuss and set joint goals.** After you're married, you and your spouse should set aside time once a year, or every few years, to discuss personal and financial goals for the years ahead. When you talk about where you want to go, you help ensure that you're both rowing your financial boat in unison.
- **Decide whether to keep finances separate or manage them jointly.** Philosophically, I like the idea of pooling your finances better. After all, marriage is a partnership. In some marriages, however, spouses may choose to keep some money separate so they don't feel the scrutiny of a spouse with different spending preferences. Spouses who have been through divorce may choose to keep the assets they bring into the new marriage separate in order to protect their money in the event of another divorce. As long as you're jointly accomplishing what you need to financially, some separation of money is okay. But for the health of your marriage, don't hide money from one another, and if you're the higher-income spouse, don't assume power and control over your joint income.
- **Coordinate and maximize employer benefits.** If one or both of you have access to a package of employee benefits through an employer, understand how best to make use of those benefits. Coordinating and using the best that each package has to offer is like getting a pay raise. If you both have access to health insurance, compare which of you has better benefits. Likewise, one of you may have a better

retirement savings plan — one that matches and offers superior investment options. Unless you can afford to save the maximum through both your plans, saving more in the better plan will increase your combined assets. (***Note:*** If you're concerned about what will happen if you save more in one of your retirement plans and then you divorce, in most states, the money is considered part of your joint assets to be divided equally.)

- **Discuss life and disability insurance needs.** If you and your spouse can make do without each other's income, you may not need any income-protecting insurance. However, if you both depend on each other's incomes, or if one of you depends fully or partly on the other's income, you may each need long-term disability and term life insurance policies (refer to Chapter 16).
- **Update your wills.** When you marry, you should make or update your wills. Having a will is potentially more valuable when you're married, especially if you want to leave money to others in addition to your spouse, or if you have children for whom you need to name a guardian. See Chapter 17 for more on wills.
- **Reconsider beneficiaries on investment and life insurance.** With retirement accounts and life insurance policies, you name beneficiaries to whom the money or value in those accounts will go in the event of your passing. When you marry, you'll probably want to rethink your beneficiaries.

Buying a Home

Most Americans eventually buy a home. You don't need to own a home to be a financial success, but home ownership certainly offers financial rewards. Over the course of your adult life, the real estate you own is likely going to appreciate in value. Additionally, you'll pay off your mortgage someday, which will greatly reduce your housing costs. If you're thinking about buying a home, take these steps:

- **Get your overall finances in order.** Before buying, analyze your current budget, your ability to afford debt, and your future financial goals. Make sure your expected housing expenses allow you to save properly for retirement and other long-or short-term objectives. Don't buy a home based on what lenders are willing to lend.
- **Determine whether now's the time.** Buying a house when you don't see yourself staying put three to five years rarely makes financial sense. Buying and selling a home gobbles up a good deal of money in transaction costs — you'll be lucky to recoup all those costs even within a five-year period. Also, if your income is likely to drop or you have other pressing goals, such as starting a business, you may want to wait to buy.

For more about buying a home, be sure to read Chapter 14.

Having Children

If you think that being a responsible adult, holding down a job, paying your bills on time, and preparing for your financial future are tough, wait 'til you add kids to the equation. Most parents find that with children in the family, the already precious commodities of free time and money become even scarcer. The sooner you discover how to manage your time and money, the better able you'll be to have a sane, happy, and financially successful life as a parent. Here are some key things to do both before and after you begin your family:

- **Set your priorities.** As with many other financial decisions, starting or expanding a family requires that you plan ahead. Set your priorities and structure your finances and living situation accordingly. Is having a bigger home in a particular community important, or would you rather feel less pressure to work hard, giving you more time to spend with your family? Keep in mind that a less hectic work life not only gives you more free time but also often reduces your cost of living by decreasing meals out, dry-cleaning costs, day-care expenses, and so on.

- **Take a hard look at your budget.** Having kids requires you to increase your spending. At a minimum, expenditures for food and clothing will increase. But you're also likely to spend more on housing, insurance, day care, and education. On top of that, if you want to play an active role in raising your children, working at a full-time job won't be possible. So while you consider the added expenses, you may also need to factor in a decrease in income.

  No simple rules exist for estimating how kids will affect your household's income and expenses. On the income side, figure out how much you want to cut back on work. On the expense side, government statistics show that the average household with school-age children spends about 20 percent more than a household without children. Going through your budget category by category and estimating how kids will change your spending is a more scientific approach. (You can use the worksheets in Chapter 3.)

- **Boost insurance coverage *before* getting pregnant.** Make sure your health insurance plan offers maternity benefits. (Ask about waiting periods that may exclude coverage for a pregnancy within the first year or so of the insurance.) With disability insurance, pregnancy is considered a preexisting condition, so women should secure this coverage before getting pregnant. And most families-to-be should buy life insurance. Buying life insurance *after* the bundle of joy comes home from the hospital is a risky proposition — if one of the parents develops a health problem, he or she may be denied coverage. You should also consider buying life insurance for a stay-at-home parent. Even though the stay-at-home parent is not bringing in income, if he or she were to pass away, hiring assistance could cripple the family budget.

- **Check maternity leave with your employers.** Many of the larger employers offer some maternity leave for women and, in rare but thankfully increasing cases, for men. Some employers offer paid leaves, while others may offer unpaid leaves. Understand the options and the financial ramifications before you consider the leave and, ideally, before you get pregnant. Also, check laws within your state for mandated maternity and paternity leave.
- **Update your will.** If you have a will, update it; if you don't have a will, make one now. With children in the picture, you need to name a guardian who will be responsible for raising your children should you and your spouse both pass away.
- **Enroll the baby in your health plan.** After your baby is welcomed into this world, enroll him or her in your health insurance plan. Most insurers give you about a month or so to enroll.
- **Understand child-care tax benefits.** For every one of your children with an official Social Security number, you get a $3,800 deduction on your income taxes (for tax year 2012). So if you're in the 25 percent federal tax bracket, each child saves you $950 in federal taxes. On top of that, you may be eligible for a $1,000 tax credit for each child under the age of 17. That should certainly motivate you to apply for your kid's Social Security number!

  If you and your spouse both work and you have children under the age of 13, you can also claim a tax credit for child-care expenses. Or you may work for an employer who offers a flexible benefit or spending plan. These plans allow you to put away up to $5,000 per year on a pretax basis for child-care expenses. For many parents, especially those in higher income tax brackets, these plans can save a lot in taxes. Keep in mind, however, that if you use one of these plans, you can't claim the child-care tax credit. Also, if you don't deplete the account every tax year, you forfeit any money left over.

- **Skip saving in custodial accounts.** One common concern is how to sock away enough money to pay for the ever-rising cost of a college education. If you start saving money in your child's name in a so-called custodial account, however, you may harm your child's future ability to qualify for financial aid and miss out on the tax benefits that come with investing elsewhere (see Chapter 13).

- **Don't indulge the children.** Toys, art classes, music lessons, travel sports and associated lessons, field trips, and the like can rack up big bills, especially if you don't control your spending. Some parents fail to set guidelines or limits when spending on children's programs. Others mindlessly follow the examples set by the families of their children's peers. Introspective parents have told me that they feel some insecurity about providing the best for their children. The parents (and kids) who seem the happiest and most financially successful are the ones who clearly distinguish between material luxuries and family necessities.

  As children get older and become indoctrinated into the world of shopping, all sorts of other purchases come into play. Consider giving your kids a weekly allowance and letting them discover how to spend and manage it. And when they're old enough, having your kids get a part-time job can help teach financial responsibility.

Starting a Small Business

Many people aspire to be their own bosses, but far fewer people actually leave their jobs in order to achieve that dream. Giving up the apparent security of a job with benefits and a built-in network of co-workers is difficult for most people, both psychologically and financially. Starting a small business is not for everyone, but don't let inertia stand in your way. Here are some tips to help get you started and increase your chances for long-term success:

- **Prepare to ditch your job.** To maximize your ability to save money, live as Spartan a lifestyle as you can while you're employed; you'll develop thrifty habits that'll help you weather the reduced income and increased expenditure period that come with most small-business start-ups. You may also want to consider easing into your small business by working at it part-time in the beginning, with or without cutting back on your normal job.
- **Develop a business plan.** If you research and think through your business idea, not only will you reduce the likelihood of your business's failing and increase its success if it thrives, but you'll also feel more comfortable taking the entrepreneurial plunge. A good business plan describes in detail the business idea, the marketplace you'll compete in, your marketing plans, and expected revenue and expenses.
- **Replace your insurance coverage.** Before you finally leave your job, get proper insurance. With health insurance, employers allow you to continue your existing coverage (at your own expense) for 18 months. Individuals with existing health problems are legally entitled to purchase an individual policy at the same price that a healthy individual pays. With disability insurance, secure coverage before you leave your job so you have income to qualify for coverage. If you have life insurance through your employer, obtain new individual coverage as soon as you know you're going to leave your job. (See Chapter 16 for details.)
- **Establish a retirement savings plan.** After your business starts making a profit, consider establishing a retirement savings plan such as a SEP-IRA or Keogh. As I explain in Chapter 11, such plans allow you to shelter up to 20 percent of your business income from federal and state taxation.

Caring for Aging Parents

For many of us, there comes a time when we reverse roles with our parents and become the caregivers. As your parents age, they may need help with a variety of issues and living tasks. Although you probably won't have the time or ability to perform all these functions yourself, you may end up coordinating some service providers who will. Here are key issues to consider when caring for aging parents:

- **Get help where possible.** In most communities, a variety of nonprofit organizations offer information and counseling to families who are caring for elderly parents. Numerous for-profit agencies can help with everything from simple cleaning and cooking, to health checks and medication monitoring, to assisted living and health advocacy. You may be able to find your way to such resources through your state's department of insurance, as well as through recommendations from local hospitals and doctors. You'll especially want to get assistance and information if your parents need some sort of home care, nursing home care, or assisted living arrangement.
- **Get involved in their health care.** Your aging parents may already have a lot on their minds, or they simply may not be able to coordinate and manage all the healthcare providers who are giving them medications and advice. Try, as best as you can, to be their advocate. Speak with their doctors so you can understand their current medical condition, the need for various medications, and how to help coordinate caregivers. Visit home care providers and nursing homes, and speak with prospective care providers.
- **Understand tax breaks.** If you're financially supporting your parents, you may be eligible for a number of tax credits and deductions for elder care. Some employers' flexible benefit plans allow you to put away money on a pretax basis to pay

for the care of your parents. Also explore the dependent care tax credit, which you can take on your federal income tax Form 1040. And if you provide half or more of the support costs for your parents, you may be able to claim them as dependents on your tax return.

- **Discuss getting the estate in order.** Parents don't like thinking about their demise, and they may feel awkward discussing this issue with their children. But opening a dialogue between you and your folks about such issues can be healthy in many ways. Not only does discussing wills, living wills, living trusts, and estate planning strategies (see Chapter 17) make you aware of your folks' situation, but it can also improve their plans to both their benefit and yours.
- **Take some time off.** Caring for an aging parent, particularly one who is having health problems, can be time-consuming and emotionally draining. Do your parents and yourself a favor by using some vacation time to help get things in order.

Divorcing

In most marriages that are destined to split up, both parties usually recognize early warning signs. Sometimes, however, one spouse may surprise the other with an unexpected request for divorce. Whether the divorce is planned or unexpected, here are some important considerations when getting a divorce:

- **Question the divorce.** Some say that divorcing in America is too easy, and I tend to agree. Although some couples are indeed better off parting ways, others give up too easily, thinking that the grass is greener elsewhere, only to later discover that all lawns have weeds and crabgrass. Just as with lawns that aren't watered and fertilized, relationships can wither without nurturing.

  Money and disagreements over money are certainly contributing factors in marital unhappiness. Unfortunately, in some relationships, money is wielded as power by the spouse who earns more of it. Try talking things over, perhaps with a marital counselor.

- **Separate your emotions from the financial issues.** Feelings of revenge may be common in some divorces, but they'll probably only help ensure that the attorneys get rich as you and your spouse butt heads. If you really want a divorce, work at doing it efficiently and harmoniously so that you can get on with your lives and have more of your money to work with.

- **Detail resources and priorities.** Draw up a list of all the assets and liabilities that you and your spouse have. Make sure you list all the financial facts, including investment account records and statements. After you know the whole picture, begin to think about what is and isn't important to you financially and otherwise.

- **Educate yourself about personal finance and legal issues.** Divorce sometimes forces nonfinancially oriented spouses to get a crash course in personal finance at a difficult emotional time. This book can help educate you financially. Visit a bookstore and pick up a good legal guide or two about divorce.

- **Choose advisors carefully.** Odds are that you'll retain the services of one or more specialists to assist you with the myriad issues, negotiations, and concerns of your divorce. Legal, tax, and financial advisors can help, but make sure you recognize their limitations and conflicts of interest. The more complicated things become and the more you haggle with your spouse, the more attorneys, unfortunately, benefit financially. Don't use your divorce attorney for financial or tax advice — your lawyer probably knows no more than you do in these areas. Also, realize that you don't need an attorney to get divorced. A variety of books and kits can help you. As for choosing tax and financial advisors, if you think you need that type of help, see Chapters 7 and 18 for advice on how to find good advisors.

- **Analyze your spending.** Some divorcees find themselves financially squeezed in the early years following a divorce because two people living together in the same property can generally do so less expensively than two people living separately. Analyzing your spending needs pre-divorce can help you adjust to a new budget and negotiate a fairer settlement with your spouse.

- **Review needed changes to your insurance.** If you're covered under your spouse's employer's insurance plan, make sure you get this coverage replaced (see Chapter 16). If you or your children will still be financially dependent upon your spouse post-divorce, make sure that the divorce agreement mandates life insurance coverage. You should also revise your will (see Chapter 17).

- **Revamp your retirement plan.** With changes to your income, expenses, assets, liabilities, and future needs, your retirement plan will surely need a post-divorce overhaul. Refer to Chapter 4 for a reorientation.

Receiving a Windfall

Whether through inheritance, stock options, small-business success, or lottery winnings, you may receive a financial windfall at some point in your life. Like many people who are totally unprepared psychologically and organizationally for their sudden good fortune, you may find that a flood of money can create more problems than it solves. Here are a few tips to help you make the most of your financial windfall:

- **Educate yourself.** If you've never had to deal with significant wealth, I don't expect you to know how to handle it. Don't pressure yourself to invest it as soon as possible. Leaving the money where it is or stashing it in one of the higher-yielding money market funds I recommend in Chapter 12 is far better than jumping into investments that you don't understand and haven't researched.

- **Beware of the sharks.** You may begin to wonder whether someone has posted your net worth, address, and home telephone number in the local newspaper and on the Internet. Brokers and financial advisors may flood you with marketing materials, telephone solicitations, and lunch date requests. These folks pursue you for a reason: They want to convert your money into their income either by selling you investments and other financial products or by managing your money. Stay away from the sharks, educate yourself, and take charge of your own financial moves. Decide on your own terms whom to hire, and then seek them out.
- **Recognize the emotional side of coming into a lot of money.** One of the side effects of accumulating wealth quickly is that you may have feelings of guilt or otherwise be unhappy, especially if you expected money to solve your problems. If you didn't invest in your relationship with your parents and after their passing, you regret how you interacted with them, getting a big inheritance from your folks may make you feel badly. If you poured endless hours into a business venture that finally paid off, all that money in your investment accounts may leave you with a hollow feeling if you're divorced and you lost friends by neglecting your relationships.
- **Pay down debts.** People generally borrow money to buy things that they otherwise can't buy in one fell swoop. Paying off your debts is one of the simplest and best investments you can make when you come into wealth.
- **Diversify.** If you want to protect your wealth, don't keep it all in one pot. Mutual funds (see Chapter 10) are an ideally

diversified, professionally managed investment vehicle to consider. And if you want your money to continue growing, consider the wealth-building investments — stocks, real estate, and small-business options — that I discuss in Part III of this book.

- **Make use of the opportunity.** Most people work for a paycheck their whole lives so they can pay a never-ending stream of monthly bills. Although I'm not advocating a hedonistic lifestyle, why not take some extra time to travel, spend time with your family, and enjoy the hobbies you've long been putting off? How about trying a new career that you may find more fulfilling and that may make the world a better place? And what about donating some to your favorite charities?

Retiring

If you've spent the bulk of your adult life working, retiring can be a challenging transition. Most Americans have an idealized vision of how wonderful retirement will be — no more irritating bosses and pressure of work deadlines; unlimited time to travel, play, and lead the good life. Sounds good, huh? Well, the reality for most Americans is different, especially for those who don't plan ahead (financially and otherwise). Here are some tips to help you through retirement:

- **Plan both financially and personally.** Planning your activities is even more important than planning financially. If the focus during your working years is solely on your career and saving money, you may lack interests, friends, and the ability to know how to spend money when you retire.
- **Take stock of your resources.** Many people worry and wonder whether they have sufficient assets for cutting back on work or retiring completely, yet they don't crunch any

numbers to see where they stand. Ignorance may cause you to misunderstand how little or how much you really have for retirement when compared to what you need. See Chapters 4 and 11 for help with retirement planning and investing.

- **Reevaluate your insurance needs.** When you have sufficient assets to retire, you don't need to retain insurance to protect your employment income any longer. On the other hand, as your assets grow over the years, you may be underinsured with regards to liability insurance (refer to Chapter 17).

- **Evaluate healthcare/living options.** Medical expenses in your retirement years (particularly the cost of nursing home care) can be daunting. Which course of action you take — supplemental insurance, buying into a retirement community, or not doing anything — depends on your financial and personal situation. Early preparation increases your options; if you wait until you have major health problems, it may be too late to choose specific paths. (See Chapter 16 for more details on healthcare options.)

- **Decide what to do with your retirement plan money.** If you have money in a retirement savings plan, your employer may offer you the option of leaving the money in the plan rather than rolling it over into your own retirement account. Brokers and financial advisors clearly prefer that you do the latter because it means more money for them, but it can also give you many more (and perhaps better) investment choices to consider. Read Part III of this book to find out about investing and evaluating the quality of your employer's retirement plan investment options.

- **Pick a pension option.** Selecting a *pension option* (a plan that pays a monthly benefit during retirement) is similar to choosing a good investment — each pension option carries different risks, benefits, and tax consequences. Pensions are structured by actuaries, who base pension options on reasonable life expectancies. The younger you are when you start collecting your pension, the less you get per month. Check to see whether the amount of your monthly pension stops increasing past a certain age. You obviously don't want to delay access to your pension benefits past that age, because you won't receive a reward for waiting any longer and you'll collect the benefit for fewer months.

If you know that you have a health problem that shortens your life expectancy, you may benefit from drawing your pension sooner. If you plan to continue working in some capacity and earning a decent income after retiring, waiting for higher pension benefits when you're in a lower tax bracket is probably wise.

At one end of the spectrum, you have the risky single life option, which pays benefits until you pass away and then provides no benefits for your spouse thereafter. This option maximizes your monthly take while you're alive. Consider this option only if your spouse can do without this income. The least risky option, and thus least financially rewarding while the pensioner is still living, is the *100-percent joint and survivor option,* which pays your survivor the same amount that you received while still alive. The other joint and survivor options fall somewhere between these two extremes and generally make sense for most couples who desire decent pensions early in retirement but want a reasonable amount to continue in the event that the pensioner dies first. The 75-percent joint and survivor option is a popular choice, because it closely matches the lower expense needs of the lone surviving spouse at 75 percent of the expenses of the couple, and it provides higher payments than the 100-percent joint and survivor option while both spouses are alive.

- **Get your estate in order.** Confronting your mortality is never fun, but when you're considering retirement or you're already retired, getting your estate in order makes all the more sense. Find out about wills and trusts that may benefit you and your heirs. You may also want to consider giving monetary gifts now if you have more than you need.

Chapter 22

Ten Tactics to Thwart Identity Theft and Fraud

In This Chapter

- Protecting your personal information
- Paying attention to activity in your accounts and credit history

Hucksters and thieves are often several steps ahead of law enforcement. Eventually, some of the bad guys get caught, but many don't, and those who do get nabbed often go back to their unsavory ways after penalties and some jail time. They may even be in your neighborhood or on your local Little League board. (For an enlightening read, check out Dr. Martha Stout's book *The Sociopath Next Door* [Three Rivers Press].)

Years ago when I lived on the West Coast, I got a call from my bank informing me that it had just discovered "concerning activity" on the joint checking account I held with my wife. Specifically, what had happened was that a man with a bogus ID in my name had gone into five different Bank of America branches on the same day and withdrawn $80 from our checking account at each one. After some detective work on my part, I discovered that someone had pilfered our personal banking information at my wife's employer's payroll office. Fortunately, the bank made good on the money that it had allowed to be withdrawn by the Eric Tyson impostor.

I had been the victim of identity theft. In my situation, the crook had accessed one of my accounts; in other cases, the criminal activity may develop with someone opening an account (such as a credit card) using someone's stolen personal information. Victims of card) using someone's stolen personal information. Victims of identity theft can suffer trashed credit reports, reduced ability to qualify for loans and even jobs (with employers who check credit reports), out-of-pocket costs and losses, and dozens of hours of time to clean up the mess and clear their credit record and name.

Unfortunately, identity theft is hardly the only way to be taken to the cleaners by crooks. All sorts of scamsters hatch schemes to separate you from your money. Please follow the ten tips in this chapter to keep yourself from falling prey and unnecessarily losing money.

Save Phone Discussions for Friends Only

Never, ever give out personal information over the phone, especially when you aren't the one who initiated the call. Suppose you get a call and the person on the other end of the line claims to be with a company you conduct business with (such as your credit-card company or bank). Ask for the caller's name and number and call back the company's main number (which you look up) to be sure he is indeed with that company and has a legitimate business reason for contacting you.

With caller ID on your phone line, you may be able to see what number a call is originating from, but more often than not, calls from business-registered phone numbers come up as "unavailable." A major red flag: calling back the number that comes through on caller ID and discovering that the number is bogus (a nonworking number).

Never Respond to E-Mails Soliciting Information

If you’re an e-mail user, you may have seen or heard about official-looking e-mails sent from companies you know of and may do business with asking you to promptly visit their website to correct some sort of billing or account problem. Crooks can generate a return/sender e-mail address that looks like it comes from a known institution but really does not. This unscrupulous practice is known as phishing, and if you bite at the bait, visit the site, and provide the requested personal information, your reward is likely to be some sort of future identity-theft problem.

To find out more about how to protect yourself from phishing scams, visit the website of the AntiPhishing Working Group (APWG) at www.antiphishing.org.

Review Your Monthly Financial Statements

Although financial institutions such as banks may call you if they notice unusual activity on one of your accounts, some people discover problematic account activity by simply reviewing their monthly credit-card, checking-account, and other statements.

Do you need to balance bank account statements to the penny? No, you don’t. I haven’t for years (decades actually), and I don’t have the time or patience for such minutiae. The key is to review the line items on your statement to be sure that all the transactions were yours.

Secure All Receipts

When you make a purchase, be sure to keep track of and secure receipts, especially those that contain your personal financial or account information. You can keep these in an envelope in your home, for example. Then cross-check them against your monthly statement.

When you no longer need to retain your receipts, be sure to dispose of them in a way that prevents a thief, who may get into your garbage, from being able to decipher the information on them. Rip up the receipts or, if you feel so inclined, buy a small paper shredder for your home and/or small business.

Close Unnecessary Credit Accounts

Open your wallet and remove all the pieces of plastic within it that enable you to charge purchases. The more credit cards and credit lines you have, the more likely you are to have problems with identity theft and fraud and the more likely you are to overspend and carry debt balances. Also, reduce preapproved credit offers by contacting 888-5OPTOUT (888-567-8688) or visiting www.optoutprescreen.com.

Unless you maintain a card for small business transactions, you really "need" only one piece of plastic with a VISA or MasterCard logo. Give preference to a debit card if you have a history of accumulating credit-card-debt balances.

Regularly Review Your Credit Reports

You may also be tipped off to shenanigans going on in your name when you review your credit report. Some identity-theft victims have found out about credit accounts opened in their name by reviewing their credit reports.

Because you're entitled to a free credit report from each of the three major credit agencies every year, I recommend reviewing your reports at least that often. The reports generally contain the same information, so you can request and review one agency report every four months, which enables you to keep a closer eye on your reports and still obtain them without cost.

I don't recommend spending the $100 or so annually for a so-called credit monitoring service that updates you when something happens on your credit reports. If you're concerned about someone illegally applying for credit in your name, know that another option for you (in some states) to stay on top of things is to "freeze" your personal credit reports and scores (see the next tip).

Freeze Your Credit Reports

To address the growing problem of identity theft, increasing numbers of states are passing credit freeze laws, which enable consumers to prevent access to their reports. Many states enable consumers, typically for a nominal fee, to freeze their credit information.

In some states, only identity-theft victims may freeze their reports. The individual whose credit report is frozen is the only person who may grant access to the frozen credit report.

Keep Personal Info Off Your Checks

Don't place personal information on checks. Information that is useful to identity thieves — and that you should not put on your checks — includes your credit-card number, driver's license number, Social Security number, and so on. I also encourage you to leave your home address off your preprinted checks when you order them. Otherwise, every Tom, Dick, and Jane whose hands your check passes through knows exactly where you live.

When writing a check to a merchant, question the need for adding personal information to the check (in fact, in numerous states, requesting and placing credit-card numbers on checks is against the law). Use a debit card instead for such transactions and remember that your debit card doesn't advertise your home address and other financial account data, so there's no need to publicize it to the world on your checks.

Protect Your Computer and Files

Especially if you keep personal and financial data on your computer, consider the following safeguards to protect your computer and the confidential information on it:

- Install a firewall.
- Use virus protection software.
- Password-protect access to your programs and files.

Protect Your Mail

Some identity thieves have collected personal information by simply helping themselves to mail in home mailboxes. Stealing mail is easy, especially if your mail is delivered to a curbside box.

Consider using a locked mailbox or a post office box to protect your incoming mail from theft. Consider having your investment and other important statements sent to you via e-mail, or simply access them online and eliminate mail delivery of the paper copies.

Be careful with your outgoing mail as well, such as bills with checks attached. Minimize your outgoing mail and save yourself hassles by signing up for automatic bill payment for as many bills as possible. Drop the rest of your outgoing mail in a secure U.S. postal box, such as those you find at the post office.

as those you find at the post office.

Glossary

adjustable-rate mortgage (ARM): A mortgage whose interest rate and monthly payments vary throughout its life. ARMs typically start with an artificially low interest rate that gradually rises over time. The interest rate is determined by a formula: margin (which is a fixed number) plus index (which varies). Generally speaking, if the overall level of interest rates drops, as measured by a variety of different indexes, the interest rate of your ARM generally follows suit. Similarly, if interest rates rise, so does your mortgage's interest rate and monthly payment. Caps limit the amount that the interest rate can fluctuate. Before you agree to an ARM, be certain that you can afford its highest possible payments.

adjusted cost basis: For capital gains tax purposes, the adjusted cost basis is how the IRS determines your profit or loss when you sell an asset such as a home or a security. For an investment such as a mutual fund or stock, your cost basis is what you originally invested plus any reinvested money. For a home, you arrive at the adjusted cost basis by adding the original purchase price to the cost of any capital improvements (expenditures that increase your property's value and life expectancy).

adjusted gross income (AGI): The sum of your taxable income (such as wages, salaries, and tips) and taxable interest less allowable adjustments (such as retirement account contributions and moving expenses). AGI is calculated before subtracting your personal exemptions and itemized deductions, which are used to derive your taxable income.

after-tax contributions: Some retirement plans allow you to contribute money that has already been taxed. Such contributions are known as after-tax contributions.

alternative minimum tax (AMT): The name given to a sort of shadow tax system that may cause you to pay a higher amount in federal income taxes than you otherwise would. The AMT was designed to prevent higher income earners from lowering their tax bills too much through large deductions.

annual percentage rate (APR): The figure that states the total yearly cost of a loan as expressed by the actual rate of interest paid. The APR includes the base interest rate and any other add-on loan fees and costs. The APR is thus inevitably higher than the rate of interest that the lender quotes.

annuity: An investment that is a contract backed by an insurance company. An annuity is frequently purchased for retirement purposes. Its main benefit is that it allows your money to compound and grow without taxation until withdrawal. Selling annuities is a lucrative source of income for insurance agents and financial planners who work on commission, so don't buy an annuity until you're sure it makes sense for your situation.

asset allocation: When you invest your money, you need to decide how to proportion (allocate) it between risky, growth-oriented investments (such as stocks), whose values fluctuate, and more stable, income-producing investments (like bonds). How soon you'll need the money and how tolerant you are of risk are two important determinants when deciding how to allocate your money.

audit: An IRS examination of your financial records, generally at the IRS offices, to substantiate your tax return. IRS audits are among life's worst experiences.

bank prime rate: See ***prime rate.***

bankruptcy: Legal action that puts a halt to creditors' attempts to collect unpaid debts from you. Of use to people who have a high proportion of consumer debt to annual income (25 percent or greater).

bear market: A period (such as the early 2000s and late 2000s) when the stock market experiences a strong downward swing. It is often accompanied by (and sometimes precedes) an economic recession.

Imagine a bear in hibernation, because this is what happens in a bear market: Investors hibernate, and the market falters. During a bear market, the value of stocks can decrease significantly. The market usually has to drop at least 20 percent from its peak before it is considered a bear market.

beneficiaries: The people to whom you want to leave your assets (or in the case of life insurance or a pension plan, benefits) in the event of your death. You denote beneficiaries for each of your retirement accounts.

blue chip stock: The stock of the largest and most consistently profitable corporations. This term comes from poker, where the most valuable chips are blue. This list is unofficial and changes.

bond: A loan investors make to a corporation or government. Bonds generally pay a set amount of interest on a regular basis. They're an appropriate investment vehicle for conservative investors who don't feel comfortable with the risk involved in investing in stocks and who want to receive a steady income. All bonds have a maturity date when the bond issuer must pay back the bond at *par* (full) value to the bondholders (lenders). Bonds should not be your primary long-term investment vehicle, because they produce little real growth on your original investment after inflation is factored in.

bond rating: See ***Standard & Poor's (S&P) ratings*** and ***Moody's ratings.***

bond yield: A yield is quoted as an annual percentage rate of return that a bond will produce based on its current value if it makes its promised interest payments. How much a bond will yield to an investor depends on three important factors: the stated interest rate paid by the bond, changes in the creditworthiness of the bond's issuer, and the maturity date of the bond. The better the rating a bond receives, the less risk involved and, thus, the lower the yield. As far as the maturity date is concerned, the longer you loan your money, the higher the risk (because it's more likely that rates will fluctuate) and the higher your yield generally will be.

broker: A person who acts as an intermediary for the purchase or sale of investments. When you buy a house, insurance, or stock, you're most likely to do so through a broker. Most brokers are paid on commission, which creates a conflict of interest with their clients: The more the broker sells, the more he makes. Some insurance companies let you buy their policies directly, and many mutual fund families bypass stockbrokers. If you're going to work with a broker, a discount broker can help you save on commissions.

bull market: A period (such as most of the 1990s and mid-2000s in the United States) when the stock market moves higher, usually accompanied and driven by a growing economy and increasing corporate profits.

callable bond: A bond for which the lender can decide to pay the holder earlier than the previously agreed-upon final maturity date. If interest rates are relatively high when a bond is issued, lenders may prefer to issue callable bonds because they have the flexibility to call back these bonds and issue new, lower-interest-rate bonds if interest rates decline. Callable bonds are risky for investors, because if interest rates decrease, the bond holder will get his investment money returned early and may have to reinvest his money at a lower interest rate.

capital gain: The profit from selling your stock at a higher price than the price for which it was purchased. For example, if you buy 50 shares of Rocky and Bullwinkle stock at $20 per share and two years later you sell your shares when the price rises to $25 per share, your profit or capital gain is $5 per share, or $250. If you hold this stock outside of a tax-sheltered retirement account, you'll owe federal tax on this profit when you sell the stock. Many states also levy such a tax.

capital gains distribution: Taxable distribution by a mutual fund or real-estate investment trust (REIT) created by securities that are sold within the fund or REIT at a profit. These distributions may be either short-term (assets held a year or less) or long-term (assets held for more than one year).

cash value insurance: A type of life insurance that's extremely popular with insurance salespeople because it commands a high commission. In a cash value policy, you buy life insurance coverage but also get a savings-type account. Unless you're looking for ways to limit your taxable estate (if you're extremely wealthy, for example), avoid cash value insurance. The investment returns tend to be mediocre, and your contributions aren't tax-deductible.

certificate of deposit (CD): A specific-term loan that you make to your banker. The maturity date for CDs ranges from a month up to several years. The interest paid on CDs is fully taxable, thus making CDs inappropriate for higher tax-bracket investors investing outside tax-sheltered retirement accounts.

closed-end mutual fund: A mutual fund for which the exact number of shares that are going to be issued to investors is decided upfront. After all the shares are sold, an investor seeking to invest in the closed-end fund can only do so by purchasing shares from an existing investor. Shares of closed-end funds trade on the major stock exchanges and therefore sell at either a discount, if the sellers exceed the buyers, or at a premium, if demand exceeds supply.

COBRA (Consolidated Omnibus Budget Reconciliation Act): Name of the federal legislation that requires health insurers and larger employers to continue to offer health insurance, at the employee's expense, for 18 months after coverage would otherwise end — for example, when an employee is laid off.

commercial paper: A short-term debt or IOU issued by larger, stable companies to help make their businesses grow and prosper. Creditworthy companies can sell this debt security directly to large investors and thus bypass borrowing money from bankers. Money-market funds invest in soon-to-mature commercial paper.

commission: The percentage of the selling price of a house, stock, bond, or other investment that's paid to agents and brokers. Because most agents and brokers are paid by commission, understanding how the commission can influence their behavior and recommendations is important for investors and home buyers. Agents and brokers make money only when you make a purchase, and they make more money when you make a bigger purchase. Choose an agent carefully and take your agent's advice with a grain of salt, because this conflict of interest can often set an agent's visions and goals at odds with your own.

commodity: A raw material (gold, wheat, sugar, or gasoline, for example) traded on the futures market.

common stock: Shares in a company that don't offer a guaranteed amount of dividend to investors; the amount of dividend distributions, if any, is at the discretion of company management. Although common-stock investors may or may not make money through dividends, they hope that the stock price will appreciate as the company expands its operations and increases its profits. Common stock tends to offer you a better return (profit) than other investments, such as bonds or preferred stock. However, if the company falters, you may lose some or all of your original investment.

comparable market analysis (CMA): A written analysis of similar houses currently being offered for sale and those that have recently sold. Real estate agents usually complete CMAs.

consumer debt: Debt on consumer items that depreciate in value over time. Credit card balances and auto loans are examples of consumer debt. This type of debt is bad for your financial health because it carries a high interest rate and encourages you to live beyond your means.

Consumer Price Index (CPI): The Consumer Price Index reports price changes, on a monthly basis, in the cost of living for such items as food, housing, transportation, healthcare, entertainment, clothing, and other miscellaneous expenses. The CPI is used to adjust government benefits, such as Social Security, and is used by many employers to determine cost-of-living increases in wages and pensions. An increase in prices is also known as inflation.

co-payment: The percentage of your medical bill that your health plan requires you to pay out of your own pocket with each medical visit or treatment, often even after you satisfy your annual deductible. A typical co-payment is 20 percent.

credit report: A report that details your credit history. It's the main report that a lender uses to determine whether to give you a loan. You may now obtain free copies of your credit reports annually.

debit card: Although they may look like credit cards, debit cards are different in one important way: When you use a debit card, the cost of the purchase is deducted from your checking account. Thus, a debit card gives you the convenience of a credit card without the danger of building up a mountain of consumer debt.

deductible: You may be thinking that this is a new product from the Keebler elves. Unfortunately, a deductible is actually much more mundane. With insurance, the deductible is the amount you pay when you file a claim. For example, say that your car sustains $800 of damage. If your deductible is $500, the insurance covers $300, and you pay $500 out of your own pocket for the repairs. The higher the deductible, the lower your insurance premiums and the less paperwork you expose yourself to when filing claims (because small losses that are less than the deductible don't require filing a claim). Take the highest deductibles that you can afford when selecting insurance.

deduction: An expense you may subtract from your income to lower your taxable income. Examples include mortgage interest and property taxes (itemized deductions), and most retirement account contributions.

derivative: An investment instrument whose value is derived from other securities. For example, the value of an option to buy IBM stock is derived from the price of IBM's stock.

disability insurance: Disability insurance replaces a portion of your employment income in the unlikely event that you suffer a disability that keeps you from working.

discount broker: Unlike a full-service broker, a discount broker generally offers no investment advice and has employees who work on salary rather than on commission. In addition to trading individual securities, most discount brokerage firms also offer no-load (commission-free) mutual funds.

diversification: If you put all your money into one type of investment, you're potentially setting yourself up for a big shock. If that investment collapses, so does your investment world. By spreading (diversifying) your money among different investments — bonds, U.S. stocks, international stocks, real estate, and so on — you ensure yourself a better chance of investing success and fewer sleepless nights.

dividend: The dividend is the income paid to investors holding an investment. With stock, the dividend is a portion of a company's profits paid to its shareholders. For example, if a company has an annual dividend of $2 per share and you own 100 shares, your total dividend is $200. Usually, established and slower-growing companies pay dividends, while smaller and faster-growing companies reinvest their profits for growth. For assets held outside retirement accounts, dividends (except from tax-free money-market and tax-free bond funds) are taxable.

Dow Jones Industrial Average (DJIA): A widely followed stock market index comprised of 30 large, actively traded U.S. company stocks. Senior editors at *The Wall Street Journal* select the stocks in the DJIA.

down payment: The part of the purchase price for a house that the buyer pays in cash upfront and does not finance with a mortgage. The larger the down payment, the smaller the mortgage amount and often the lower the interest rate. You can usually get access to the best mortgage programs with a down payment of at least 20 percent of the home's purchase price.

earthquake insurance: Although the West Coast is often associated with earthquakes, other areas are also quake prone. An earthquake insurance rider (which usually comes with a deductible of 5 to 15 percent of the cost to rebuild the home) on a homeowner's policy pays to repair or rebuild your home if it is damaged in an earthquake. If you live in an area with earthquake risk, consider earthquake insurance coverage!

Emerging Markets Index: The Emerging Markets Index, which is published by Morgan Stanley, tracks stock markets in developing countries. The main reason for investing in emerging markets is that these economies typically experience a higher rate of economic growth than developed markets. However, the potential for higher returns is coupled with greater risk.

equity: In the real-estate world, this term refers to the difference between the market value of your home and what you owe on it. For example, if your home is worth $250,000, and you have an outstanding mortgage of $190,000, your equity is $60,000. Equity is also a synonym for stock.

estate: The value, at the time of your death, of your assets minus your loans and liabilities.

estate planning: The process of deciding where and how your assets will be transferred when you die and structuring your assets during your lifetime so as to minimize likely estate taxes.

Federal National Mortgage Association (FNMA): The FNMA (or Fannie Mae) is one of the best-known institutions in the secondary mortgage market. Fannie Mae buys mortgages from banks and other mortgage-lending institutions and, in turn, sells them to investors. These loan investments are considered safe because Fannie Mae buys mortgages only from companies that conform to its stringent mortgage regulations, and Fannie Mae guarantees the repayment of principal and interest on the loans that it sells. FNMA, although it is a public company, also has an implicit federal government guarantee that was demonstrated in late 2008 during the financial crisis.

financial assets: A property or investment (such as investment real estate or a stock, mutual fund, or bond) that is held primarily as an investment to generate a positive return over time.

financial liabilities: Your outstanding loans and debts. To determine your net worth, subtract your financial liabilities from your financial assets.

financial planners (or advisors): A motley crew that professes an ability to direct your financial future. Financial planners come with varying backgrounds and degrees: MBAs, Certified Financial Planners, and Certified Public Accountants, to name a few. A useful way to distinguish among this mixed bag of nuts is to determine whether the planners are commission-, fee-, or hourly-based.

fixed-rate mortgage: The granddaddy of all mortgages. You lock into an interest rate (for example, 6 percent), and it never changes during the life (term) of your 15-or 30-year mortgage. Your mortgage payment and interest rate will be the same amount each and every month. If you become a cursing, frothing maniac when you miss your morning coffee or someone is five minutes late, then this mortgage may be for you!

flood insurance: If there’s a remote chance that your area may flood, having flood insurance, which reimburses rebuilding your home and replacing its contents in the event of a flood, is wise.

401(k) plan: A type of retirement savings plan offered by many for-profit companies to their employees. Your contributions compound without taxation over time and are usually exempt (yes!) from federal and state income taxes until withdrawal.

403(b) plan: Similar to a 401(k) plan but for employees of nonprofit organizations.

full-service broker: A broker who gives advice and charges a high commission relative to discount brokers. Because the brokers work on commission, they have a significant conflict of interest: namely, to advocate strategies that will benefit them financially.

futures: An obligation to buy or sell a commodity or security on a specific day for a preset price. When used by most individual investors, futures represent a short-term gamble on the short-term direction of the price of a commodity. Companies and farmers use futures contracts to hedge their risks of changing prices.

guaranteed-investment contracts (GICs): Insurance company investments that appeal to skittish investors. GICs generally tell you one year in advance what your interest rate will be for the coming year. Thus, you don't have to worry about fluctuations and losses in your investment value. On the other hand, GICs offer you little upside, because the interest rate is comparable to what you may get on a short-term bank certificate of deposit.

home equity: See ***equity.***

home equity loan: Technical jargon for what used to be called a second mortgage. With this type of loan, you borrow against the equity in your house. If used wisely, a home equity loan can help pay off high-interest consumer debt or be tapped for other short-term needs (such as a remodeling project). In contrast with consumer debt, mortgage debt usually has a lower interest rate and is tax-deductible.

homeowner's insurance: Dwelling coverage that covers the cost of rebuilding your house in the event of fire or other calamity. The liability insurance portion of this policy protects you against lawsuits associated with your property. Another essential element of homeowner's insurance is the personal property coverage, which pays to replace your damaged or stolen worldly possessions.

index: 1) A security market index, such as the Standard & Poor's 500 Index, is a statistical composite that tracks the price level and performance of a basket of many securities, typically within a specific investment asset class. Indexes exist for various stock and bond markets and are typically set at a round number, such as 100, at a particular point in time. See also ***Dow Jones Industrial Average*** and ***Russell 2000.*** 2) The index can also refer to the measure of the overall level of interest rates that a lender uses as a reference to calculate the specific interest rate on an adjustable-rate loan. The index plus the margin is the formula for determining the interest rate on an adjustable-rate mortgage.

Individual Retirement Account (IRA): A retirement account into which anyone with sufficient employment income or alimony may contribute up to $5,000 per year ($6,000 if age 50 or older). Based on your eligibility for other employer-based retirement programs and which type of IRA you select (regular or Roth), your contributions may be tax-deductible.

inflation: The technical term for a general rise in prices in the economy. Inflation usually occurs when too much money is in circulation and not enough goods and services are available to spend it on. As a result of this excess money, prices rise. A link is present between inflation and interest rates: If interest rates don't keep up with inflation, no one will invest in bonds issued by the government or corporations. When the interest rates on bonds are high, it usually reflects a high rate of expected inflation that will eat away at your return.

initial public offering (IPO): The first time a company offers stock to the investing public. An IPO typically occurs when a company wants to expand more rapidly and seeks additional money to support its growth. A number of studies have demonstrated that buying into IPOs in which the general public can participate produces subpar investment returns. A high level of IPO activity may indicate a cresting stock market, as companies and their investment bankers rush to cash in on a "pricey" marketplace. (IPO could stand for *It's Probably Overpriced.*)

interest rate: The rate lenders charge you to use their money. The higher the interest rate, the higher the risk entailed in the loan. With bonds of a given maturity, a higher rate of interest means a lower quality of bond — one that's less likely to return your money.

international stock markets: Stock markets outside of the United States account for a significant portion of the world stock market capitalization (value). Some specific stock indices track international markets (see ***Morgan Stanley EAFE index*** and ***Emerging Markets Index***). International investing offers one way for you to diversify your portfolio and reduce your risk. Some of the foreign countries with major stock exchanges outside the United States include Japan, Britain, France, Germany, and Canada.

junk bond: A bond rated Ba (Moody's) or BB (Standard & Poor's) or lower. Historically, these bonds have had a 1 to 2 percent chance of default, which is not exactly "junky." Of course, the higher risk is accompanied by a higher interest rate.

Keogh plan: A tax-deductible retirement savings plan available to self-employed individuals. Certain Keoghs allow you to put up to 25 percent of your net self-employment income into the account.

leverage: Financial leverage affords its users a disproportionate amount of financial power relative to the amount of their own cash invested. In some circumstances, you can borrow up to 50 percent of a stock price and use all funds (both yours and those that you borrow) to make a purchase. You repay this so-called margin loan when you sell the stock. If the stock price rises, you make money on what you invested plus what you borrowed. Although this money sounds attractive, remember that leverage cuts both ways — when prices decline, you lose money not only on your investment but also on the money you borrowed.

limited partnership (LP): A private partnership, which is designed to limit the legal liability of the investors who participate, is often promoted in a way that promises high returns, but it generally limits one thing: your investment return. Why? Because it's burdened with high commissions and management fees. Another problem is that it's typically not liquid for many years.

load mutual fund: A mutual fund that includes a sales load, which is the commission paid to brokers who sell commission-based mutual funds. The commission typically ranges from 4 to 8.5 percent. This commission is deducted from your investment money, so it reduces your returns.

marginal tax rate: The rate of income tax you pay on the last dollars you earn over the course of a year. Why the complicated distinction? Because not all income is treated equally: You pay less tax on your first dollars of your annual earnings and more tax on the last dollars of your annual income. Knowing your marginal tax rate is helpful because it can help you analyze the tax implications of important personal financial decisions.

market capitalization: The value of all the outstanding stock of a company. Market capitalization is the quoted price per share of a stock multiplied by the number of shares outstanding. Thus, if Rocky and Bullwinkle Corporation has 100 million shares of outstanding stock and the quoted price per share is $20, the company has a market capitalization of $2 billion (100 million × $20).

Moody's ratings: Moody's rating service measures and rates the credit (default) risks of various bonds. Moody's investigates the financial condition of a bond issuer. Its ratings use the following grading system, which is expressed from highest to lowest: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C. Higher ratings imply a lower risk but also mean that the interest rate will be lower.

Morgan Stanley EAFE (Europe, Australia, Far East) index: The Morgan Stanley EAFE index tracks the performance of the more established countries' stock markets in Europe and Asia. This index is important for international-minded investors who want to follow the performance of overseas stock investments.

mortgage-backed bond (GNMAs and FNMAs): The Government National Mortgage Association (GNMA, or Ginnie Mae) specializes in mortgage-backed securities. It passes the interest and principal payments of borrowers to investors. When a homeowner makes a mortgage payment, GNMA deducts a small service charge and forwards the mortgage payments to its investors. The payments are guaranteed in case a borrower fails to pay his mortgage. The Federal National Mortgage Association (FNMA or Fannie Mae) is a publicly owned, government-sponsored corporation that purchases mortgages from lenders and resells them to investors. FNMA mainly deals with mortgages backed by the Federal Housing Administration.

mortgage broker: Mortgage brokers buy mortgages wholesale from lenders and then mark the mortgages up (typically from 0.5 to 1 percent) and sell them to borrowers. A good mortgage broker is most helpful for people who don't want to shop around on their own for a mortgage or people who have blemishes on their credit reports.

mortgage life insurance: Mortgage life insurance guarantees that the lender will receive its money in the event that you meet an untimely demise. Many people may try to convince you that you need this insurance to protect your dependents and loved ones. Mortgage life insurance is relatively expensive given the cost of the coverage provided. If you need life insurance, buy low-cost, high-quality term life insurance instead.

municipal bond: A loan for public projects, such as highways, parks, or cultural centers, that an investor makes to cities, towns, and states. The tax-exempt status of their interest is what makes municipal bonds special: They're exempt from federal taxes and, if you reside in the state where the bond is issued, state taxes. Because of that tax exclusion, municipal bonds are generally issued with interest rates that are lower than taxable corporate bonds of comparable credit quality. Municipal bonds are most appropriate for people in high tax brackets who invest money outside of tax-sheltered retirement accounts.

mutual fund: A portfolio of stocks, bonds, or other securities that is owned by numerous investors and managed by an investment company. See also ***no-load mutual fund.***

National Association of Securities Dealers Automated Quotation (NASDAQ) system: An electronic network that allows brokers to trade from their offices all over the country. With NASDAQ, brokers buy and sell shares using constantly updated prices that appear on their computer screens.

negative amortization: Negative amortization occurs when your outstanding mortgage balance increases despite the fact that you're making the required monthly payments. Negative amortization occurs with adjustable-rate mortgages that cap the increase in your monthly payment but do not cap the interest rate. Therefore, your monthly payments don't cover all the interest that you actually owe. Avoid loans with this "feature."

net asset value (NAV): The dollar value of one share of a mutual fund. For a no-load fund, the market price is its NAV. For a load fund, the NAV is the "buy" price minus the commission.

New York Stock Exchange (NYSE): The largest stock exchange in the world in terms of total volume and value of shares traded. It lists companies that tend to be among the oldest, largest, and best-known companies.

no-load mutual fund: A mutual fund that doesn't come with a commission payment attached to it. Some funds claim to be no-load but simply hide their sales commissions as an ongoing sales charge; you can avoid these funds by educating yourself and reading the prospectuses carefully.

open-end mutual fund: A mutual fund that issues as many shares as investors demand. These open-end funds do not generally limit the number of investors or amount of money in the fund. Some open-end funds have been known to close to new investors, but investors with existing shares can often still buy more shares from the company.

option: The right to buy or sell a specific security (such as a stock) for a preset price during a specified period of time. Options differ from futures in that with an option, you pay a premium fee upfront and you can either exercise the option or let it expire. If the option expires worthless, you lose 100 percent of your original investment. The use of options is best left to companies as hedging tools. Investment managers may use options to reduce the risk in their investment portfolio. As with futures, when most individual investors buy an option, they're doing so as a short-term gamble, not as an investment.

pension: Pensions (also known as defined-benefit plans) are a benefit offered by some employers. These plans generally pay you a monthly retirement income based on your years of service and former pay with the employer.

performance: You traditionally judge an investment's performance by looking at the historic rate of return. The longer the period over which these numbers are tallied, the more useful they are. Considered alone, these numbers are practically meaningless. You must also note how well a fund has performed in comparison to competitors with the same investment objectives. Beware of advertisements that tout the high returns of a mutual fund, because they may not be looking at risk-adjusted performance, or they may be promoting performance over a short time period. Keep in mind that high return statistics are usually coupled with high risk and that this year's star may turn out to be next year's crashing meteor.

precertification: A condition for health insurance benefit coverage that requires a patient to get approval before being admitted to a hospital for nonemergency care.

preferred stock: Preferred stock dividends must be paid before any dividends are paid to the common stock shareholders. Although preferred stock reduces your risk as an investor (because of the more secure dividend and greater likelihood of getting your money back if the company fails), it also often limits your reward if the company expands and increases its profits.

price/earnings (P/E) ratio: The current price of a stock divided by the current (or sometimes the projected) earnings per share of the issuing company. This ratio is a widely used stock analysis statistic that helps an investor get an idea of how cheap or expensive a stock price is. In general, a relatively high P/E ratio indicates that investors feel that the company's earnings are likely to grow quickly.

prime rate: The rate of interest that major banks charge their most creditworthy corporate customers. Why should you care? Well, because the interest rates on various loans you may be interested in are often based on the prime rate. And, guess what — you pay a higher interest rate than those big corporations!

principal: No, I'm not talking about the big boss from elementary school who struck fear into the hearts of most 8-year-olds. The principal is the amount you borrow for a loan. If you borrow $100,000, your principal is $100,000. Principal can also refer to the amount you originally placed in an investment.

prospectus: Individual companies and mutual funds are required by the Securities and Exchange Commission to issue a prospectus. For a company, the prospectus is a legal document presenting a detailed analysis of that company's financial history, its products and services, its management's background and experience, and the risks of investing in the company. A mutual fund prospectus tells you about the fund's investment objectives, costs, risk, and performance history.

real estate investment trust (REIT): Real estate investment trusts are like a mutual fund of real estate investments. Such trusts invest in a collection of properties (from shopping centers to apartment buildings). REITs trade on the major stock exchanges. If you want to invest in real estate while avoiding the hassles inherent in owning property, real estate investment trusts may be the right choice for you.

refinance: Refinance, or refi, is a fancy word for taking out a new mortgage loan (usually at a lower interest rate) to pay off an existing mortgage (generally at a higher interest rate). Refinancing is not automatic, nor is it guaranteed. Refinancing can also be a hassle and expensive. Weigh the costs and benefits of refinancing carefully before proceeding.

return on investment: The percentage of profit you make on an investment. If you put $1,000 into an investment and then one year later it's worth $1,100, you make a profit of $100. Your return on investment is the profit ($100) divided by the initial investment ($1,000) — in this case, 10 percent.

reverse mortgage: A reverse mortgage enables elderly homeowners, typically those who are low on cash, to tap into their home's equity without selling their home or moving from it. Specifically, a lending institution makes a check out to you each month, and you can use the check as you want. This money is really a loan against the value of your home, so it's tax-free when you receive it. The downside of these loans is that they deplete your equity in your estate, the fees and interest rates tend to be on the high side, and some require repayment within a certain number of years.

Russell 2000: An index that tracks the returns of 2,000 small-company U.S. stocks. Small-company stocks tend to be more volatile than large-company stocks. If you invest in small-company stocks or stock funds, this index is an appropriate benchmark to compare your stock's performance to.

Securities and Exchange Commission (SEC): The federal agency that administers U.S. securities laws and regulates and monitors investment companies, brokers, and financial advisors.

simplified employee pension individual retirement account (SEP-IRA): Like other retirement plans, a SEP-IRA allows your money to compound over the years without the parasitic effect of taxes. SEP-IRAs are relatively easy to set up, and they allow self-employed people to make annual contributions on a pretax basis.

Social Security: If you're retired or disabled, Social Security is a government safety net that can provide you with some income. The program is based on the idea that government is responsible for the social welfare of its citizens. Whether you agree with this notion or not, part of your paycheck goes to Social Security, and when you retire, you receive money from the program.

Standard & Poor's 500 Index: An index that measures the performance of 500 large-company U.S. stocks that account for about 80 percent of the total market value of all stocks traded in the United States. If you invest in larger-company stocks or stock funds, the S&P 500 Index is an appropriate benchmark to compare the performance of your investments to.

Standard & Poor's (S&P) ratings: Standard & Poor's rating service is one of two services that measure and rate the risks in buying a bond. The S&P ratings use the following grading system, listed from highest to lowest: AAA, AA, A, BBB, BB, B, CCC, CC, C. See also ***Moody's ratings.***

stock: Shares of ownership in a company. When a company goes public, it issues shares of stock to the public (see also ***initial public offering***). Many, but not all, stocks pay dividends — a distribution of a portion of the company's profits. In addition to dividends, you make money investing in stock via appreciation in the price of the stock, which normally results from growth in revenues and corporate profits. You can invest in stock by purchasing individual shares or by investing in a stock mutual fund that offers a diversified package of stocks.

term life insurance: If people are dependent on your income for their living expenses, you may need this insurance. Term life insurance functions simply: You determine how much protection you would like and then pay an annual premium based on that amount. Although much less touted by insurance salespeople than cash value insurance, it's the best life insurance out there for the vast majority of people.

Treasury bill: IOUs from the federal government that mature within a year. The other types of loans that investors can make to the federal government are Treasury notes, which mature within one to ten years, and Treasury bonds, which mature in more than ten years. The interest that these federal government bonds pay is free of state taxes, but it's federally taxable.

underwriting: The process an insurance company uses to evaluate a person's likelihood of filing a claim on a particular type of insurance policy. If significant problems are discovered, an insurer will often propose much higher rates or refuse to sell the insurance coverage.

will: A legal document that ensures that your wishes regarding your assets and the care of your minor children are heeded when you die.

zero-coupon bond: A bond that doesn't pay explicit interest during the term of the loan. Zero-coupon bonds are purchased at a discounted price relative to the principal value paid at maturity. Thus, the interest is implicit in the discount. These bonds do not offer a tax break, because the investor must pay taxes on the implicit interest that is paid when the bond matures.

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- Open a small business

Eric Tyson, MBA

Bestselling author of Personal Finance For Dummies *and* Mutual Funds For Dummies

20 Rules for Successful Investing

- **Saving is a prerequisite to investing.** Unless you have wealthy, benevolent relatives, living within your means and saving money are prerequisites to investing and building wealth.
- **Know the three best wealth-building investments.** People of all economic means make their money grow in ownership assets — stocks, real estate, and small business — where you share in the success and profitability of the asset.
- **Be realistic about expected returns.** Over the long term, 9 to 10 percent per year is about right for ownership investments (such as stocks and real estate). If you run a small business, you can earn higher returns and even become a multimillionaire, but years of hard work and insight are required.
- **Think long term.** Because ownership investments are riskier (more volatile), you must keep a long-term perspective when investing in them. Don't invest money in such investments unless you plan to hold them for a minimum of five years, and preferably a decade or longer.
- **Match the time frame to the investment.** Selecting good investments for yourself involves matching the time frame you have to the riskiness of the investment. For example, for money that you expect to use within the next year, focus on safe investments, such as money market funds. Invest your longer-term money mostly in wealth-building investments.
- **Diversify.** Diversification is a powerful investment concept that helps you to reduce the risk of holding more aggressive investments. Diversifying simply means that you should hold a variety of investments that don't move in tandem in

different market environments. For example, if you invest in stocks, invest worldwide, not just in the U.S. market. You can further diversify by investing in real estate.

- **Look at the big picture first.** Understand your overall financial situation and how wise investments fit within it. Before you invest, examine your debt obligations, tax situation, ability to fund retirement accounts, and insurance coverage.

- **Ignore the minutiae.** Don't feel mystified by or feel the need to follow the short-term gyrations of the financial markets. Ultimately, the prices of stocks, bonds, and other financial instruments are determined by supply and demand, which are influenced by thousands of external issues and millions of investors' expectations and fears.

- **Allocate your assets.** How you divvy up or allocate your money among major investments greatly determines your returns. The younger you are and the more money you earmark for the long term, the greater the percentage you should devote to ownership investments.

- **Do your homework before you invest.** You work hard for your money, and buying and selling investments costs you money. Investing isn't a field where acting first and asking questions later works well. Never buy an investment based on an advertisement or a salesperson's solicitation of you.

- **Keep an eye on taxes.** Take advantage of tax-deductible retirement accounts and understand the impact of your tax bracket when investing outside tax-sheltered retirement accounts.

- **Consider the value of your time and your investing skills and desires.** Investing in stocks and other securities via the best mutual funds and exchange-traded funds is both time-efficient and profitable. Real estate investing and running a small business are the most time-intensive investments.

- **Where possible, minimize fees.** The more you pay in commissions and management fees on your investments, the greater the drag on your returns. And don't fall prey to the thinking that "you get what you pay for."
- **Don't expect to beat the market.** If you have the right skills and interest, your ability to do better than the investing averages is greater with real estate and small business than with stock market investing. The large number of full-time, experienced stock market professionals makes it next to impossible for you to choose individual stocks that will consistently beat a relevant market average over an extended time period.
- **Don't bail when things look bleak.** The hardest time, psychologically, to hold on to your investments is when they're down. Even the best investments go through depressed periods, which is the worst possible time to sell. Don't sell when there's a sale going on; if anything, consider buying more.
- **Ignore soothsayers and prognosticators.** Predicting the future is nearly impossible. Select and hold good investments for the long term. Don't try to time when to be in or out of a particular investment.
- **Minimize your trading.** The more you trade, the more likely you are to make mistakes. You also get hit with increased transaction costs and higher taxes (for non-retirement account investments).
- **Hire advisors carefully.** Before you hire investing help, first educate yourself so you can better evaluate the competence of those you may hire. Beware of conflicts of interest when you consider advisors to hire.
- **You are what you read and listen to.** Don't pollute your mind with bad investing strategies and philosophies. The quality of what you read and listen to is far more important

than the quantity. Find out how to evaluate the quality of what you read and hear.

- **Your personal life and health are the highest-return, lowest-risk investments.** They're far more important than the size of your financial portfolio.

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Praise for Eric Tyson's Bestselling For Dummies Titles

"Eric Tyson For President!!! Thanks for such a wonderful guide. With a clear, no-nonsense approach to . . . investing for the long haul, Tyson's book says it all without being the least bit long-winded. Pick up a copy today. It'll be your wisest investment ever!!!"

— Jim Beggs, VA

"Eric Tyson is doing something important — namely, helping people at all income levels to take control of their financial futures. This book is a natural outgrowth of Tyson's vision that he has nurtured for years. Like Henry Ford, he wants to make something that was previously accessible only to the wealthy accessible to middle-income Americans."

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— Steven T. Goldberg, *Kiplinger's Personal Finance Magazine*

"Eric Tyson . . . seems the perfect writer for a . . . *For Dummies* book. He doesn't tell you what to do or consider doing without explaining the why's and how's — and the booby traps to avoid — in plain English. . . . It will lead you through the thickets of your own finances as painlessly as I can imagine."

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"*Personal Finance For Dummies* is the perfect book for people who feel guilty about inadequately managing their money but are intimidated by all of the publications out there. It's a painless way to learn how to take control."

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Investing For Dummies®, 6th Edition

by Eric Tyson, MBA

Financial counselor, syndicated columnist, and author of six national bestsellers, including *Personal Finance For Dummies®*, *Real Estate Investing For Dummies®*, and *Mutual Funds For Dummies®*

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John Wiley & Sons, Inc.

Investing For Dummies®, 6th Edition

Published by
John Wiley & Sons, Inc.
111 River St.
Hoboken, NJ 07030-5774
www.wiley.com

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Published by John Wiley & Sons, Inc., Hoboken, NJ

Published simultaneously in Canada

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Library of Congress Control Number: 2011934636

ISBN 978-0-47090545-6 (pbk); ISBN 978-1-118-11483-4 (ebk); ISBN 978-1-118-11484-1 (ebk); ISBN 978-1-118-11485-8 (ebk)

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1

About the Author

Eric Tyson is an internationally acclaimed and bestselling personal finance author, lecturer, and advisor. Through his work, he is dedicated to teaching people to manage their money better and to successfully direct their own investments.

Eric is a former management consultant to businesses for which he helped improve operations and profitability. Before, during, and after this time of working crazy hours and traveling too much, he had the good sense to focus on financial matters.

He has been involved in the investing markets in many capacities for more than three decades. Eric first invested in mutual funds back in more than three decades. Eric first invested in mutual funds back in the mid-1970s, when he opened a mutual fund account at Fidelity. With the assistance of Dr. Martin Zweig, a now-famous investment market analyst, Eric won his high school's science fair in 1976 for a project on what influences the stock market. In addition to investing in securities over the decades, Eric has also successfully invested in real estate and started and managed his own business. He has counseled thousands of clients on a variety of investment quandaries and questions.

He earned a bachelor's degree in economics at Yale and an MBA at the Stanford Graduate School of Business. Despite these impediments to lucid reasoning, he came to his senses and decided that life was too short to spend it working long hours and waiting in airports for the benefit of larger companies.

An accomplished freelance personal finance writer, Eric is the author of numerous bestselling books including *For Dummies* books on personal finance, mutual funds, taxes (coauthor), and home buying (coauthor) and is a syndicated columnist. His work has been featured and quoted in hundreds of national and local publications, including *Kiplinger's Personal Finance Magazine, Los Angeles Times, Chicago Tribune, The Wall Street Journal,* and *Bottom Line/Personal,* and on NBC's *Today Show,* ABC, CNBC, PBS's *Nightly Business Report,* FOX, CNN, CBS national radio, Bloomberg Business Radio, National Public Radio, and Business Radio Network. He's also been a featured speaker at a White House conference on retirement planning.

To stay in tune with what real people care about and struggle with, Eric still maintains a financial counseling practice.

You can visit him on the web at www.erictyson.com.

Dedication

Actually, before I get to the thank-yous, please allow me a *really* major thank-you and dedication.

This book is hereby and irrevocably dedicated to my family and friends, as well as to my counseling clients and customers, who ultimately have taught me everything I know about how to explain financial terms and strategies so that all of us may benefit.

Author's Acknowledgments

First, I'd like to thank Chrissy Guthrie. Thanks also to Jessica Smith for all of her fine editing and to all of the fine folks in Composition and Graphics for making this book and all of my charts and graphs look great! Thanks also to everyone else who contributed to getting this book done well and on time.

And last but not least, a tip of my cap to the fine technical reviewer who helped to ensure that I didn't write something that wasn't quite right. For the sixth edition, this important job was well handled by Gary Karz.

Publisher's Acknowledgments

We're proud of this book; please send us your comments at http://dummies.custhelp.com. For other comments, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

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Investing For Dummies®, 6th Edition

Visit www.dummies.com/cheatsheet/investing to view this book's cheat sheet.

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Introduction

During the financial crisis of 2008, things got scary. Large Wall Street firms were going under, stock prices were plummeting, and layoffs and unemployment rates were soaring. And, all this was happening in the midst of the 2008 presidential election. Talk of another Great Depression was in the air. In fact, polls showed a majority of Americans feared another depression was actually happening. Housing prices were dropping sharply in most communities, and more and more properties were ending up in foreclosure.

Investing didn't seem so fun anymore. However, despite the fact that the downturn was the worst in decades, it had similarities to prior downturns, and those who kept their perspective and their cash ready were able to invest at attractive prices.

The best investment vehicles for building wealth — stocks, real estate, and small business — haven't changed. But, you still need money to play in the investment world. Like the first edition of *Investing For Dummies,* the sixth edition of this national best-seller includes complete coverage of these wealth-building investments as well as other common investments, such as bonds. Here are the biggest changes in this edition:

- **Completely revised and updated:** I've freshened up the data and examples in this book to provide you the latest insights and analyses. Confused about how tax law changes should affect your investment strategies? Wondering about investing in gold and other commodities? Seeking a way to invest in stocks without exposing yourself to the tremendous risks experienced during the financial crisis of the late 2000s? Curious about what an exchange-traded fund or hedge fund is and whether you should invest in one? Wondering how to use leveraged exchange-traded funds to boost your portfolio's return? Weighing whether to invest in real estate given current market conditions and the severe downturn in the late 2000s? Wondering what the best ways are to invest globally? Having trouble making sense of various economic indicators and what they mean to your investment strategy? Wanting to invest in a Health Savings Account (HSA) but don't know why, where, or how? You can find the answers to these questions and many more in this edition.

- **Investing resources:** With the continued growth in websites, software, publications, media outlets, and many other information sources offering investing advice and information, you're probably overwhelmed about how to choose among the numerous investing research tools and resources. Equally problematic is knowing who you can trust and listen to — and who you need to ignore. So many pundits and prognosticators claim excellent track records for their past predictions, but who, really, can you believe? I explain how to evaluate the quality of current investment tools and resources, and I provide tips for who to listen to and who to tune out.

How Savvy Investors Build Wealth

I know from working with people of modest and immodest economic means that the time-tested ways they increase their wealth are by doing the following:

- Living within their means and systematically saving and investing money, ideally in a tax-favored manner
- Buying and holding a diversified portfolio of stocks
- Building their own small business or career
- Investing in real estate

This book explains each of these wealth boosters in detail. Equally, if not more, important, however, is the information I provide to help you understand and choose investments compatible with your personal and financial goals.

You don't need a fancy college or graduate-school degree, and you don't need a rich dad (or mom), biological or adopted! What you do need is a desire to read and practice the many simple yet powerful lessons and strategies in this book.

Seriously, investing intelligently isn't rocket science. By all means, if you're dealing with a complicated, atypical issue, get quality professional help. But educate yourself first. Hiring someone is dangerous if you're financially challenged. If you do decide to hire someone, you'll be much better prepared if you educate yourself. Doing so can also help you be more focused in your questions and better able to assess that person's competence.

Conventions Used in This Book

I use the following conventions in this book to help you maneuver through topics:

- I *italicize* all new words and terms that are defined.
- I **boldface** keywords or the main parts of bulleted items.
- I use `monofont` for all web addresses.
- I refer to the decade from 2000 to 2009 as the 2000s. I just wanted to avoid any confusion in case you were thinking of, say, the year 2025.

When this book was printed, some web addresses may have needed to break across two lines of text. If that happened, rest assured that I haven't added any extra characters, such as hyphens, to indicate the break. So when using one of these addresses, just type in exactly what you see in this book, pretending as though the line break doesn't exist.

Foolish Assumptions

Every book is written with a certain reader in mind, and this book is no different. Here are some assumptions I made about you:

- You may have some investments, but you're looking to develop a full-scale investment plan.
- You'd like to strengthen your portfolio.
- You want to evaluate your investment advisor's advice.
- You have a company-sponsored investment plan, like a 401(k), and you're looking to make some decisions or roll it over into a new plan.

If one or more of these descriptions sound familiar, you've come to the right place.

How This Book Is Organized

This book helps you fill gaps in your investment knowledge. It's structured so you can read it cover to cover or simply dive in to particular sections that most interest you. Here are the major parts.

Part I: Investing Fundamentals

Before you can confidently and intelligently choose investments, you need to be able to cut through the lingo and jargon to get to the heart of what investments are and aren't, and you also need to know how they differ from one another. In this part, I explain what rate of return you can reasonably expect to earn and how much risk you need to take to get it. This part also details how investments best fit your specific financial goals and situation.

Part II: Stocks, Bonds, and Wall Street

I know you probably don't want to trade in your day job for one where you wear a three-piece suit and know which page of the daily *Wall Street Journal* shows the yield curves. But you *do* need to understand what the financial markets are and how you can participate in them without suffering too many bumps and bruises. In this part, I explain what stocks and bonds are all about and how to best buy them and build your future fortune.

Part III: Growing Wealth with Real Estate

Everyone needs places to live, work, and shop, so it makes sense that real estate can be a profitable part of your investment portfolio. Intelligently buying and managing real estate is harder than it looks, however, which is why this part covers lots of territory. I show you the best ways to invest in real estate, and I provide a crash course in mortgages, landlording, buying low, selling high, taxes, and more.

Part IV: Savoring Small Business

There's nothing small about the potential profits you can make from small business. You can choose the small-business investment option that matches your skills and time. If you aspire to be the best boss you've ever had, this part shows you the right ways to start your own small business or buy someone else's. Or maybe you'd like to try your hand at spotting up-and-comers but don't want to be on the front lines. In this case, you can try investing in someone else's small business.

Part V: Investing Resources

Flip through your cable television channels, crack open a magazine or newspaper, or go website surfing, and you quickly discover that you can’t escape investment advice. Surprisingly, each new guru you stumble on to contradicts the one who came before him. Before you know it, although you’ve spent a ton of your valuable free time on all this investment stuff, you’re no closer to making an informed decision. In fact, if you’re like most people, you find yourself even more confused and paralyzed. Fear not! In this important part, I explain why many experts really aren’t experts and why most of them try to make the world of investing so mysterious. I highlight the best resources to use and the experts worth listening to.

Part VI: The Part of Tens

These shorter chapters build your investment knowledge further. You find advice about topics such as overcoming common psychological investment obstacles, points to ponder when you sell an investment, and tips for investing in a down market.

Icons Used in This Book

Throughout this book, icons help guide you through the maze of suggestions, solutions, and cautions. I hope you find that the following images make your journey through investment strategies smoother.

In the shark-infested investing waters, you’ll find creatures that feast on novice waders, ready to take a bite out of a swimmer’s savings. This icon notes when and where the sharks may be circling.

If you see this icon, I’m pointing out companies, products, services, and resources that have proved to be exceptional over the years. These are resources that I would or do use personally or would recommend to my friends and family.

I use this icon to highlight an issue that requires more detective work on your part. Don’t worry, though; I prepare you for your work so you don’t have to start out as a novice gumshoe.

I think the name says it all, but this icon indicates something really, really important — don't you forget it!

Skip it or read it; the choice is yours. You'll fill your head with more stuff that may prove valuable as you expand your investing know-how, but you risk overdosing on stuff that you may not need right away.

This icon denotes strategies that can enable you to build wealth faster and leap over tall obstacles in a single bound.

This icon indicates treacherous territory that has made mincemeat out of lesser mortals who have come before you. Skip this point at your own peril.

Where to Go from Here

If you have the time and desire, I encourage you to read this book in its entirety. It provides you with a detailed picture of how to maximize your returns while minimizing your risks through wealth-building investments. But you don't have to read this book cover to cover. If you have a specific question or two that you want to focus on today, or you want to find some additional information tomorrow, it's not a problem. *Investing For Dummies,* 6th Edition, makes it easy to find answers to specific questions. Just turn to the table of contents to locate the information you need. You can get in and get out, just like that.

If you're the kind of reader who jumps around from topic to topic instead of reading from cover to cover, you'll be pleased to know that this book has a helpful index and that it highlights the pages where investing terms are defined.

Chapter 3

Getting Your Financial House in Order before You Invest

In This Chapter

- Saving money for emergencies
- Managing your debt
- Setting financial goals
- Funding retirement and college accounts
- Understanding tax issues
- Exploring diversification strategies

Before you make any great, wealth-building investments, I recommend that you get your financial house in order. Understanding and implementing some simple personal financial management concepts can pay off big for you in the decades ahead.

You want to know how to earn healthy returns on your investments without getting clobbered, right? Who doesn't? Although you generally must accept greater risk to have the potential for earning higher returns (see Chapter 2), in this chapter, I tell you about some high-return, low-risk investments. You have a right to be skeptical about such investments, but don't stop reading this chapter yet. Here, I point out some of the easy-to-tap opportunities for managing your money that you may have overlooked.

Establishing an Emergency Reserve

You never know what life will bring, so having a readily accessible reserve of cash to meet unexpected expenses makes good financial sense. If you have a sister who works on Wall Street as an investment banker or a wealthy and understanding parent, you can use one of them as your emergency reserve. (Although you should ask them how they feel about that before you count on receiving funding from them!) If you don't have a wealthy family member, the ball's in your court to establish a reserve.

Should you invest emergency money in stocks?

As interest rates drifted lower during the 1990s, keeping emergency money in money market accounts became less and less rewarding. When interest rates were 8 or 10 percent, fewer people questioned the wisdom of an emergency reserve. However, in the late 1990s, which had low money market interest rates and stock market returns of 20 percent per year, more investors balked at the idea of keeping a low-interest stash of cash.

I began seeing articles that suggested you simply keep your emergency reserve in stocks. After all, you can easily sell stocks (especially those of larger companies) any day the financial markets are open. Why not treat yourself to the 20 percent annual returns that stock market investors enjoyed during the 1990s rather than earning a paltry few percent?

At first, that logic sounds great. But, as I discuss in Chapter 2, stocks historically have returned about 9 to 10 percent per year. In some years — in fact, about one-third of the time — stocks decline in value, sometimes substantially.

Stocks can drop and have dropped 20, 30, or 50 percent or more over relatively short periods of time. Consider what happened to stock prices in the early

2000s and then again in the late 2000s. Suppose that such a drop coincides with an emergency — such as the loss of your job, major medical bills, and so on. Your situation may force you to sell at a loss, perhaps a substantial one.

Here’s another reason not to keep emergency money in stocks: If your stocks appreciate and you need to sell some of them for emergency cash, you get stuck paying taxes on your gains.

I suggest that you invest your emergency money in stocks (ideally through well-diversified mutual funds) only if you have a relative or some other resource to tap for money in an emergency. Having a backup resource for money minimizes your need to sell your stock holdings on short notice. As I discuss in Chapter 5, stocks are intended to be a longer-term investment, not an investment that you expect (or need) to sell in the near future.

Make sure you have quick access to at least three months’ to as much as six months’ worth of living expenses. Keep this emergency money in a money market fund (see Chapter 8). You may also be able to borrow against your employer-based retirement account or against your home equity should you find yourself in a bind, but these options are much less desirable.

If you don’t have a financial safety net, you may be forced into selling an investment that you’ve worked hard for. And selling some investments, such as real estate, costs big money (because of transaction costs, taxes, and so on).

Consider the case of Warren, who owned his home and rented an investment property in the Pacific Northwest. He felt, and appeared to be, financially successful. But then Warren lost his job, accumulated sizable medical expenses, and had to sell his investment property to come up with cash for living expenses. Warren didn’t have enough equity in his home to borrow. He didn’t have other sources — a wealthy relative, for example — to borrow from either, so he was stuck selling his investment property. Warren wasn't able to purchase another investment property and missed out on the large appreciation the property earned over the subsequent two decades. Between the costs of selling and taxes, getting rid of the investment property cost Warren about 15 percent of its sales price. Ouch!

Evaluating Your Debts

Yes, paying down debts is boring, but it makes your investment decisions less difficult. Rather than spending so much of your time investigating specific investments, paying off your debts (if you have them and your cash coming in exceeds the cash going out) may be your best high-return, low-risk investment. Consider the interest rate you pay and your investing alternatives to determine which debts you should pay off.

Conquering consumer debt

Borrowing via credit cards, auto loans, and the like is an expensive way to borrow. Banks and other lenders charge higher interest rates for consumer debt than for debt for investments, such as real estate and business. The reason: Consumer loans are the riskiest type of loan for a lender.

Many folks have credit card or other consumer debt, such as an auto loan, that costs 8, 10, 12, or perhaps as much as 18-plus percent per year in interest (some credit cards whack you with interest rates exceeding 20 percent if you make a late payment). Reducing and eventually eliminating this debt with your savings is like putting your money in an investment with a guaranteed *tax-free* return equal to the rate that you pay on your debt.

For example, if you have outstanding credit card debt at 15 percent interest, paying off that debt is the same as putting your money to work in an investment with a guaranteed 15 percent tax-free annual return. Because the interest on consumer debt isn't tax-deductible, you need to earn more than 15 percent by investing your money elsewhere in order to net 15 percent after paying taxes. Earning such high investing returns is highly unlikely, and in order to earn those returns, you'd be forced to take great risk.

Consumer debt is hazardous to your long-term financial health (not to mention damaging to your credit score and future ability to borrow for a home or other wise investments) because it encourages you to borrow against your future earnings. I often hear people say such things as "I can't afford to buy most new cars for cash — look at how expensive they are!" That's true, new cars *are* expensive, so you need to set your sights lower and buy a good used car that you *can* afford. You can then invest the money that you'd otherwise spend on your auto loan.

However, using consumer debt may make sense if you're financing a business. If you don't have home equity, personal loans (through a credit card or auto loan) may actually be your lowest-cost source of small-business financing. (See Chapter 14 for more details.)

Mitigating your mortgage

Paying off your mortgage more quickly is an “investment” for your spare cash that may make sense for your financial situation. However, the wisdom of making this financial move isn’t as clear as paying off high-interest consumer debt; mortgage interest rates are generally lower, and the interest is typically tax-deductible. When used properly, debt can help you accomplish your goals — such as buying a home or starting a business — and make you money in the long run. Borrowing to buy a home generally makes sense. Over the long term, homes generally appreciate in value.

If your financial situation has changed or improved since you first needed to borrow mortgage money, you need to reconsider how much mortgage debt you need or want. Even if your income hasn’t escalated or you haven’t inherited vast wealth, your frugality may allow you to pay down some of your debt sooner than the lender requires. Whether paying down your debt sooner makes sense for you depends on a number of factors, including your other investment options and goals.

Consider your investment opportunities

When evaluating whether to pay down your mortgage faster, you need to compare your mortgage interest rate with your investments' rates of return (which I define in Chapter 2). Suppose you have a fixed-rate mortgage with an interest rate of 6 percent. If you decide to make investments instead of paying down your mortgage more quickly, your investments need to produce an average annual rate of return, before taxes, of about 6 percent to come out ahead financially. (This comparison, technically, should be done on an after-tax basis, but the outcome is unlikely to change.)

Besides the most common reason of lacking the money to do so, other good reasons *not* to pay off your mortgage any quicker than necessary include the following:

- **You instead contribute to your retirement accounts, such as a 401(k), an IRA, or a Keogh plan (especially if your employer offers matching money).** Paying off your mortgage faster has no tax benefit. By contrast, putting additional money into a retirement plan can immediately reduce your federal and state income tax burdens. The more years you have until retirement, the greater the benefit you receive if you invest in your retirement accounts. Thanks to the compounding of your retirement account investments without the drain of taxes, you can actually earn a lower rate of return on your investments than you pay on your mortgage and still come out ahead. (I discuss the various retirement accounts in detail in the "Funding Your Retirement Accounts" section later in this chapter.)
- **You're willing to invest in growth-oriented, volatile investments, such as stocks and real estate.** In order to have a reasonable chance of earning more on your investments

than it costs you to borrow on your mortgage, you must be aggressive with your investments. As I discuss in Chapter 2, stocks and real estate have produced annual average rates of return of about 8 to 10 percent. You can earn even more by creating your own small business or by investing in others' businesses. Paying down a mortgage ties up more of your capital, and thus reduces your ability to make other attractive investments. To more aggressive investors, paying off the house seems downright boring — the financial equivalent of watching paint dry.

You have no guarantee of earning high returns from growth-type investments, which can easily drop 20 percent or more in value over a year or two.

- **Paying down the mortgage depletes your emergency reserves.** Psychologically, some people feel uncomfortable paying off debt more quickly if it diminishes their savings and investments. You probably don't want to pay down your debt if doing so depletes your financial safety cushion. Make sure that you have access — through a money market fund or other sources (a family member, for example) — to at least three months' worth of living expenses (as I explain in the earlier section "Establishing an Emergency Reserve").

Don't be tripped up by the misconception that somehow a real estate market downturn, such as the one that most areas experienced in the mid-to late 2000s, will harm you more if you pay down your mortgage. Your home is worth what it's worth — its value has *nothing* to do with your debt load. Unless you're willing to walk away from your home and send the keys to the bank (also known as *default*), you suffer the full effect of a price decline, regardless of your mortgage size, if real estate prices drop.

Don’t get hung up on mortgage tax deductions

Although it’s true that mortgage interest is usually tax-deductible, don’t forget that you must also pay taxes on investment profits generated outside of retirement accounts (if you do forget, you’re sure to end up in trouble with the IRS). You can purchase tax-free investments like municipal bonds (see Chapter 7), but over the long haul, such bonds and other types of lending investments (bank savings accounts, CDs, and other bonds) are unlikely to earn a rate of return that’s higher than the cost of your mortgage.

And don’t assume that those mortgage interest deductions are that great. Just for being a living, breathing human being, you automatically qualify for the so-called “standard deduction” on your federal tax return. In 2011, this standard deduction was worth $5,800 for single filers and $11,600 for married people filing jointly. If you have no mortgage interest deductions — or have fewer than you used to — you may not be missing out on as much of a write-off as you think. (Plus, it’s a joy having one less schedule to complete on your tax return!)

Establishing Your Financial Goals

You may have just one purpose for investing money, or you may desire to invest money for several different purposes simultaneously. Either way, you should establish your financial goals before you begin investing. Otherwise, you won’t know how much to save.

For example, when I was in my 20s, I put away some money for retirement, but I also saved a stash so I could hit the eject button from my job in management consulting. I knew that I wanted to pursue an entrepreneurial path and that in the early years of starting my own business, I couldn’t count on an income as stable or as large as the one I made from consulting.

I invested my two “pots” of money — one for retirement and the other for my small-business cushion — quite differently. As I discuss in the section “Choosing the Right Investment Mix” later in this chapter, you can afford to take more risk with the money that you plan on using longer term. So I invested the bulk of my retirement nest egg in stock mutual funds.

With the money I saved for the start-up of my small business, I took an entirely different track. I had no desire to put this money in risky stocks — what if the market plummeted just as I was ready to leave the security of my full-time job? Thus, I kept this money safely invested in a money market fund that had a decent yield but didn’t fluctuate in value.

Tracking your savings rate

In order to accomplish your financial goals (and some personal goals), you need to save money, and you also need to know your savings rate. Your *savings rate* is the percentage of your past year's income that you saved and didn't spend. Without even doing the calculations, you may already know that your rate of savings is low, nonexistent, or negative and that you need to save more.

> Part of being a smart investor involves figuring out how much you need to save to reach your goals. Not knowing what you want to do a decade or more from now is perfectly normal — after all, your goals and needs evolve over the years. But that doesn't mean you should just throw your hands in the air and not make an effort to see where you stand today and think about where you want to be in the future.

An important benefit of knowing your savings rate is that you can better assess how much risk you need to take to accomplish your goals. Seeing the amount that you need to save to achieve your dreams may encourage you to take more risk with your investments.

During your working years, if you consistently save about 10 percent of your annual income, you're probably saving enough to meet your goals (unless you want to retire at a relatively young age). On average, most people need about 75 percent of their pre-retirement income throughout retirement to maintain their standards of living.

If you're one of the many people who don't save enough, you need to do some homework. To save more, you need to reduce your spending, increase your income, or both. For most people, reducing spending is the more feasible way to save.

To reduce your spending, first figure out where your money goes. You may have some general idea, but you need to have facts. Get out your checkbook register, examine your online bill-paying records, and review your credit card bills and any other documentation that shows your spending history. Tally up how much you spend on dining out, operating your car(s), paying your taxes, and on everything else. After you have this information, you can begin to prioritize and make the necessary trade-offs to reduce your spending and increase your savings rate. Earning more income may help boost your savings rate as well. Perhaps you can get a higher-paying job or increase the number of hours that you work. But if you already work a lot, reining in your spending is usually better for your emotional and economic well-being.

Investing as couples

You've probably learned over the years how challenging it is just for you to navigate the investment maze and make sound investing decisions. When you have to consider someone else, dealing with these issues becomes doubly hard given the typically different money personalities and emotions that come into play.

In most couples with whom I've worked as a financial counselor, usually one person takes primary responsibility for managing the household finances, including investments. As with most marital issues, the couples that do the best job with their investments are those who communicate well, plan ahead, and compromise.

Here are a couple of examples to illustrate my point. Martha and Alex scheduled meetings with each other every three to six months to discuss financial issues. With investments, Martha came prepared with a list of ideas, and Alex would listen and explain what he liked or disliked about each option. Alex would lean toward more aggressive, growth-oriented investments, whereas Martha preferred conservative, less volatile investments. Inevitably, they would compromise and develop a diversified portfolio that was moderately aggressive. Martha and Alex worked as a team, discussed options, compromised, and made decisions they were both comfortable with. Ideas that made one of them very uncomfortable were nixed.

Henry and Melissa didn't do so well. The only times they managed to discuss investments were in heated arguments. Melissa often criticized what Henry was doing with their money. Henry got defensive and counter-criticized Melissa for other issues. Much of their money lay dormant in a low-interest bank account, and they did little long-term planning and decision making. Melissa and Henry saw each other as adversaries, argued and criticized rather than discussed, and were plagued with inaction because they couldn't agree and compromise. They needed a motivation to change their behavior toward each other and some counseling (or a few advice guides for couples) to make progress with investing their money.

Aren't your long-term financial health and marital harmony important? Don't allow your problems to fester! Remember what the famous psychologist Dr.

Phil McGraw says about problems and making changes: "You can't change what you don't acknowledge." I couldn't agree more with this assessment when it comes to money problems, including investing issues.

In my work as a financial counselor, one of the most valuable and difficult things I did for couples stuck in unproductive patterns of behavior was to help them get the issue out on the table. For these couples, the biggest step was making an appointment to discuss their financial management. Once they did, I could get them to explain their different points of view and then offer compromises.

If you don't know how to evaluate and reduce your spending or haven't thought about your retirement goals, looked into what you can expect from Social Security, or calculated how much you should save for retirement, now's the time to do so. Pick up the latest edition of my book *Personal Finance For Dummies* (John Wiley & Sons, Inc.) to find out all the necessary details for retirement planning and much more.

Determining your investment tastes

Many good investing choices exist: You can invest in real estate, the stock market, mutual funds, exchange-traded funds, or your own or some else's small business. Or you can pay down mortgage debt more quickly. What makes sense for you depends on your goals as well as your personal preferences. If you detest risk-taking and volatile investments, paying down your mortgage, as recommended earlier in this chapter, may make better sense than investing in the stock market.

To determine your general investment tastes, think about how you would deal with an investment that plunges 20 percent, 40 percent, or more in a few years or less. Some aggressive investments can fall fast. (See Chapter 2 for examples.) You shouldn't go into the stock market, real estate, or small-business investment arena if such a drop is likely to cause you to sell low or make you a miserable, anxious wreck. If you haven't tried riskier investments yet, you may want to experiment a bit to see how you feel with your money invested in them.

A simple way to "mask" the risk of volatile investments is to *diversify* your portfolio — that is, to put your money into different investments. Not watching prices too closely helps, too — that's one of the reasons real estate investors are less likely to bail out when the market declines. Stock market investors, unfortunately from my perspective, can get daily and even minute-by-minute price updates. Add that fact to the quick phone call or click of your computer mouse that it takes to dump a stock in a flash, and you have all the ingredients for short-sighted investing — and potential financial disaster.

Funding Your Retirement Accounts

Saving money is difficult for most people. Don't make a tough job impossible by forsaking the tax benefits that come from investing through most retirement accounts.

Gaining tax benefits

Retirement accounts should be called "tax-reduction accounts" — if they were, people may be more motivated to contribute to them. Contributions to these plans are generally deductible on both your federal and state taxes. Suppose that you pay about 35 percent between federal and state income taxes on your last dollars of income. (See the section "Determining your tax bracket" later in this chapter.) With most of the retirement accounts that I describe in this chapter, you can save yourself about $350 in taxes for every $1,000 that you contribute in the year that you make your contribution.

After your money is in a retirement account, any interest, dividends, and appreciation grow inside the account without taxation. With most retirement accounts, you defer taxes on all the accumulating gains and profits until you withdraw your money down the road, which you can do without penalty after age 59 1⁄2. In the meantime, more of your money works for you over a long period of time. In some cases, such as with the Roth IRAs described later in this chapter, withdrawals are tax free, too.

The good, old U.S. government now provides a tax credit for lower-income earners who contribute up to $2,000 into retirement accounts. The maximum credit of 50 percent applies to the first $2,000 contributed for single taxpayers with an adjusted gross income (AGI) of no more than $17,000 and married couples filing jointly with an AGI of $34,000 or less. Singles with an AGI of between $17,000 and $18,250 and married couples with an AGI between $34,000 and $36,500 are eligible for a 20 percent tax credit. Single taxpayers with an AGI of more than $18,250 but no more than $28,250 and married couples with an AGI between $36,500 and $56,500 can get a 10 percent tax credit.

Starting your savings sooner

The common mistake that many investors make is neglecting to take advantage of retirement accounts because of their enthusiasm to spend or invest in non-retirement accounts. Not investing in tax-sheltered retirement accounts can cost you hundreds, perhaps thousands, of dollars per year in lost tax savings. Add that loss up over the many years that you work and save, and not taking advantage of these tax reduction accounts can easily cost you tens of thousands to hundreds of thousands of dollars in the long term. Ouch!

To take advantage of retirement savings plans and the tax savings that accompany them, you must first spend less than you earn. Only then can you afford to contribute to these retirement savings plans (unless you already happen to have a stash of cash from previous savings or inheritance).

The sooner you start to save, the less painful it is each year to save enough to reach your goals. Why? Because your contributions have more years to compound.

Each decade you delay saving approximately doubles the percentage of your earnings that you need to save to meet your goals. For example, if saving 5 percent per year in your early 20s gets you to your retirement goal, waiting until your 30s to start may mean socking away 10 percent to reach that same goal; waiting until your 40s, 20 percent. Beyond that, the numbers get truly daunting.

If you enjoy spending money and living for today, you should be more motivated to start saving sooner. The longer that you wait to save, the more you ultimately need to save and, therefore, the less you can spend today!

Checking out retirement account options

If you earn employment income (or receive alimony), you have options for putting money away in a retirement account that compounds without taxation until you withdraw the money. In most cases, your contributions to these retirement accounts are tax-deductible.

Company-based plans

If you work for a for-profit company, you may have access to a *401(k)* plan, which typically allows you to save up to $16,500 per year (for tax year 2011). Many nonprofit organizations offer *403(b)* plans to their employees. As with a 401(k), your contributions to 403(b) plans are deductible on both your federal and state taxes in the year that you make them. Nonprofit employees can generally contribute up to 20 percent or $16,500 of their salaries, whichever is less. In addition to the upfront and ongoing tax benefits of these retirement savings plans, some employers match your contributions.

Older employees (defined as being at least age 50) can contribute even more into these company-based plans — up to $22,000 in 2011. Of course, the challenge for many people is to reduce their spending enough to be able to sock away these kinds of contributions.

If you're self-employed, you can establish your own retirement savings plans for yourself and any employees that you have. In fact, with all types of self-employment retirement plans, business owners need to cover their employees as well. *Simplified employee pension individual retirement accounts* (SEP-IRA) and *Keogh plans* allow you to sock away about 20 percent of your self-employment income (business revenue minus expenses), up to an annual maximum of $49,000 (for tax year 2011). Each year, *you* decide the amount you want to contribute — no minimums exist (unless you do a Money

Purchase Pension Plan type of Keogh).

Keogh plans require a bit more paperwork to set up and administer than SEP-IRAs. Unlike SEP-IRAs, Keogh plans allow *vesting schedules* that require employees to remain with the company a number of years before they earn the right to their retirement account balances. (If you're an employee in a small business, you *can't* establish your own SEP-IRA or Keogh — that's up to your employer.) Many plans also allow business owners to exclude employees from receiving contributions until they complete a year or two of service.

If an employee leaves prior to being fully vested, his unvested balance reverts to the remaining Keogh plan participants. Keogh plans also allow for *Social Security integration,* which effectively allows those in the company who earn high incomes (usually the owners) to receive larger-percentage contributions for their accounts than the less highly compensated employees. The logic behind this idea is that Social Security taxes and benefits top out after you earn $106,800 (for tax year 2011). Social Security integration allows higher-income earners to make up for this ceiling.

Owners of small businesses shouldn't deter themselves from doing a retirement plan because employees may receive contributions, too. If business owners take the time to educate employees about the value and importance of these plans in saving for the future and reducing taxes, they'll see it as a rightful part of their total compensation package.

IRAs

If you work for a company that doesn't offer a retirement savings plan, or if you've exhausted contributing to your company's plan, consider an *individual retirement account* (IRA). Anyone with employment income (or who receives alimony) may contribute up to $5,000 each year to an IRA (or the amount of your employment or alimony income if it's less than $5,000 in a year). If you're a nonworking spouse, you're eligible to put up to $5,000 per year into a spousal IRA. Those age 50 and older can put away up to $6,000 per year (effective in 2011).

Your contributions to an IRA may or may not be tax-deductible. For tax year 2011, if you're single and your adjusted gross income is $56,000 or less for the year, you can deduct your full IRA contribution. If you're married and you file your taxes jointly, you're entitled to a full IRA deduction if your AGI is $90,000 per year or less.

> If you can't deduct your contribution to a standard IRA account, consider making a contribution to a nondeductible IRA account called the *Roth IRA.* Single taxpayers with an AGI less than $107,000 and joint filers with an AGI less than $169,000 can contribute up to $5,000 per year to a Roth IRA. Those age 50 and older can contribute $6,000. Although the contribution isn't deductible, earnings inside the account are shielded from taxes, and, unlike a standard IRA, qualified withdrawals from the account are free from income tax.

Annuities

If you've contributed all you're legally allowed to contribute to your IRA accounts and still want to put away more money for retirement, consider annuities. *Annuities* are contracts that insurance companies back. If you, the *annuity holder* (investor), should die during the so-called *accumulation phase* (that is, prior to receiving payments from the annuity), your designated beneficiary is guaranteed reimbursement of the amount of your original investment.

Annuities, like IRAs, allow your capital to grow and compound tax deferred. You defer taxes until you withdraw the money. However, unlike an IRA that has an annual contribution limit of a few thousand dollars, you can deposit as much as you want in any year to an annuity — even millions of dollars, if you've got it! However, as with a Roth IRA, you get no upfront tax deduction for your contributions.

> Because annuity contributions aren't tax-deductible, and because annuities carry higher annual operating fees to pay for the small amount of insurance that comes with them, don't consider contributing to one until you've fully exhausted your other retirement account investing options. Because of their higher annual expenses, annuities generally make sense only if you have 15 or more years to wait until you need the money.

Choosing retirement account investments

When you establish a retirement account, you may not realize that the retirement account is simply a shell or shield that keeps the federal, state, and local governments from taxing your investment earnings each year. You still must choose what investments you want to hold inside your retirement account shell.

You may invest your IRA or self-employed plan retirement account (SEP-IRAs, Keoghs) money into stocks, bonds, mutual funds, and even bank accounts. Mutual funds (offered in most employer-based plans), which I cover in detail in Chapter 8, are an ideal choice because they offer diversification and professional management. After you decide which financial institution you want to invest through, simply obtain and complete the appropriate paperwork for establishing the specific type of account you want. (Flip to the later section “Choosing the Right Investment Mix” for more information.)

Taming Your Taxes in Non-Retirement Accounts

When you invest outside of tax-sheltered retirement accounts, the profits and distributions on your money are subject to taxation. So the non-retirement account investments that make sense for you depend (at least partly) on your tax situation.

> If you have money to invest, or if you’re considering selling current investments that you hold, taxes should factor into your decision. But tax considerations alone shouldn’t dictate how and where you invest your money. You should also weigh investment choices, your desire and the necessity to take risk,

personal likes and dislikes, and the number of years you plan to hold the investment (see the “Choosing the Right Investment Mix” section, later in the chapter, for more information on these other factors).

Figuring your tax bracket

You may not know it, but the government charges you different tax rates for different parts of your annual income. You pay less tax on the *first* dollars of your earnings and more tax on the *last* dollars of your earnings. For example, if you're single and your taxable income totaled $50,000 during 2011, you paid federal tax at the rate of 10 percent on the first $8,500, 15 percent on the taxable income above $8,500 up to $34,500, and 25 percent on income above $34,500 up to $50,000.

Your *marginal tax rate* is the rate of tax that you pay on your *last,* or so-called *highest,* dollars of income. In the example of a single person with taxable income of $50,000, that person's federal marginal tax rate is 25 percent. In other words, he effectively pays a 25 percent federal tax on his last dollars of income — those dollars earned between $34,500 and $50,000. (Don't forget to factor in the state income taxes that most states assess.)

Knowing your marginal tax rate allows you to quickly calculate the following:

- Any additional taxes that you would pay on additional income
- The amount of taxes that you save if you contribute more money into retirement accounts or reduce your taxable income (for example, if you choose investments that produce tax-free income)

Table 3-1 shows the federal income tax rates for singles and for married households that file jointly.

Table 3-1 2011 Federal Income Tax Rates

Singles Taxable Income

Married Filing Jointly Taxable Income

Federal Tax Rate		
Less than $8,500	Less than $17,000	10%
$8,500 to $34,500	$17,000 to $69,000	15%
$34,500 to $83,600	$69,000 to $139,350	25%
$83,600 to $174,400	$139,350 to $212,300	28%
$174,400 to $379,150	$212,300 to $379,150	33%
More than $379,150	More than $379,150	35%

Knowing what's taxed and when to worry

Interest you receive from bank accounts and corporate bonds is generally taxable. U.S. Treasury bonds pay interest that's state-tax-free. Municipal bonds, which state and local governments issue, pay interest that's federal-tax-free and also state-tax-free to residents in the state where the bond is issued. (I discuss bonds in Chapter 7.)

Taxation on your *capital gains,* which is the *profit* (sales minus purchase price) on an investment, works under a unique system. Investments held less than one year generate *short-term capital gains,* which are taxed at your normal marginal rate. Profits from investments that you hold longer than 12 months are *long-term capital gains.* These long-term gains cap at 15 percent, except for those in the two lowest tax brackets of 10 and 15 percent. For these folks, the long-term capital gains tax rate is just 5 percent.

Use these strategies to reduce the taxes you pay on investments that are exposed to taxation:

- **Opt for tax-free money markets and bonds.** If you're in a high enough tax bracket, you may find that you come out ahead with tax-free investments. Tax-free investments yield less than comparable investments that produce taxable earnings, but because of the tax differences, the earnings from tax-free investments *can* end up being greater than what taxable investments leave you with. In order to compare properly, subtract what you'll pay in federal as well as state taxes from the taxable investment to see which investment nets you more.

- **Invest in tax-friendly stock funds.** Mutual funds that tend to trade less tend to produce lower capital gains distributions. For mutual funds held outside tax-sheltered retirement accounts, this reduced trading effectively increases an investor's total rate of return. *Index funds* are mutual funds that invest in a relatively static portfolio of securities, such as stocks and bonds (this is also true of some exchange-traded funds). They don't attempt to beat the market. Rather, they invest in the securities to mirror or match the performance of an underlying index, such as the Standard & Poor's 500 (which I discuss in Chapter 5). Although index funds can't beat the market, the typical actively managed fund doesn't either, and index funds have several advantages over actively managed funds. See Chapter 8 to find out more about tax-friendly stock mutual funds, which includes some non-index funds, and exchange-traded funds.
- **Invest in small business and real estate.** The growth in value of business and real estate assets isn't taxed until you sell the asset. Even then, with investment real estate, you often can roll over the gain into another property as long as you comply with tax laws. However, the current income that small business and real estate assets produce is taxed as ordinary income.

Short-term capital gains (investments held one year or less) are taxed at your ordinary income tax rate. This fact is another reason that you shouldn't trade your investments quickly (within 12 months).

Choosing the Right Investment Mix

Diversifying your investments helps buffer your portfolio from being sunk by one or two poor performers. In this section, I explain how to mix up a great recipe of investments.

Considering your age

When you're younger and have more years until you plan to use your money, you should keep larger amounts of your long-term investment money in *growth* (ownership) vehicles, such as stocks, real estate, and small business. As I discuss in Chapter 2, the attraction of these types of investments is the potential to really grow your money. The risk: The value of your portfolio can fall from time to time.

The younger you are, the more time your investments have to recover from a bad fall. In this respect, investments are a bit like people. If a 30-year-old and an 80-year-old both fall on a concrete sidewalk, odds are higher that the younger person will fully recover and the older person may not. Such falls sometimes disable older people.

A long-held guiding principle says to subtract your age from 110 and invest the resulting number as a percentage of money to place in growth (ownership) investments. So if you're 35 years old:

> 110 – 35 = 75 percent of your investment money can be in growth investments.

If you want to be more aggressive, subtract your age from 120:

> 120 – 35 = 85 percent of your investment money can be in growth investments.

Note that even retired people should still have a healthy chunk of their investment dollars in growth vehicles like stocks. A 70-year-old person may want to totally avoid risk, but doing so is generally a mistake. Such a person can live another two or three decades. If you live longer than anticipated, you can run out of money if it doesn’t continue to grow.

These tips are only general guidelines and apply to money that you invest for the long term (ideally for ten years or more). For money that you need to use in the shorter term, such as within the next several years, more-aggressive growth investments aren’t appropriate. See Chapters 7 and 8 for short-term investment ideas.

Making the most of your investment options

No hard-and-fast rules dictate how to allocate the percentage that you’ve earmarked for growth among specific investments like stocks and real estate. Part of how you decide to allocate your investments depends on the types of investments that you want to focus on. As I discuss in Chapter 5, diversifying in stocks worldwide can be prudent as well as profitable.

Here are some general guidelines to keep in mind:

- **Take advantage of your retirement accounts.** Unless you need accessible money for shorter-term non-retirement goals, why pass up the free extra returns from the tax benefits of retirement accounts?
- **Don’t pile your money into investments that gain lots of attention.** Many investors make this mistake, especially those who lack a thought-out plan to buy stocks. In Chapter 5, I provide numerous illustrations of the perils of buying attention-grabbing stocks.
- **Have the courage to be a contrarian.** No one likes to feel that he is jumping on board a sinking ship or supporting a losing cause. However, just like shopping for something at retail stores, the best time to buy something of quality is

when its price is reduced.

- **Diversify.** As I discuss in Chapter 2, the values of different investments don't move in tandem. So when you invest in growth investments, such as stocks or real estate, your portfolio's value will have a smoother ride if you diversify properly.

- **Invest more in what you know.** Over the years, I've met successful investors who have built substantial wealth without spending gobs of their free time researching, selecting, and monitoring investments. Some investors, for example, concentrate more on real estate because that's what they best understand and feel comfortable with. Others put more money in stocks for the same reason. No one-size-fits-all code exists for successful investors. Just be careful that you don't put all your investing eggs in the same basket (for example, don't load up on stocks in the same industry that you believe you know a lot about).

- **Don't invest in too many different things.** Diversification is good to a point. If you purchase so many investments that you can't perform a basic annual review of all of them (for example, reading the annual report from your mutual fund), you have too many investments.

- **Be more aggressive with investments inside retirement accounts.** When you hit your retirement years, you'll probably begin to live off your non-retirement account investments first. Allowing your retirement accounts to continue growing can generally save you tax dollars. Therefore, you should be relatively less aggressive with investments outside of retirement accounts because that money may be invested for a shorter time period.

Easing into risk: Dollar cost averaging

Dollar cost averaging (DCA) is the practice of investing a regular amount of money at set time intervals, such as monthly or quarterly, into volatile investments, such as stocks and stock mutual funds. If you've ever deducted money from a paycheck and pumped it into a retirement savings plan investment account that holds stocks and bonds, you've done DCA.

Most people invest a portion of their employment compensation as they earn it, but if you have extra cash sitting around, you can choose to invest that money in one fell swoop or to invest it gradually via DCA. The biggest appeal of gradually feeding money into the market via DCA is that you don't dump all your money into a potentially overheated investment just before a major drop. Thus, DCA helps shy investors psychologically ease into riskier investments.

DCA is made to order for skittish investors with large lump sums of money sitting in safe investments like CDs or savings accounts. For example, using DCA, an investor with $100,000 to invest in stock funds can feed her money into investments gradually — say, at the rate of $12,500 or so quarterly over two years — instead of investing her entire $100,000 in stocks at once and possibly buying all of her shares at a market peak. Most large investment companies, especially mutual funds, allow investors to establish automatic investment plans so the DCA occurs without an investor's ongoing involvement.

Of course, like any risk-reducing investment strategy, DCA has drawbacks. If growth investments appreciate (as they're supposed to), a DCA investor misses out on earning higher returns on his money awaiting investment. Finance professors Richard E. Williams and Peter W. Bacon found that approximately two-thirds of the time, a lump-sum stock market investor earned higher first-year returns than an investor who fed the money in monthly over the first year. (They studied data from the U.S. market over the past seven decades.)

However, knowing that you'll probably be ahead most of the time if you dump a lump sum into the stock market is little solace if you happen to invest just before a major plunge in prices. In the fall of 1987, the U.S. stock market, as measured by the Dow Jones Industrial Average, plummeted 36 percent, and from late 2007 to early 2009, the market shed 55 percent of its value.

So investors who fear that stocks are due for such a major correction should practice DCA, right? Well, not so fast. Apprehensive investors who shun lump-sum investments and use DCA are more likely to stop the DCA investment process if prices plunge, thereby defeating the benefit of doing DCA during a declining market.

So what's an investor with a lump sum of money to do?

- **First, weigh the significance of the lump sum to you.** Although $100,000 is a big chunk of most people's net worth, it's only 10 percent if your net worth is $1,000,000. It's not worth a millionaire's time to use DCA for $100,000. If the cash that you have to invest is less than a quarter of your net worth, you may not want to bother with DCA.
- **Second, consider how aggressively you invest (or invested) your money.** For example, if you aggressively invested your money through an employer's retirement plan that you roll over, don't waste your time on DCA.

DCA makes sense for investors with a large chunk of their net worth in cash who want to minimize the risk of transferring that cash to riskier investments, such as stocks. If you fancy yourself a market prognosticator, you can also assess the current valuation of stocks. Thinking that stocks are pricey (and thus riper for a fall) increases the appeal of DCA.

If you use DCA too quickly, you may not give the market sufficient time for a correction to unfold, during and after which some of the DCA purchases may take place. If you practice DCA over too long of a period of time, you may miss a major upswing in stock prices. I suggest using DCA over one to two years to strike a balance.

As for the times of the year that you should use DCA, mutual fund investors should use DCA early in each calendar quarter because mutual funds that make taxable distributions tend to do so late in the quarter.

Your money that awaits investment in DCA should have a suitable parking place. Select a high-yielding money market fund that's appropriate for your tax situation.

One last critical point: When you use DCA, establish an automatic investment plan so you're less likely to chicken out. And for the more courageous, you may want to try an alternative strategy to DCA — *value averaging,* which allows you to invest more if prices are falling and invest less if prices are rising.

Suppose, for example, that you want to value average $500 per quarter into an aggressive stock mutual fund. After your first quarterly $500 investment, the fund drops 10 percent, reducing your account balance to $450. Value averaging suggests that you invest $500 the next quarter plus another $50 to make up the shortfall. (Conversely, if the fund value had increased to $550 after your first investment, you would invest only $450 in the second round.) Increasing the amount that you invest requires confidence when prices fall, but doing so magnifies your returns when prices ultimately turn around.

Treading Carefully When Investing

for College

Many well-intentioned parents want to save for their children's future educational expenses. The mistake they often make, however, is putting money in accounts in their child's name (in so-called *custodial accounts*) or saving outside of retirement accounts in general.

The more money you accumulate outside tax-sheltered retirement accounts, the less assistance you're likely to qualify for from federal and state financial aid sources. Don't make the additional error of assuming that financial aid is only for the poor. Many middle-income and even some modestly affluent families qualify for some aid, which can include grants and loans available, even if you're not deemed financially needy.

Under the current financial needs analysis that most colleges use in awarding financial aid, the value of your retirement plan is *not* considered an asset. Money that you save *outside* of retirement accounts, including money in the child's name, is counted as an asset and reduces eligibility for financial aid.

Also, be aware that your family's assets, for purposes of financial aid determination, also generally include equity in real estate and businesses that you own. Although the federal financial aid analysis no longer counts equity in your primary residence as an asset, many private (independent) schools continue to ask parents for this information when they make their own financial aid determinations. Thus, paying down your home mortgage more quickly instead of funding retirement accounts can harm you financially. You may end up with less financial aid and pay more in taxes.

Don't forgo contributing to your own retirement savings plan(s) in order to save money in a non-retirement account for your children's college expenses. When you do, you pay higher taxes both on your current income and on the interest and growth of this money. In addition to paying higher taxes, you're expected to contribute more to your child's educational expenses (because you'll receive less financial aid).

If you plan to apply for financial aid, it's a good idea to save non-retirement account money in your name rather than in your child's name (as a custodial account). Colleges expect a greater percentage of money in your child's name (35 percent) to be used for college costs than money in your name (6 percent). Remember, though, that from the standpoint of getting financial aid, you're better off saving inside retirement accounts.

However, if you're affluent enough that you expect to pay for your cherub's full educational costs without applying for financial aid, you can save a bit on taxes if you invest through custodial accounts. Prior to your child reaching age 19, the first $1,900 of interest and dividend income is taxed at your child's income tax rate rather than yours. After age 19 (for full-time students, it's those under the age of 24), *all* income that the investments in your child's name generate is taxed at your child's rate.

Education Savings Accounts

Be careful about funding an Education Savings Account (ESA), a relatively new savings vehicle. In theory, an ESA sounds like a great place to park some college savings. You can make nondeductible contributions of up to $2,000 per child per year, and investment earnings and account withdrawals are free of tax as long as you use the funds to pay for elementary and secondary school or college costs. However, funding an ESA can undermine your child's ability to qualify for financial aid. It's best to keep the parents as the owners of such an account for financial aid purposes, but be forewarned that some schools may treat money in an ESA as a student's asset.

Section 529 plans

Also known as *qualified state tuition plans,* Section 529 plans offer a tax-advantaged way to save and invest more than $100,000 per child toward college costs (some states allow upward of $300,000 per student). After you contribute to one of these state-based accounts, the invested funds grow without taxation. Withdrawals are also tax free so long as the funds are used to pay for qualifying higher educational costs (which include college, graduate school, and certain additional expenses of special-needs students). The schools need not be in the same state as the state administering the Section 529 plan.

As I discuss in the previous section dealing with Education Savings Accounts, Section 529 plan balances can harm your child's financial aid chances. Thus, such accounts make the most sense for affluent families who are sure that they won't qualify for any type of financial aid. If you do opt for an ESA and intend to apply for financial aid, you should be the owner of the accounts (not your child) to maximize qualifying for financial aid.

How to pay for college

If you keep stashing away money in retirement accounts, it's reasonable for you to wonder how you'll actually pay for education expenses when the momentous occasion arises. Even if you have some liquid assets that can be directed to your child's college bill, you will, in all likelihood, need to borrow some money. Only the affluent can truly afford to pay for college with cash.

One good source of money is your home's equity. You can borrow against your home at a relatively low interest rate, and the interest is generally tax-deductible. Some company retirement plans — 401(k)s, for example — allow borrowing as well.

A plethora of financial aid programs allow you to borrow at reasonable interest rates. The Unsubsidized Stafford Loans and Parent Loans for Undergraduate Students (PLUS), for example, are available, even when your family isn't deemed financially needy. In addition to loans, a number of grant programs are available through schools and the government as well as through independent sources.

Complete the Free Application for Federal Student Aid (FAFSA) to apply for the federal government programs. Grants available through state government programs may require a separate application. Specific colleges and other private organizations, including employers, banks, credit unions, and community groups, also offer grants and scholarships.

Many scholarships and grants don't require any work on your part — simply apply for such financial aid through your college. However, you may need to seek out other programs as well — check directories and databases at your local library, your kid's school counseling department, and college financial aid offices. Also try local organizations, churches, employers, and so on, because you have a better chance of getting scholarship money through these avenues than through countrywide scholarship and grant databases.

Your child also can work and save money during high school and college for school. In fact, if your child qualifies for financial aid, she's generally expected to contribute a certain amount to education costs from employment (both during the school year and summer breaks) and from savings. Besides giving your gangly teen a stake in her own future, this training encourages sound personal financial management down the road.

Allocating college investments

If you keep up to 80 percent of your investment money in stocks (diversified worldwide) with the remainder in bonds when your child is young, you can maximize the money's growth potential without taking extraordinary risk. As your child makes his way through the later years of elementary school, you need to begin to make the mix more conservative — scale back the stock percentage to 50 or 60 percent. Finally, in the years just before entering college, whittle the stock portion down to no more than 20 percent or so.

Diversified mutual funds (which invest in stocks in the United States and internationally) and bonds are ideal vehicles to use when you invest for college. Be sure to choose funds that fit your tax situation if you invest your funds in non-retirement accounts. See Chapter 8 for more information.

Protecting Your Assets

You may be at risk of making a catastrophic investing mistake: not protecting your assets properly due to a lack of various insurance coverages. Manny, a successful entrepreneur, made this exact error. Starting from scratch, he built up a successful million-dollar business. He invested a lot of his own personal money and sweat into building the business over 15 years.

One day, catastrophe struck: An explosion ripped through his building, and the ensuing fire destroyed virtually all the firm's equipment and inventory, none of which was insured. The explosion also seriously injured several workers, including Manny, who didn't carry disability insurance. Ultimately, Manny had to file for bankruptcy.

> Decisions regarding what amount of insurance you need to carry are, to some extent, a matter of your desire and ability to accept financial risk. But some risks aren't worth taking. Don't overestimate your ability to predict what accidents and other bad luck may befall you.

Here's what you need to protect yourself and your assets:

- **Major medical health insurance:** I'm not talking about one of those policies that pays $100 a day if you need to go into the hospital, or cancer insurance, or that $5,000 medical expense rider on your auto insurance policy. I know it's unpleasant to consider, but you need a policy that pays for all types of major illnesses and major medical expenditures.

  > Consider taking a health plan with a high deductible,

which can minimize your premiums. Also consider channeling extra money into a Health Savings Account (HSA), which provides tremendous tax breaks. As with a retirement account, contributions provide an upfront tax break, and money can grow over the years in an HSA without taxation. You can also tap HSA funds without penalty or taxation for a wide range of current health expenses.

- **Adequate liability insurance on your home and car to guard your assets against lawsuits:** You should have at least enough liability insurance to protect your *net worth* (assets minus your liabilities/debts) or, ideally, twice your net worth. If you run your own business, get insurance for your business assets if they're substantial, such as in Manny's case. Also consider professional liability insurance to protect against a lawsuit. You may also want to consider incorporating your business (which I discuss more in Chapter 14).

- **Long-term disability insurance:** What would you (and your family) do to replace your income if a major disability prevents you from working? Even if you don't have dependents, odds are that *you* are dependent on you. Most larger employers offer group plans that have good benefits and are much less expensive than coverage you'd buy on your own. Also, check with your professional association for a competitive group plan.

- **Life insurance, if others are dependent on your income:** If you're single or your loved ones can live without your income, skip life insurance. If you need coverage, buy term insurance that, like your auto and home insurance, is pure insurance protection. The amount of term insurance you need to buy largely depends on how much of your income you want to replace.

- **Estate planning:** At a minimum, most people need a simple will to delineate to whom they would like to leave all their worldly possessions. If you hold significant assets outside retirement accounts, you may also benefit from establishing a living trust, which keeps your money from filtering through the hands of probate lawyers. Living wills and medical powers of attorney are useful to have in case you're ever in a medically incapacitated situation. If you have substantial assets, doing more involved estate planning is wise to minimize estate taxes and ensure the orderly passing of your assets to your heirs.

In my experience as a financial counselor, I've seen that although many people lack particular types of insurance, others possess unnecessary policies. Many people also keep very low deductibles. Remember to insure against potential losses that would be financially catastrophic for you — don't waste your money to protect against smaller losses. (See the latest edition of my book *Personal Finance For Dummies,* published by John Wiley & Sons, Inc., to discover the right and wrong ways to buy insurance, what to look for in policies, and where to get good policies.)

Part II

Stocks, Bonds, and Wall Street

"It's surprising considering his portfolio is so conservative."

In this part . . .

Stocks, bonds, mutual funds, and exchange-traded funds are the core financial market instruments that investors play with these days. But what the heck are these devices, and how can you invest in them, make some decent money, and not lose your shirt? Here in this part, you find out how and where to evaluate and buy these securities and how to comprehend the mind-numbing jargon the money pros use.

Chapter 4

The Workings of Stock and Bond Markets

In This Chapter

- Going from a private to public company
- Looking at the workings of the stock and bond markets and the economy
- Deciphering interest rates, inflation, and the Federal Reserve

To buy and enjoy a watch, you don't need to know the intricacies of how it's put together and how it works. The same holds true for investing in stocks and bonds. However, spending some time understanding how and why the financial markets function may make you more comfortable with investing and make you a better investor.

In this chapter, I explain the ways that companies raise capital and give you a brief primer on financial markets and economics so you can understand and be comfortable with investing in the financial markets.

How Companies Raise Money through the Financial Markets

All businesses start small — whether they begin in a garage, a spare bedroom, or a rented office. As companies begin to grow, they often need more money (known as *capital* in the financial world) to expand and afford their growing needs, such as hiring more employees, buying computer systems, and purchasing other equipment. Many smaller companies rely on banks to lend them money, but growing and successful firms have other options, too, in the financial markets. Companies can choose between two major money-raising options when they go into the financial markets: issuing stocks or issuing bonds.

Deciding whether to issue stocks or bonds

A world of difference exists between the two major types of securities, both from the perspective of the investor and from that of the issuing company, as the following explanations illustrate:

- **Bonds are loans that a company must pay back.** Rather than borrowing money from a bank, many companies elect to sell *bonds,* which are IOUs to investors. The primary disadvantage of issuing bonds compared with issuing stock, from a company's perspective, is that the company must repay this money with interest. On the other hand, the business doesn't have to relinquish ownership when it borrows money. Companies are also more likely to issue bonds if the stock market is depressed, meaning that companies can't fetch as much for their stock.
- **Stocks are shares of ownership in a company.** Some companies choose to issue stock to raise money. Unlike bonds, the money that the company raises through a stock offering isn't paid back, because it's not a loan. When the investing public buys stock, these outside investors continue to hold and trade it. (Although companies may occasionally choose to buy their own stock back, usually because they think it's a good investment, they're under no obligation to

do so.)

When a company issues stock, doing so allows its founders and owners to sell some of their relatively illiquid private stock and reap the rewards of their successful company. Many growing companies also favor stock offerings because they don't want the cash drain that comes from paying loans (bonds) back.

Although many company owners like to take their companies public (issuing stock) to cash in on their stake of the company, not all owners want to go public, and not all who do go public are happy that they did. One of the numerous drawbacks of establishing your company as public includes the burdensome financial reporting requirements, such as publishing of quarterly earnings statements and annual reports. These documents not only take lots of time and money to produce, but they can also reveal competitive secrets. Some companies also harm their long-term planning ability because of the pressure and focus on short-term corporate performance that comes with being a public company.

Ultimately, companies seek to raise capital in the lowest-cost way they can, so they elect to sell stocks or bonds based on what the finance folks tell them is the best option. For example, if the stock market is booming and new stock can sell at a premium price, companies opt to sell more stock. Some companies have preferences, for example, to avoid debt because they don't like carrying it.

From your perspective as a potential investor, you can usually make more money in stocks than bonds, but stocks are generally more volatile in the short term (see Chapter 2).

Taking a company public: Understanding

IPOs

Suppose that The Capitalist Company (TCC) wants to issue stock for the first time, which is called an *initial public offering* (IPO). If TCC decides to go public, the company's management team works with *investment bankers,* who help companies decide when and at what price to sell stock.

Suppose further that based upon their analysis of the value of TCC, the investment bankers believe that TCC can raise $20 million by issuing stock that represents a particular portion of the company. When a company issues stock, the price per share that the stock is sold for is somewhat arbitrary. The amount that a prospective investor will pay for a particular portion of the company's stock should depend on the company's profits and future growth prospects. Companies that produce higher levels of profits and grow faster can generally command a higher sales price for a given portion of the company.

Consider the following ways that investment bankers can structure the IPO for TCC:

Price of Stock	*Number of Shares Issued*
$5	4 million shares
$10	2 million shares
$20	1 million shares

In fact, TCC can raise $20 million in an infinite number of ways, thanks to varying stock prices. If the company wants to issue the stock at a higher price, the company sells fewer shares.

A stock's price per share by itself is meaningless in evaluating whether to buy a stock. Ultimately, the amount that investors will pay for a company's stock should depend greatly on the company's growth and profitable prospects. To determine the price-earnings ratio of a particular company’s stock, you take the price per share of the company’s stock and divide it by the company’s earnings per share.

$$\frac{\text{The value of a company's stock}}{\text{relative to (divided by) its earnings}} = \text{its } \textit{price-earnings ratio}$$

In the case of TCC, suppose that its stock is currently valued in the marketplace at $30 per share and that it earned $2 per share in the past year, which produces a price-earnings ratio of 15. Here are the numbers:

$$\frac{\$30 \text{ per share}}{\$2 \text{ per share}} = 15$$

In Chapter 5, I talk more about price-earnings ratios and the factors that influence stock prices.

Understanding Financial Markets and Economics

Tens of thousands of books, millions of articles, and enough PhD dissertations to pack a major landfill explore the topics of how the financial markets and economy will perform in the years ahead. You can spend the rest of your life reading all this stuff, and you still won’t get through it. In this section, I explain what you need to know about how the factors that influence the financial markets and economy work so you can make informed investing decisions.

Driving stock prices through earnings

The goal of most companies is to make money, or earnings (also called profits). *Earnings* result from the difference between what a company takes in (*revenue*) and what it spends (*costs*). I say *most* companies because some organizations’ primary purpose is not to maximize profits. Nonprofit organizations, such as colleges and universities, are a good example. But even nonprofits can’t thrive and prosper without a steady money flow.

Companies that trade publicly on the stock exchanges seek to maximize their profit — that’s what their shareholders want. Higher profits generally make stock prices rise. Most private companies seek to maximize their profits as well, but they retain much more latitude to pursue other goals.

Among the major ways that successful companies increase profits are by doing the following:

- **Building better mousetraps:** Some companies develop or promote an invention or innovation that better meets customer needs. For example, many consumers welcomed the invention of the digital camera that eliminated the need for costly and time-consuming development of film. The digital camera also made transferring and working with pictures much easier.
- **Opening new markets to your products:** Many successful U.S.-based companies, for example, have been stampeding into foreign countries to sell their products. Although some product adaptation is usually required to sell overseas, selling an already proven and developed product or service to new markets generally increases a company’s chances for success.
- **Being in related businesses:** Consider the hugely successful Walt Disney Company, which was started in the 1920s as a small studio that made cartoons. Over the years, it expanded into many new but related businesses, such as theme parks and resorts, movie studios, radio and television programs, toys and children’s books, and video games.
- **Building a brand name:** Popular sodas and many types of

well-known beers rate comparably in blind taste tests to many generic colas and beers that are far cheaper. Yet some consumers fork over more of their hard-earned loot because of the name and packaging. Companies build brand names largely through advertising and other promotions. (*For Dummies* is a brand name, but *For Dummies* books cost about the same as lower-quality and smaller books on similar subjects!)

- **Managing costs and prices:** Smart companies control costs. Lowering the cost of manufacturing their products or providing their services allows companies to offer their products and services more cheaply. Managing costs may help fatten the bottom line (profit). Sometimes, though, companies try to cut too many corners, and their cost-cutting ways come back to haunt them in the form of dissatisfied customers — or even lawsuits based on a faulty or dangerous product.
- **Watching the competition:** Successful companies don't follow the herd, but they do keep an eye on what their competition is up to. If lots of competitors target one part of the market, some companies target a less-pursued segment that, if they can capture it, may produce higher profits thanks to reduced competition.

Weighing whether markets are efficient

Companies generally seek to maximize profits and maintain a healthy financial condition. Ultimately, the financial markets judge the worth of a company's stock or bond. Trying to predict what happens to the stock and bond markets and to individual securities consumes many a market prognosticator.

In the 1960s, to the chagrin of some market soothsayers, academic scholars developed a theory called the *efficient market hypothesis.* This theory basically maintains the following logic: Lots of investors collect and analyze all sorts of information about companies and their securities. If investors think that a security, such as a stock, is overpriced, they sell it or don't buy it. Conversely, if the investors believe that a security is underpriced, they buy it or hold what they already own. Because of the competition among all these investors, the price that a security trades at generally reflects what many (supposedly informed) people think it's worth.

Therefore, the efficient market theory implies that trading in and out of securities and the overall market in an attempt to obtain the right stocks at the right time is a futile endeavor. Buying or selling a security because of "new" news is also fruitless because the stock price adjusts so quickly to this news that investors can't profit by acting on it. As Burton Malkiel so eloquently said in his classic book *A Random Walk Down Wall Street,* this theory, "Taken to its logical extreme . . . means that a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by the experts." Malkiel added, "Financial analysts in pin-striped suits don't like being compared with bare-assed apes."

Some money managers have beaten the market averages. In fact, beating the market over a year or three years isn't difficult, but few can beat the market over a decade or more. Efficient market supporters argue that some of those who beat the markets, even over a ten-year period, do so because of luck. Consider that if you flip a coin five times, on some occasions you get five consecutive heads. This coincidence actually happens, on average, once every 32 times you do five coin-flip sequences because of random luck, not skill. Consistently identifying in advance which sequence gives you five consecutive heads isn't possible.

Strict believers in the efficient market hypothesis say that it's equally impossible to identify the best money managers in advance. Some money managers, such as those who manage mutual funds, possess publicly available track records. Inspecting those track records (and understanding the level of risk taken for the achieved returns) and doing other common-sense things, such as investing in funds that have lower expenses, improve your odds of performing a bit better than the market.

Various investment markets differ in how efficient they are. *Efficiency* means that the current price of an investment accurately reflects its true value. Although the stock market is reasonably efficient, many consider the bond market to be even more efficient. The real estate market is less efficient because properties are unique, and sometimes less competition and access to information exist. If you can locate a seller who really needs to sell, you may be able to buy property at a sizeable discount from what it's really worth. Small business is also less efficient. Entrepreneurs with innovative ideas and approaches can sometimes earn enormous returns.

Moving the market: Interest rates, inflation, and the Federal Reserve

For decades, economists, investment managers, and other (often self-anointed) gurus have attempted to understand the course of interest rates, inflation, and the monetary policies set forth by the Federal Reserve. Millions of investors follow these economic factors. Why? Because interest rates, inflation, and the Federal Reserve's monetary policies seem to move the financial markets and the economy.

Realizing that high interest rates are generally bad

Many businesses borrow money to expand. People like you and me, who are affectionately referred to as consumers, also borrow money to finance home and auto purchases and education.

Interest rate increases tend to slow the economy. Businesses scale back on expansion plans, and some debt-laden businesses can't afford high interest rates and go under. Most individuals possess limited budgets as well and have to scale back some purchases because of higher interest rates. For example, higher interest rates translate into higher mortgage payments for home buyers.

If high interest rates choke business expansion and consumer spending, economic growth slows or the economy shrinks — and possibly ends up in a recession. The definition of a *recession* is two consecutive quarters (six months) of contracting economic activity.

The stock market usually develops a case of the queasies as corporate profits shrink. High interest rates may depress investors' appetites for stocks as the yields increase on certificates of deposit (CDs), Treasury bills, and other bonds.

Higher interest rates actually make some people happy. If you locked in a fixed-rate mortgage on your home or on a business loan, your loan looks much better than if you had a variable-rate mortgage. Some retirees and others who live off the interest income on their investments are happy with interest rate increases as well. Consider back in the early 1980s, for example, when a retiree received $10,000 per year in interest for each $100,000 that he invested in certificates of deposit that paid 10 percent.

Fast-forward to the early 2000s: A retiree purchasing the same CDs saw interest income slashed by about 70 percent, because rates on the CDs were just 3 percent. So for every $100,000 invested, only $3,000 in interest income was paid.

If you try to live off the income that your investments produce, a 70 percent drop in that income is likely to cramp your lifestyle. So higher interest rates are better if you're living off your investment income, right? Not necessarily.

Discovering the inflation and interest rate connection

Consider what happened to interest rates in the late 1970s and early 1980s. After the United States successfully emerged from a terrible recession in the mid-1970s, the economy seemed to be on the right track. But within just a few years, the economy was in turmoil again. The annual increase in the cost of living (known as the *rate of inflation*) burst through 10 percent on its way to 14 percent. Interest rates, which are what bondholders receive when they lend their money to corporations and governments, followed inflation skyward.

Inflation and interest rates usually move in tandem. The primary driver of interest rates is the rate of inflation. Interest rates were much higher in the 1980s because the United States had double-digit inflation. If the cost of living increases at the rate of 10 percent per year, why would you, as an investor, lend your money (which is what you do when you purchase a bond or CD) at 5 percent? Interest rates were so much higher in the early 1980s because you or I would never do such a thing.

In recent years, interest rates have been low. Therefore, the rate of interest that investors can earn lending their money has dropped accordingly. Although low interest rates reduce the interest income that comes in, the corresponding low rate of inflation doesn’t devour the purchasing power of your principal balance. That’s why lower interest rates aren’t necessarily worse and higher interest rates aren’t necessarily better as you try to live off your investment income.

So what’s an investor to do when he’s living off the income he receives from his investments but doesn’t receive enough because of low interest rates? Some retirees have woken up to the risk of keeping all or too much of their money in short-term CD and bond investments. (Review the sections in Chapter 3 dealing with asset allocation and investment mix.) A simple but psychologically difficult solution is to use up some of your principal to supplement your interest and dividend income. Using up your principal to supplement your income is what effectively happens anyway when inflation is higher — the purchasing power of your principal erodes more quickly. You may also find that you haven’t saved enough money to meet your desired standard of living — that’s why you should consider your retirement goals well before retiring (see Chapter 3).

Exploring the role of the Federal Reserve

When the chairman of the Federal Reserve Board, Ben Bernanke, speaks, an extraordinary number of people listen. Most financial market watchers and the media want to know what the Federal Reserve has decided to do about *monetary policy.* The Federal Reserve is the central bank of the United States. The Federal Reserve Board comprises the 12 presidents from the respective Federal Reserve district banks and the 7 Federal Reserve governors, including the chairman who conducts the Federal Open Market Committee meetings behind closed doors eight times a year.

What exactly is the Fed, as it’s known, and what does it do? The *Federal Reserve* sets monetary policy. In other (perhaps clearer) words, the Fed influences interest-rate levels and the amount of money or currency in circulation, known as the *money supply,* in an attempt to maintain a stable rate of inflation and growth in the U.S. economy.

Buying money is no different from buying lettuce, computers, or sneakers. All these products and goods cost you dollars when you buy them. The cost of money is the interest rate that you must pay to borrow it. And the cost or interest rate of money is determined by many factors that ultimately influence the supply of and demand for money.

The Fed, from time to time and in different ways, attempts to influence the supply and demand for money and the cost of money. To this end, the Fed raises or lowers short-term interest rates, primarily by buying and selling U.S. Treasury bills on the open market. Through this trading activity, known as open market operations, the Fed is able to target the Federal funds rate — the rate at which banks borrow from one another overnight.

The senior officials at the Fed readily admit that the economy is quite complex and affected by many things, so it’s difficult to predict where the economy is heading. If forecasting and influencing markets are such difficult undertakings, why does the Fed exist? Well, the Fed officials believe that they can have a positive influence in creating a healthy overall economic environment — one in which inflation is low and growth proceeds at a modest pace.

Over the years, the Fed has come under attack for various reasons. Various pundits have accused former Fed Chairman Alan Greenspan of causing speculative bubbles (see Chapter 5), such as the boom in technology stock prices in the late 1990s or in housing in the early 2000s. Some economists have argued that the Federal Reserve has, at times, goosed the economy by loosening up on the money supply, which leads to a growth spurt in the economy and a booming stock market, just in time to make El Presidente look good prior to an election. Conveniently, the consequences of inflation take longer to show up — they’re not evident until after the election. In recent years, others have questioned the Fed’s ability to largely do what it wants without accountability.

Many factors influence the course of stock prices. Never, ever make a trade or investment based on what someone at the Federal Reserve says or what someone in the media or some market pundit reads into the Fed chairman’s comments. You need to make your investment plans based on your needs and goals, not what the Fed does or doesn’t do.

Chapter 7

Exploring Bonds and Other Lending Investments

In This Chapter

- Getting the most out of a bank
- Selecting the right type of bonds for you
- Choosing among individual bonds and bond mutual funds
- Understanding other lending investments

Lending investments are those in which you lend your money to an organization, such as a bank, company, or government, which typically pays you a set or fixed rate of interest. (*Ownership investments,* by contrast, provide partial ownership of a company or some other asset, such as real estate, that has the ability to generate revenue and potential profits.) Lending investments aren't the best choice if you really want to make your money grow. However, even the most aggressive investors should consider placing some of their money into lending investments. The following table shows when such investments do and don't make sense.

Consider Lending Investments If . . .	***Consider Ownership Investments When . . .***
You need current income.	You don't need or want much current income.
You expect to sell within five years.	You're investing for the long term (seven to ten-plus years).
Investment volatility makes you a wreck, or you just want to cushion some of the volatility of your other riskier investments.	You don't need to make your money grow after inflation and taxes.
You don't need to make your money grow after inflation and taxes.	You don't need to make your money grow after inflation and taxes.

Lending investments are everywhere — through banks, credit unions, brokerage firms, insurance companies, and mutual fund companies. Lending investments that you may have heard of include bank accounts (savings and certificates of deposit), treasury bills and other bonds, bond mutual funds (and now exchange-traded bond funds), mortgages, and guaranteed-investment contracts.

In this chapter, I walk you through these investments, explain what's good and bad about each, and show you when you should and shouldn't use them. I also tell you what to look for (and look out for) when comparing them.

Banks: Considering the Cost of Feeling Secure

Putting your money in a bank may make you feel safe for a variety of reasons. If you're like most people, your first investing experience was at your neighborhood bank where you established checking and savings accounts.

Part of the comfort of keeping money in the bank stems from the fact that the bank is where your parents may have first steered you financially. Also, at a local branch, often within walking distance of your home or office, you find vaults, security-monitoring cameras, and barriers in front of the tellers. Most of these latter accoutrements shouldn't make you feel safer about leaving your money with the bank, however — they're needed because of bank robberies!

Bank branches cost a lot of money to operate. Guess where that money comes from? From bank depositors, of course! These operating costs are one of the reasons the interest rates that banks pay often pale in comparison to some of the similarly secure alternatives discussed in this chapter.

Facing the realities of bank insurance

Some people are consoled by the Federal Deposit Insurance Corporation (FDIC) insurance that comes with bank accounts. It's true that if your bank fails, your account is insured by the U.S. government up to $250,000. So what? Every Treasury bond is issued and backed by the federal government — the same debt-laden organization that stands behind the FDIC. Plenty of other equally safe lending investments yield higher returns than bank accounts.

Just because the federal government stands behind the banking FDIC system doesn't mean that your money is 100 percent safe in the event of a bank failure. Although you're insured for $250,000 in a bank, if the bank crashes, you may wait quite a while to get your money back — and you may get less interest than you thought you would. Banks fail and will continue to fail. During the 1980s and early 1990s, and again in the late 2000s, hundreds of insured banks and savings and loans failed annually. (Between the early 1990s and late 2000s, only a handful of banks failed annually.) Any investment that involves lending your money to someone else or to some organization, including putting your money in a bank or buying a Treasury bond that the federal government issues, carries risk. Although I'm not a doomsayer, any student of history knows that governments and civilizations fail.

Being wary of the certificate of deposit (CD)

Other than savings accounts, banks also sell *certificates of deposit* (CDs). CDs are an often overused bank investment — investors use them by default, often without researching their pros and cons. The attraction is that you get a higher rate of return on a CD than on a bank savings or money market account. And unlike a bond (which I discuss in the "Why Bother with Bonds?" section later in this chapter), a CD's principal value doesn't fluctuate. CDs also give you the peace of mind afforded by the government's FDIC insurance program.

The reason that CDs pay higher interest rates than savings accounts is that you commit to tie up your money for a period of time, such as 6, 12, or 24 months. The bank pays you 2 to 3 percent and then turns around and lends your money to others through credit cards, auto loans, and so on. The bank then charges those borrowers an interest rate of 10 percent or more. Not a bad business!

When you tie up your money in a CD and later decide you want it back before the CD matures, a hefty penalty (typically about six months' interest) is shaved from your return. With other lending investments, such as bonds and bond mutual funds, you can access your money without penalty and generally at little or no cost.

In addition to penalties for early withdrawal, CDs yield less than a high-quality bond with a comparable maturity (for example, two, five, or ten years). Often, the yield difference is 1 percent or more, especially if you don't shop around and simply buy CDs from the local bank where you keep your checking account.

High-tax-bracket investors who purchase CDs outside of their retirement accounts should be aware of a final and perhaps fatal flaw of CDs: The interest on CDs is fully taxable at the federal and state levels. Bonds, by contrast, are available (if you desire) in tax-free (federal and/or state) versions.

REMEMBER You can earn higher returns and have better access to your money when it's in bonds than you can when it's in CDs. Bonds make especially good sense when you're in a higher tax bracket and would benefit from tax-free income in a non-retirement account. CDs make the most sense when you know, for example, that you can invest your money for one year, after which you need the money for some purchase that you expect to make. Just make sure that you shop around to get the best interest rate. If having the U.S. government insurance gives you peace of mind, also take a look at Treasury bonds, which I discuss later in this chapter. Treasury bonds (also known as *Treasuries*) tend to pay more interest than many CDs.

Swapping your savings account for a money market fund

Because bank savings accounts generally pay pretty crummy interest rates, you need to think long and hard about keeping your spare cash in the bank.

You can, if you so choose, keep your checking account at your local bank. But you don't have to. I don't because I use a money market fund that offers unlimited check writing at a mutual fund company. I also don't keep my extra savings in the bank.

Instead of relying on the bank, try *money market funds,* which are a type of mutual fund (other funds focus on bonds or stocks), as a place to keep your extra savings. Money market funds offer a higher-yielding alternative to bank savings and bank money market deposit accounts.

Money market funds, which are offered by mutual fund companies (see Chapter 8), are unique among mutual funds because they don't fluctuate in value and maintain a fixed $1-per-share price. As with a bank savings account, your principal investment in a money market fund doesn't change in value. If you invest your money in a money market fund, it earns *dividends* (which is just another name for the interest you would receive in a bank account).

Money market fund advantages

The best money market mutual funds offer the following significant benefits over bank savings accounts:

- **They provide higher yields.** Money market mutual funds pay higher yields because they don't have the high overhead that banks do. The most efficient mutual fund companies (I discuss them in Chapter 8) don't have scads of branch offices.

  Banks can get away with paying lower yields because they know that many depositors believe that the FDIC insurance that comes with a bank savings account makes it safer than a money market mutual fund. Also, the FDIC insurance is an expense that banks ultimately pass on to their customers.

- **They come in a variety of tax-free versions.** So if you're in a high tax bracket (see Chapter 3), tax-free money market funds offer you something that bank accounts don't.

Another useful feature of money market mutual funds is the ability they provide you to write checks, without charge, against your account. Most mutual fund companies require that the checks that you write be for larger amounts — typically at least $250. They don't want you using these accounts to pay all your small household bills because checks cost money to process.

However, a few money market funds (such as those that brokerage cash management accounts at firms like Charles Schwab, TD Ameritrade, Vanguard, and Fidelity) allow you to write checks for any amount and can completely replace a bank checking account. Do keep in mind that some brokerage firms hit you with service fees if you don't have enough assets with them or don't have regular monthly electronic transfers, such as through direct deposit of your paycheck or money transfer from your bank account. With these types of money market funds, you can leave your bank altogether because these brokerage accounts often come with debit cards that you can use at bank ATMs for a nominal fee.

Money market funds are a good place to keep your emergency cash reserve of at least three to six months' living expenses. They're also a great place to keep money awaiting investment elsewhere in the near future. If you're saving money for a home that you expect to purchase soon (in the next year or so), a money market fund can be a safe place to accumulate and grow the down payment. You don't want to risk placing such money in the stock market, because the market can plunge in a relatively short period of time.

Just as you can use a money market fund for your personal purposes, you also can open a money market fund for your business. I have one for my business. You can use this account to deposit checks that you receive from customers, to hold excess funds, and to pay bills via the check-writing feature.

Money market fund disadvantages (if you'd really call them that)

Higher yields, tax-free alternatives, and check writing — money market funds almost sound too good to be true. What's the catch? Good money market funds really don't have a catch, but you need to know about one difference between bank accounts and money market mutual funds: Money market funds aren't insured (they were for a one-year period during the 2008–2009 financial crisis).

As I discuss earlier in this chapter, bank accounts come with FDIC insurance that protects your deposited money up to $250,000. So if a bank fails because it lends too much money to people and companies that go bankrupt or abscond with the funds, you should get your money back from the FDIC.

The lack of FDIC insurance on a money market fund shouldn't trouble you. Mutual fund companies can't fail because they have a dollar invested in securities for every dollar that you deposit in their money market funds. By contrast, banks are required to have available just a portion, such as 10 to 12 cents, for every dollar that you hand over to them (the exact amount depends on the type of deposit).

A money market fund's investments can decline slightly in value, which can cause the money market fund's share price to fall below a dollar. Cases have occurred where money market funds bought some bad investments (this happened more during the 2008–2009 financial crisis). However, in nearly every case, the parent company running the money market fund infused cash into the affected fund, thus enabling it to maintain the $1-per-share price.

The only money market funds that did "break the buck" didn't take in money from people like you or me but was run in one case by a bunch of small banks for themselves. This money market fund made some poor investments. The share price of the fund declined by 6 percent, and the fund owners decided to disband the fund; they didn't bail it out because they would only have been repaying themselves. In another case, a money market fund that took in money from institutions declined by 3 percent.

Stick with bigger mutual fund companies if you're worried about the lack of FDIC insurance. They have the financial wherewithal and the largest incentive to save a foundering money market fund. Fortunately, the bigger fund companies have the best money market funds anyway. You can find more details about money market funds in Chapter 8.

Why Bother with Bonds?

Conservative investors prefer bonds (that is, conservative when it comes to taking risk, not when professing their political orientation). Otherwise-aggressive investors who seek diversification or investments for shorter-term financial goals also prefer bonds. The reason? Bonds offer higher yields than bank accounts, usually without the volatility of the stock market.

Bonds are similar to CDs, except that bonds are securities that trade in the market with a fluctuating value. For example, you can purchase a bond, scheduled to mature five years from now, that a company such as the retailing behemoth Wal-Mart issues. A Wal-Mart five-year bond may pay you 5.25 percent interest. The company sends you interest payments on the bond for five years. And as long as Wal-Mart doesn't have a financial catastrophe, the company returns your original investment to you after the five years is up. So in effect, you're loaning your money to Wal-Mart (instead of the bank when you deposit money in a bank account).

> The worst that can happen to your bond investment is that Wal-Mart's business goes into a tailspin and the company ends up in financial ruin — also known as bankruptcy. If the company does go bankrupt, you may lose all your original investment and miss out on the remaining interest payments you were supposed to receive.

But bonds that high-quality companies such as Wal-Mart issue are quite safe — they rarely default. Besides, you don't have to invest all your money in just one or two bonds. If you own bonds in many companies and one bond unexpectedly takes a hit, it affects only a small portion of your portfolio. And unlike CDs, you can generally sell your bonds anytime you want at minimal cost. (Selling and buying most bond mutual funds costs nothing, as I explain in Chapter 8.) Bond investors accept the risk of default because bonds generally pay you more than bank savings accounts and money market mutual funds. But there's a catch. As I discuss later in this chapter, bonds are riskier than money market funds and savings accounts because their value can fall if interest rates rise. Plus you're forgoing the security of FDIC insurance (which bank accounts have). However, bonds tend to be more stable in value than stocks. (I cover the risks and returns of bonds and stocks in Chapter 2.) Investing in bonds is a time-honored way to earn a better rate of return on money that you don't plan to use within the next couple of years or more. As with stocks, bonds can generally be sold any day that the financial markets are open. Because their value fluctuates, though, you're more likely to lose money if you're forced to sell your bonds sooner rather than later. In the short term, if the bond market happens to fall and you need to sell, you could lose money. In the longer-term, as is the case with stocks, you're far less likely to lose money.

> Don't put your emergency cash reserve into bonds — that's what a money market fund or bank savings account is for. And don't put too much of your longer-term investment money into bonds, either. As I explain in Chapter 2, bonds are generally inferior investments for making your money grow. Growth-oriented investments, such as stocks, real estate, and your own business, hold the greatest potential to build real wealth.

The following list provides some common situations when investing in bonds can make sense:

- **You're looking to make a major purchase.** This purchase should be one that won't happen for at least two years, such as buying a home or some other major expenditure. Shorter-term bonds may work for you as a higher-yielding and slightly riskier alternative to money market funds.

- **You want to diversify your portfolio.** Bonds don't move in tandem with the performance of other types of investments, such as stocks. In fact, in a terrible economic environment (such as during the Great Depression in the early 1930s or the financial crisis of 2008), bonds may appreciate in value while riskier investments such as stocks plunge.

- **You’re interested in long-term investments.** You may invest some of your money in bonds as part of a longer-term investment strategy, such as for retirement. You should have an overall plan for how you want to invest your money, sometimes referred to as an *asset allocation strategy* (see Chapter 8). Aggressive, younger investors should keep less of their retirement money in bonds than older folks who are nearing retirement.
- **You need income-producing investments.** If you’re retired or not working, bonds can be useful because they’re better at producing current income than many other investments.

Assessing the Different Types of Bonds

Bonds differ from one another according to a number of factors — length to maturity, credit quality, and the entities that issue the bonds (the latter of which has associated tax implications that you need to be aware of). After you have a handle on these issues, you’re ready to consider investing in individual bonds and bond mutual funds.

Unfortunately, due to shady marketing practices by some investing companies and salespeople who sell bonds, you can have your work cut out for you while trying to get a handle on what many bonds really are and how they differ from their peers. But don’t worry. I help you wade through the muddy waters in the following sections.

Determining when you get your money back: Maturity matters

Maturity simply means the time at which the bond promises to pay back your principal — next year, in 7 years, in 15 years, and so on. You need to care about how long a bond takes to mature because a bond's maturity gives you a good (although far-from-perfect) sense of how volatile a bond may be if interest rates change. If interest rates fall, bond prices rise; if interest rates rise, bond prices fall. Longer-term bonds drop more in price when the overall level of interest rates rises.

Suppose you're considering investing in two bonds that the same organization issues, and both yield 7 percent. The bonds differ from one another only in when they will mature: One is a 2-year bond; the other is a 20-year bond. If interest rates were to rise just 1 percent (from 7 percent to 8 percent), the 2-year bond may decline about 2 percent in value, whereas the 20-year bond could fall approximately five times as much — 10 percent.

If you hold a bond until it matures, you get your principal back unless the issuer defaults. In the meantime, however, if interest rates rise, bond prices fall. The reason is simple: If the bond that you hold is issued at, say, 7 percent, and interest rates on similar bonds rise to 8 percent, no one (unless they don't know any better) wants to purchase your 7 percent bond. The value of your bond has to decrease enough so that it effectively yields 8 percent.

Bonds are generally classified by the length of time until maturity:

- **Short-term bonds** mature in the next few years.
- **Intermediate-term bonds** come due within three to ten years.
- **Long-term bonds** mature in more than 10 years and generally up to 30 years. Although rare, a number of companies issue 100-year bonds! A number of railroads did as well as Coca-Cola, Disney, IBM, the New York Port Authority, and the government of China! Such bonds are quite dangerous to

purchase, especially if they're issued during a period of relatively low interest rates.

Most of the time, longer-term bonds pay higher yields than short-term bonds. You can look at a chart of the current yield of similar bonds plotted against when they mature — such a chart is known as a *yield curve.* At most times, this curve slopes upward. Investors generally demand a higher rate of interest for taking the risk of holding longer-term bonds. (To see the current yield curve, visit my website at www.erictyson.com.) Weighing the likelihood of default

In addition to being issued for various lengths of time, bonds also differ from one another in the creditworthiness of the issuer. To minimize investing in bonds that default, purchase highly rated bonds. Credit rating agencies such as Moody's, Standard & Poor's, and Duff & Phelps rate the credit quality and likelihood of default of bonds.

The *credit rating* of a bond depends on the issuer's ability to pay back its debt. Bond credit ratings are usually done on some sort of a letter-grade scale where, for example, AAA is the highest rating and ratings descend through AA and A, followed by BBB, BB, B, CCC, CC, C, and so on. Here's the lowdown on the ratings: ✓**AAA-and AA-rated bonds** are considered *high-grade* or *high-credit quality bonds.* Such bonds possess little chance — a fraction of 1 percent — of default.

- ✓ **A-and BBB-rated bonds** are considered *investment-grade* or *general-quality bonds.*
- ✓ **BB-or lower-rated bonds** are known as *junk bonds* (or by their marketed name, *high-yield bonds*). Junk bonds, also known as *non-investment grade bonds,* are more likely to default — perhaps as many as a couple of percent per year actually default.

  Why would any sane investor buy a bond with a low credit rating? They may purchase one of these bonds because issuers pay a higher interest rate on lower-quality bonds to attract investors. The lower a bond's credit rating and quality, the higher the yield you can and should expect from such a bond. Poorer-quality bonds, though, aren't for the faint of heart because they're generally more volatile in value.

I don't recommend buying individual junk bonds — consider investing in these only through a well-run junk-bond fund.

Examining the issuers (and tax implications)

Bonds also differ from one another according to the type of organization that issues them — in other words, what kind of organization you lend your money to. The following sections go over the major options and tell you when each option may make sense for you.

Treasury bonds

Treasuries are IOUs from the U.S. government. The types of Treasury bonds include Treasury *bills* (which mature within a year), Treasury *notes* (which mature between one and ten years), and Treasury *bonds* (which mature in more than ten years). These distinctions and delineations are arbitrary — you don't need to know them for an exam.

Treasuries pay interest that's state-tax-free but federally taxable. Thus, they make sense if you want to avoid a high state-income-tax bracket but not a high federal-income-tax bracket. However, most people in a high state-income-tax bracket also happen to be in a high federal-income-tax bracket. Such high-tax-bracket investors may be better off in municipal bonds (explained in the next section), which are both federal-and state-income-tax-free (in their state of issuance).

> The best use of Treasuries is in place of bank CDs. If you feel secure with the federal government insurance (which is limited to $250,000) that a bank CD provides, check out a Treasury bond (which has the unlimited backing of the U.S. government). Treasuries that mature in the same length of time as a CD may pay the same or a better interest rate. Remember that bank CD interest is fully taxable, whereas a Treasury's interest is state-tax-free. Unless you really shop for a bank CD, you'll likely earn a lower return on a CD than on a Treasury. I explain how to purchase Treasury bonds in the section "Purchasing Treasuries," later in this chapter.

Municipal bonds

Municipal bonds are state and local government bonds that pay interest that's federal-tax-free and state-tax-free to residents in the state of issue. For example, if you live in California and buy a bond issued by a California government agency, you probably won't owe California state or federal income tax on the interest.

International bonds

You can buy bonds outside of the country that you call home. If you live in the United States, for example, you can buy most of the bonds that I describe in this chapter from foreign issuers as well. These bonds, called *international bonds,* are riskier to you because their interest payments can be offset by currency price changes.

The prices of international bonds tend not to move in tandem with U.S. bonds. International bond values benefit from and thus protect against a declining U.S. dollar and, therefore, offer some diversification value. Although the declining dollar during most of the 2000s boosted the return of international bonds, the U.S. dollar appreciated versus most currencies during the 1980s and 1990s, which lowered a U.S. investor's return on international bonds.

International bonds aren't a vital holding for a diversified portfolio. International bonds are generally more expensive to purchase and hold than comparable domestic bonds.

The government organizations that issue municipal bonds know that the investors who buy these bonds don't have to pay most or any of the income tax that is normally required on other bonds — which means that the issuing governments can pay a lower rate of interest.

If you're in a high tax bracket and want to invest in bonds outside of your tax-sheltered retirement accounts, you may end up with a higher after-tax yield from a municipal bond (often called *muni*) than a comparable bond that pays taxable interest. Compare the yield on a given municipal bond (or *muni bond fund*) to the after-tax yield on a comparable taxable bond (or *bond fund*).

Corporate bonds

Companies such as Boeing, Johnson & Johnson, and Sunoco issue corporate bonds. *Corporate bonds* pay interest that's fully taxable. Thus, they're appropriate for investing inside retirement accounts. Lower-tax-bracket investors should consider buying such bonds outside a tax-sheltered retirement account. (Higher-bracket investors should instead consider municipal bonds, which I discuss in the preceding section.) In the section "Understanding bond prices," later in this chapter, I show you how to read price listings for such bonds. If you buy corporate bonds through a well-managed mutual fund, an approach I advocate, you don't need to price such bonds.

Mortgage bonds

Remember that mortgage you took out when you purchased your home? Well, you can actually purchase a bond, naturally called a *mortgage bond,* to invest in a portfolio of mortgages just like yours! Many banks actually sell their mortgages as bonds in the financial markets, which allows other investors to invest in them. The repayment of principal on such bonds is usually guaranteed at the bond's maturity by a government agency, such as the Government National Mortgage Association (GNMA, also known as *Ginnie Mae*) or the Federal National Mortgage Association (FNMA, also known as *Fannie Mae*).

REMEMBER The vast majority of mortgage bonds are quite safe to invest in. The risky ones that were in the news in the late 2000s for defaulting were so-called subprime mortgages, which lacked government agency backing.

Convertible bonds

Convertible bonds are hybrid securities — they're bonds you can convert under a specified circumstance into a preset number of shares of stock in the company that issued the bond. Although these bonds do pay taxable interest, their yield is lower than nonconvertible bonds because convertibles offer you the upside potential of being able to make more money if the underlying stock rises.

Inflation-protected Treasury bonds

The U.S. government offers bonds called *Treasury inflation-protected securities* (TIPS). Compared with traditional Treasury bonds (which I discuss earlier in this chapter), the inflation-indexed bonds carry a lower interest rate. The reason for this lower rate is that the other portion of your return with these inflation-indexed bonds comes from the inflation adjustment to the principal you invest. The inflation portion of the return gets added back into principal.

For example, if inflation were 3 percent the first year you hold your inflation-indexed bond into which you invested $10,000, your principal would increase to $10,300 at the end of the first year.

What's appealing about these bonds is that no matter what happens with the rate of inflation, investors who buy inflation-indexed bonds always earn some return (the yield or interest rate paid) above and beyond the rate of inflation. Thus, holders of inflation-indexed Treasuries can't have the purchasing power of their principal or interest eroded by high inflation.

Because inflation-indexed Treasuries protect the investor from the ravages of inflation, they represent a less risky security. However, consider this little known fact: If the economy experiences *deflation* (falling prices), your principal isn't adjusted down so these bonds offer deflation protection as well. As I discuss in Chapter 2, lower risk usually translates into lower returns.

Zero coupon bonds

Some bonds that you may have heard of or are interested in have unusual features. For instance, not all bonds make regular interest payments. An example is a *zero coupon bond,* which is sold at a substantial discount to its future maturity value. Thus, an investor in a zero coupon bond implicitly earns interest if the value of the bond should rise over time to reach full value by maturity. Zero coupon bonds are highly sensitive to interest rate changes, which is why I don't generally recommend them.

Buying Bonds

You can invest in bonds in one of two major ways: You can purchase individual bonds, or you can invest in a professionally selected and managed portfolio of bonds via a bond mutual fund. (Newer *exchange-traded funds* are a twist on mutual funds. See Chapter 8.) In this section, I help you make the decision on how to invest in bonds. If you want to take the individual-bond route, I cover that path here, where I explain how to decipher bond listings you find in financial newspapers or online. I also explain the purchasing process for Treasuries (a different animal in that you can buy them directly from the government) and all other bonds. If you fall on the side of mutual funds, head to Chapter 8 for more information.

Deciding between individual bonds and bond mutual funds

Unless the bonds you're considering purchasing are easy to analyze and homogeneous (such as Treasury bonds), you're generally better off investing in bonds through a mutual fund. Here's why:

- **Diversification is more difficult with individual bonds.** You shouldn't put your money into a small number of bonds of companies in the same industry or that mature at the same time. It's difficult to cost-effectively build a diversified bond portfolio with individual issues unless you have a substantial amount of money ($1 million) that you want to invest in bonds.

- **Individual bonds cost you more money.** If you purchase individual bonds through a broker, you're going to pay a commission. In most cases, the commission cost is hidden — the broker quotes you a price for the bond that includes the commission. Even if you use a discount broker, these fees take a healthy bite out of your investment. The smaller the amount that you invest, the bigger the bite — on a $1,000 bond, the commission fee can equal several percent. Commissions take a smaller bite out of larger bonds — perhaps less than 0.5 percent if you use discount brokers.

On the other hand, investing in bonds through a mutual fund is cost effective. Great bond funds are yours for less than 0.5 percent per year in operating expenses. Selecting good bond funds isn't hard, as I explain in Chapter 8.

- **You've got better things to do with your time.** Do you really want to research bonds and go bond shopping? Bonds are boring to most people! And bonds and the companies that stand behind them aren't that simple to understand. For example, did you know that some bonds can be called before their maturity dates? Companies often *call* bonds (which means they repay the principal before maturity) to save money if interest rates drop significantly. After you purchase a bond, you need to do the same things that a good bond mutual fund portfolio manager needs to do, such as track the issuer's creditworthiness and monitor other important financial developments.

Understanding bond prices

Business-focused publications, such as *The Wall Street Journal,* provide daily bond pricing. You may also call a broker or browse websites to obtain bond prices. The following steps walk you through the bond listing for PhilEl (Philadelphia Electric) in Figure 7-1: **1. Bond name:** This column tells you who issued the bond. In this case, the issuer is a large utility company, Philadelphia Electric.

2. Funny numbers after the company name: The first part of the numerical sequence here — 7 1⁄8 — refers to the original interest rate (7.125 percent) that this bond paid when it was issued. This interest rate is known as the *coupon rate,* which is a percent of the maturity value of the bond. The second part of the numbers — 23 — refers to the year that the bond matures (2023, in this case).

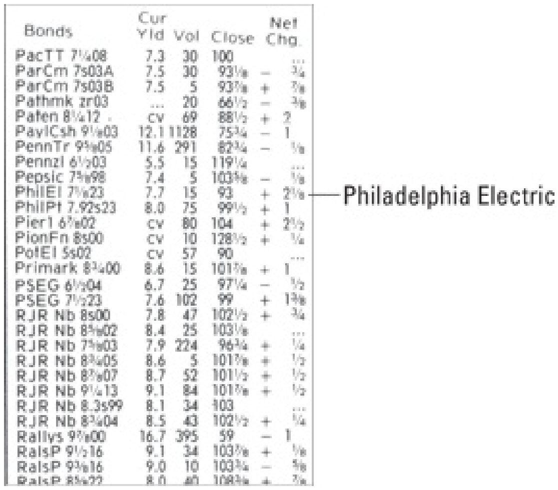
3. Current yield: Divide the interest paid, 7.125, by the current price per bond, $93, to arrive at the current yield. In this case, it equals (rounded off) 7.7 percent.

4. Volume: Indicates the number of bonds that traded on this day. In the case of PhilEl, 15 bonds were traded.

5. Close: Shows the last price that the bond traded at. The last PhilEl bond price is $93.

6. Change: Indicates how this day's close compares with the previous day's close. In the example figure, the bond rose 2 1⁄8 points. Some bonds don't trade all that often. Notice that some bonds were up and others were down on this particular day. The demand of new buyers and the supply of interested sellers influence the price movement of a given bond.

Figure 7-1: Sample bond listings.


Bonds	Cur Yld	Vol	Close	Net Chg.
PacTT 7¼08	7.3	30	100	...
ParCm 7s03A	7.5	30	93⅛	– ¾
ParCm 7s03B	7.5	5	93⅞	+ ⅞
Pathmk zr03	...	20	66½	– ⅜
Pafen 8¼12	cv	69	88½	+ 2
PaylCsh 9⅛03	12.1	1128	75¾	– 1
PennTr 9⅝05	11.6	291	82¾	– ⅛
Pennzl 6½03	5.5	15	119¼	...
Pepsic 7⅝98	7.4	5	103⅝	– ⅛
PhilEl 7⅛23	7.7	15	93	+ 2⅛
PhilPt 7.92s23	8.0	75	99½	+ 1
Pier1 6⅞02	cv	80	104	+ 2½
PionFn 8s00	cv	10	128½	+ ¼
PotEl 5s02	cv	57	90	...
Primark 8¾00	8.6	15	101⅞	+ 1
PSEG 6½04	6.7	25	97¼	– ½
PSEG 7½23	7.6	102	99	+ 1⅜
RJR Nb 8s00	7.8	47	102½	+ ¾
RJR Nb 8⅝02	8.4	25	103⅛	...
RJR Nb 7⅜03	7.9	224	96¾	+ ¼
RJR Nb 8¾05	8.6	5	101⅞	+ ½
RJR Nb 8⅞07	8.7	52	101½	+ ½
RJR Nb 9¼13	9.1	84	101⅞	+ ½
RJR Nb 8.3s99	8.1	34	103	...
RJR Nb 8¾04	8.5	43	102½	+ ¼
Rallys 9⅞00	16.7	395	59	– 1
RalsP 9½16	9.1	34	103⅞	+ ⅛
RalsP 9⅜16	9.0	10	103¾	– ⅝
RalsP 8⅝22	8.0	40	108⅜	+ ⅞

In addition to the direction of overall interest rates, changes in the financial health of the issuing entity company that stands behind the bond strongly affect the price of an individual bond.

Purchasing Treasuries

If you want to purchase Treasury bonds, buying them through the Federal Reserve is the lowest-cost method. The Federal Reserve doesn't charge for accounts with less than $100,000, and it charges $25 annually for accounts with more than $100,000 in Treasury bonds. Contact a Federal Reserve branch near you (check the government section of your local phone directory), and ask it to mail you information about how to purchase Treasury bonds through the Treasury Direct program. Or you can call 800-722-2678 or visit the U.S. Department of Treasury's website (www.treasurydirect.gov).

You may also purchase and hold Treasury bonds through brokerage firms and mutual funds. Brokers typically charge a flat fee for buying a Treasury bond. Buying Treasuries through a brokerage account makes sense if you hold other securities through the brokerage account and you like the ability to quickly sell a Treasury bond that you hold. Selling Treasury bonds held through the Federal Reserve is now much easier than it used to be. With a Treasury Direct account, you can sell online for $45 per transaction.

The advantage of a mutual fund that invests in Treasuries is that it typically holds Treasuries of differing maturities, thus offering diversification. You can generally buy and sell *no-load* (commission-free) Treasury bond mutual funds easily and without fees. Funds, however, do charge an ongoing management fee. (See Chapter 8 for my recommendations of Treasury mutual funds with good track records and low management fees.) Shopping for other individual bonds

Purchasing other types of individual bonds, such as corporate and mortgage bonds, is a much more treacherous and time-consuming undertaking than buying Treasuries. Here's my advice for doing it right and minimizing the chance of mistakes: **Don't buy through salespeople.** Brokerage firms that employ representatives on commission are in the sales business. Many of the worst bond-investing disasters have befallen customers of such brokerage firms. Your best bet is to purchase individual bonds through discount brokers (see Chapter 9).

- **Don't be suckered into high yields — buy quality.** Yes, junk bonds pay higher yields, but they also have a much higher chance of default. And did you know what a subprime mortgage was before it was all over the news in 2007 that defaults were on the rise? *Subprime mortgages* are mortgage loans made to borrowers with lower credit ratings who pay higher interest rates because of their higher risk of default. Nothing personal, but you're not going to do as good a job as a professional money manager at spotting problems and red flags. Stick with highly rated bonds so you don't have to worry about and suffer through these unfortunate consequences.

Assessing individual bonds that you already own

If you already own individual bonds, and they fit your financial objectives and tax situation, you can hold them until maturity because you already incurred a commission when they were purchased; selling them now would just create an additional fee. When the bonds mature, the broker who sold them to you will probably be more than happy to sell you some more. That's the time to check out good bond mutual funds (see Chapter 8).

Don't mistakenly think that your current individual bonds pay the yield that they had when they were originally issued. (That yield is the number listed in the name of the bond on your brokerage account statement.) As the market level of interest rates changes, the effective *yield* (the interest payment divided by the bond's price) on your bonds fluctuates to rise and fall with the market level of rates for similar bonds. So if rates have fallen since you bought your bonds, the value of those bonds has increased — which in turn reduces the effective yield that you're earning on your invested dollars.

- **Understand that bonds may be called early.** Many bonds, especially corporate bonds, can legally be called before maturity. In this case, the bond issuer pays you back early because it doesn't need to borrow as much money or because interest rates have fallen and the borrower wants to reissue new bonds at a lower interest rate. Be especially careful about purchasing bonds that were issued at higher interest rates than those that currently prevail. Borrowers pay off such bonds first.
- **Diversify.** Invest in and hold bonds from a variety of companies in different industries to buffer changes in the economy that adversely affect one industry or a few industries more than others. Of the money that you want to invest in bonds, don't put more than 5 percent into any one bond. So you need to hold at least 20 bonds. Diversification requires a good amount to invest given the size of most bonds and because trading fees erode your investment balance if you invest too little. If you can't achieve this level of diversification, use a bond mutual fund.
- **Shop around.** Just like when you buy a car, shop around for good prices on the bonds that you have in mind. The hard part is doing an apples-to-apples comparison because different brokers may not offer the same exact bonds as other brokers. Remember that the two biggest determinants of what a bond should yield are its maturity date and its credit rating (both of which I discuss earlier in this chapter).

Unless you invest in boring, simple-to-understand bonds such as Treasuries, you're better off investing in bonds via the best bond mutual funds. One exception is if you absolutely, positively must receive your principal back on a certain date. Because bond funds don’t mature, individual bonds with the correct maturity for you may best suit your needs. Consider Treasuries because they carry such low default risk. Otherwise, you need a lot of time, money, and patience to invest well in individual bonds.

Considering Other Lending Investments

Bonds, money market funds, and bank savings vehicles are hardly the only lending investments. A variety of other companies are more than willing to have you lend them your money and pay you a relatively fixed rate of interest. In most cases, though, you're better off staying away from the investments in the following sections.

Too many investors get sucked into lending investments that offer higher yields. Always remember: Risk and return go hand in hand. Higher yields mean greater risk, and vice versa.

Guaranteed-investment contracts

Insurance companies sell and back *guaranteed-investment contracts* (GICs). The allure of GICs is that your account value doesn't appear to fluctuate. Like a one-year bank certificate of deposit, GICs generally quote you an interest rate for the next year. Some GICs lock in the rate for longer periods of time, whereas others may change the interest rate several times per year.

But remember that the insurance company that issues the GIC does invest your money, mostly in bonds and maybe a bit in stocks. Like other bonds and stocks, these investments fluctuate in value — you just don't see it.

Typically once a year, you receive a new statement showing that your GIC is worth more, thanks to the newly added interest. This statement makes otherwise-nervous investors who can't stand volatile investments feel all warm and fuzzy.

The yield on a GIC is usually comparable to those available on shorter-term, high-quality bonds. Yet the insurer invests in longer-term bonds and some stocks. The difference between what these investments generate for the insurer and what the GIC pays you in interest goes to the insurer.

The insurer's take can be significant and is generally hidden. Unlike a mutual fund, which is required to report the management fee that it collects and subtracts before paying your return, GIC insurers have no such obligations. By having a return guaranteed in advance, you pay heavily — an effective fee of 2-plus percent per year — for the peace of mind in the form of lower long-term returns.

The high effective fees that you pay to have an insurer manage your money in a GIC aren't the only drawbacks. When you invest in a GIC, your assets are part of the insurer's general assets. Insurance companies sometimes fail, and although they often merge with a healthy insurer, you can still lose money. The rate of return on GICs from a failed insurance company is often slashed to help restore financial soundness to the company. So the only "guarantee" that comes with a GIC is that the insurer agrees to pay you the promised rate of interest (as long as it is able)!

Private mortgages

In the section "Mortgage bonds," earlier in this chapter, I discuss investing in mortgages that resemble the ones you take out to purchase a home. To directly invest in mortgages, you can loan your money to people who need money to buy or refinance real estate. Such loans are known as *private mortgages* or *second mortgages,* in the case where your loan is second in line behind someone's primary mortgage.

Private mortgage investments appeal to investors who don't like the volatility of the stock and bond markets and aren't satisfied with the seemingly low returns on bonds or other common lending investments. Private mortgages seem to offer the best of both worlds — stock-market-like, 10-plus percent returns without volatility.

Mortgage and real estate brokers often arrange mortgage investments, so you must tread carefully because these people have a vested interest in seeing the deal done. Otherwise, the mortgage broker doesn't get paid for closing the loan, and the real estate broker doesn't get a commission for selling a property.

One broker who also happens to write about real estate wrote a newspaper column describing mortgages as the "perfect real estate investment" and added that mortgages are a "high-yield, low-risk investment." If that wasn't enough to get you to whip out your checkbook, the writer/broker further gushed that mortgages are great investments because you have "little or no management, no physical labor."

Out of sight: Fluctuations of private mortgages,

GICs, and CDs

One of the allures of non-bond lending investments, such as private mortgages, GICs, and CDs, is that they don't fluctuate in value — at least not that you can see. Such investments appear safer and less volatile. You can't watch your principal fluctuate in value because you can't look up the value daily the way you can with bonds and stocks.

But the principal values of your mortgage, GIC, and CD investments really do fluctuate; you just don't see the fluctuations! As I explain in the section "Determining when you get your money back: Maturity matters," earlier in this chapter, just as the market value of a bond drops when interest rates rise, so does the market value of these investments (and for the same reasons). At higher interest rates, investors expect a discounted price on your fixed-interest rate investment because they always have the alternative of purchasing a new mortgage, GIC, or CD at the higher prevailing rates. Some of these investments are actually bought and sold (and behave just like bonds) among investors on what's known as a *secondary market.*

If the normal volatility of a bond's principal value makes you queasy, try not to follow your investments so closely!

You know by now that a low-risk, high-yield investment doesn't exist. Earning a relatively high interest rate goes hand in hand with accepting relatively high risk. The risk is that the borrower can default — which leaves you holding the bag. (In the mid-to late 2000s, mortgage defaults escalated significantly.) More specifically, you can get stuck with a property that you may need to foreclose on, and if you don't hold the first mortgage, you're not first in line with a claim on the property.

The fact that private mortgages are high risk should be obvious when you consider why the borrower elects to obtain needed funds privately rather than through a bank. Put yourself in the borrower's shoes. As a property buyer or owner, if you can obtain a mortgage through a conventional lender, such as a bank, wouldn't you do so? After all, banks generally give better interest rates. If a mortgage broker offers you a deal where you can, for example, borrow money at 11 percent when the going bank rate is, say, 7 percent, the deal must carry a fair amount of risk.

I would avoid private mortgages. If you really want to invest in such mortgages, you must do some time-consuming homework on the borrower's financial situation. A banker doesn't lend someone money without examining a borrower's assets, liabilities, and monthly expenses, and you shouldn't either. Be careful to check the borrower's credit, and get a large down payment (at least 20 percent). The best circumstance in which to be a lender is if you sell some of your own real estate and you're willing to act as the bank and provide the financing to the buyer in the form of a first mortgage.

Also recognize that your mortgage investment carries interest rate risk: If you need to "sell" it early, you'd have to discount it, perhaps substantially if interest rates have increased since you purchased it. Try not to lend so much money on one mortgage that it represents more than 5 percent of your total investments.

If you're willing to lend your money to borrowers who carry a relatively high risk of defaulting, consider investing in high-yield (junk) bond mutual funds instead. With these funds, you can at least diversify your money across many borrowers, and you benefit from the professional review and due diligence of the fund management team. You can also consider lending money to family members.

Chapter 12

Real Estate Financing and Deal Making

In This Chapter

- Selecting the best real estate investment financing
- Locating an excellent real estate agent
- Negotiating and inspecting your deals
- Making smart selling decisions

In this chapter, I discuss issues such as understanding and selecting mortgages, working with real estate agents, negotiating, and other important details that help you put a real estate deal together. I also provide some words of wisdom about taxes and selling your property that may come in handy down the road. (In Chapter 10, I cover what you need to know to purchase a home, and in Chapter 11, I review the fundamentals of investing in real estate.)

Financing Your Real Estate Investments

Unless you're affluent or buying a low-cost property, you likely need to borrow some money, via a mortgage, to make the purchase happen. Without financing, your dream to invest in real estate remains just that — a dream. So first you've got to maximize your chances of getting approved for a loan, which, unfortunately, has become tougher since the real estate market downturn in the late 2000s. Shopping wisely for a good mortgage can save you thousands, perhaps even tens of thousands, of dollars in extra interest and fees. Don't get saddled with a loan that you may not be able to afford someday and that could push you into foreclosure or bankruptcy.

Getting your loan approved

Even if you have perfect or near-perfect credit, you may encounter financing problems with some properties. And, of course, not all real estate buyers have a perfect credit history, tons of available cash, and no debt. Because of the soft real estate market in the late 2000s and the jump in foreclosures since that time, lenders tightened credit standards to avoid making loans to people likely to default. If you're one of those borrowers who ends up jumping through more hoops than others to get a loan, don't give up hope. Few borrowers are perfect from a lender's perspective, and many problems are fixable.

To head off any potential rejection before you apply for a loan, you can sometimes disclose to your lender anything that may cause a problem. For example, if you already know that your credit report indicates some late payments from when you were out of the country for several weeks five years ago, write a letter that explains this situation.

Solving down payment problems

Most people, especially when they make their first real estate purchase, are strapped for cash. In order to qualify for the most attractive financing, lenders typically require that your down payment be at least 20 percent of the property's purchase price. The best investment property loans sometimes require 25 to 30 percent down for the best terms. In addition, you need reserve money to pay for other closing costs, such as title insurance and loan fees.

If you don't have 20-plus percent of a property's purchase price available, don't despair. You can still own real estate with the following strategies:

- **Take out private mortgage insurance.** Some lenders may offer you a mortgage even though you can put down only, say, 10 percent of the purchase price. These lenders will likely require you to purchase *private mortgage insurance* (PMI) for your loan, however. This insurance generally costs a few hundred dollars per year and protects the lender if you default on your loan. (When you have at least 20 percent equity in the property, you can generally eliminate the PMI.)
- **Dip in to your retirement savings.** Some employers allow you to borrow against your retirement account balance under the condition that you repay the loan within a set number of years. Subject to eligibility requirements, first-time homebuyers can make penalty-free withdrawals of up to $10,000 from IRA accounts. (***Note:*** You still must pay regular income tax on the withdrawal.)
- **Postpone your purchase.** If you don't want the cost and strain of extra fees and bad mortgage terms, you can also postpone your purchase. Go on a financial austerity program

and boost your savings rate.

- **Consider lower-priced properties.** Lower-priced properties can help keep down the purchase price and the required down payment.
- **Find a partner.** Sharing the financial load with a partner often makes buying real estate easier. Just make sure you write up a legal contract to specify what happens if a partner wants out. Family members sometimes make good partners. Your parents, grandparents, and maybe even your siblings may have some extra cash they'd like to loan, invest, or even give to you as a gift!
- **Look into seller financing.** Some property owners or developers may finance your purchase with as little as 5 to 10 percent down. However, you can't be as picky about such seller-financed properties because a limited supply is available and many that are available need work or haven't yet sold for other reasons.

Improving your credit score

Late payments, missed payments, or debts that you never bothered to pay can tarnish your credit report and squelch a lender's desire to offer you a mortgage. If you're turned down for a loan because of your less-than-stellar credit history, find out the details of why by requesting (at no charge to you) a copy of your credit report from the lender that turned down your loan.

> If you think that your credit history may be a problem as you're looking for a loan, the first thing to do is get the facts. By law, you're entitled to one free credit report per year from each of the three consumer credit reporting companies — Equifax, Experian, and TransUnion. You can get all three reports at once or space them out throughout the year (checking in on one each at four-month intervals). The companies have set up one central website where you can access these reports (www.annualcreditreport.com), or you can call toll-free at 877-322-8228. Just be careful not to buy the credit services these companies will pitch you.

If you do find credit report problems, explain them to your lender. If the lender is unsympathetic, try calling other lenders. Tell them your credit problems upfront and see whether you can find one willing to offer you a loan. Mortgage brokers may also be able to help you shop for lenders in these cases. (I discuss working with mortgage brokers later in this chapter.)

Sometimes you may feel that you're not in control when you apply for a loan. In reality, however, you can fix a number of credit problems yourself, and you reap great rewards (access to better loan terms, including lower interest rates) for doing so. And you can often explain those that you can't fix. Remember that some lenders are more lenient and flexible than others. Just because one mortgage lender rejects your loan application doesn't mean that all the others will as well.

If you discover erroneous information on your credit report, get on the phone to the credit bureaus and start squawking. If specific creditors are the culprits, call them too. Keep notes from your conversations and make sure that you put your case in writing and add your comments to your credit report. If the customer service representatives you talk with are no help, send a letter to the president of each company. Let the head honcho know that his or her organization caused you problems in obtaining credit. For more information on examining and disputing items on your credit report and managing credit in general, check out the Federal Trade Commission's website at www.ftc.gov/credit.

Besides late or missed payments, another common credit problem is having too much consumer debt at the time you apply for a mortgage. The more consumer debt you rack up (including credit card and auto loan debt), the less mortgage credit you qualify for. If you're turned down for a mortgage, consider it a wake-up call to get rid of your high-cost debt. Hang on to the dream of buying real estate and plug away at paying off your debts before you attempt another foray into real estate.

To find out more about how credit scores work and techniques to improve yours, see the latest edition of my book *Personal Finance For Dummies* (John Wiley & Sons, Inc.).

Dealing with low appraisals

Even if you have sufficient income, a clean credit report, and an adequate down payment, a lender may deny your loan if the appraisal of the property that you want to buy comes in lower than you agreed to pay for the property.

If you still like the property, renegotiate a lower price with the seller by using the low appraisal to strengthen your case. If you encounter a low appraisal on a property that you already own and are refinancing, you need to follow a different path. If you have the cash available, you can simply put more money down to get the loan balance to a level for which you qualify. If you don’t have the cash, you may need to try another lender or forgo the refinance until you save more money or until the property value rises. (I discuss refinancing in more detail later in this chapter.)

Handling insufficient income

If you're self-employed or have changed jobs, your current income may not resemble your past income or, more importantly, your income may be below what a mortgage lender likes to see given the amount that you want to borrow. A way around this problem, although challenging, is to make a larger down payment.

> If you can't make a large down payment, another option is to get a cosigner for the loan. For example, your relatives may be willing to sign with you. As long as they aren't overextended themselves, they may be able to help you qualify for a larger loan than you can get on your own. As with partnerships, put your agreement in writing so that no misunderstandings occur.

Comparing fixed-rate to adjustable-rate mortgages

Two major types of mortgages exist: those with a fixed interest rate and those with an adjustable rate. Your choice depends on your financial situation, how much risk you're willing to accept, and the type of property you want to purchase. For example, obtaining a fixed-rate loan on a property that lenders perceive as a riskier investment is more difficult than getting an adjustable-rate mortgage for the same property.

Locking into fixed-rate mortgages

Fixed-rate mortgages, which are typically for a 15-or 30-year term, have interest rates that stay fixed or level — you lock in an interest rate that doesn't change over the life of your loan. Because the interest rate stays the same, your monthly mortgage payment stays the same. You have nothing complicated to track and no uncertainty. Fixed-rate loans give people peace of mind and payment stability.

Fixed-rate mortgages do, however, carry risks. If interest rates fall significantly after you obtain your mortgage and you're unable to refinance, you face the danger of being stuck with a higher-cost mortgage, which could be problematic if you lose your job or the value of your property decreases. (This scenario — declining interest rates and falling real estate values — happened to plenty of people in the late 2000s.) Even if you're able to refinance, you'll probably have to spend significant time and money to complete the paperwork.

Understanding adjustable-rate mortgages (ARMs)

In contrast to a fixed-rate mortgage, an *adjustable-rate mortgage* (ARM) carries an interest rate that varies over time (based on a formula the lender establishes). Such a mortgage begins with one interest rate, and you may pay different rates for every year, possibly even every month, that you hold the loan. Thus, the size of your monthly payment fluctuates. Because a mortgage payment makes a large dent in most property owners' checkbooks, signing up for an ARM without fully understanding it is fiscally foolish.

Beware of balloon loans

Balloon loans generally start the way traditional fixed-rate mortgages start. You make level payments based on a long-term payment schedule — over 15 or 30 years, for example. But at a predetermined time, usually within ten years from the loan's inception, the remaining loan balance becomes fully due.

Balloon loans may save you money because they have a lower interest rate than a longer-term fixed-rate mortgage and you pay that interest over a shorter period of time. However, balloon loans are dangerous — your financial situation can change, and you may not be able to refinance when your balloon loan is due. What if you lose your job or your income drops? What if the value of your property drops and the appraisal comes in too low to qualify you for a new loan? What if interest rates rise and you can't qualify at the higher rate on a new loan? You're still going to have to pay off your balloon loan when it comes due.

Sometimes, balloon loans may be the only option for the buyer (or so the buyer thinks). Buyers are more commonly backed into these loans during periods of high interest rates. When a buyer can't afford the payments on a conventional mortgage and really wants a particular property, a seller may offer a balloon loan.

Shun balloon loans. Consider a balloon loan if, and only if, such a loan is your only financing option, you've really done your homework to exhaust other financing alternatives, and you're certain that you can refinance when the balloon comes due. If you take a balloon loan, get one with as much time as possible, preferably ten years, before it becomes due.

The advantage of an ARM is that if you purchase your property during a period of higher interest rates, you can start paying your mortgage with a relatively low initial interest rate, compared with fixed-rate loans. (With a fixed-rate mortgage, a mortgage lender takes extra risk in committing to a fixed interest rate for 15 to 30 years. To be compensated for accepting this additional risk, lenders charge a premium with fixed-rate mortgages in case interest rates, which they have to pay on their source of funds in the form of deposits, move much higher in future years.) If interest rates decline, you can capture many of the benefits of lower rates without the cost and hassle of refinancing by taking out an ARM.

Choosing between fixed and adjustable mortgages

You can't predict the future course of interest rates. Even the professional financial market soothsayers and investors can't predict where rates are heading. If you could foretell interest rate movements, you could make a fortune investing in bonds and interest-rate futures and options. So cast aside your crystal ball and ask yourself the following two vital questions to decide whether a fixed or adjustable mortgage will work best for you.

How comfortable are you with taking risk?

How much of a gamble can you take with the size of your monthly mortgage payment? For example, if your job and income are unstable and you need to borrow an amount that stretches your monthly budget, you can't afford much risk. If you're in this situation, stick with fixed-rate mortgages because you likely won't be able to handle a large increase in interest rates and the payment on an ARM.

If, on the other hand, you're in a position to take the financial risks that come with an adjustable-rate mortgage, you have a better chance of saving money with an adjustable loan rather than a fixed-rate loan. Your interest rate starts lower and stays lower if the market level of interest rates remains unchanged. Even if rates go up, they'll likely come back down over the life of your loan. If you can stick with your adjustable-rate loan for better and for worse, you may come out ahead in the long run.

Adjustables also make more sense if you borrow less than you're qualified for. Or perhaps you regularly save a sizable chunk — more than 10 percent — of your monthly income. If your income significantly exceeds your spending, you may feel less anxiety about fluctuating interest rates. If you do choose an adjustable loan, you may be more financially secure if you have a hefty financial cushion (at least six months' to as much as a year's worth of expenses reserved) that you can access if rates go up.

Almost all adjustables limit, or cap, the rise in the interest rate that your loan allows. Typical caps are 2 percent per year and 6 percent over the life of the loan. Ask your lender to calculate the highest possible monthly payment that your loan allows. The number that the lender comes up with is the payment that you face if the interest rate on your loan goes to the highest level allowed, or the *lifetime cap.* If you can't afford the highest-allowed payment on an adjustable-rate mortgage, don't take one. You shouldn't take the chance that the rate may not rise that high — it can, and you could lose the property.

Don't take an adjustable mortgage because the lower initial interest rates allow you to afford the property that you want to buy (unless you're absolutely certain that your income will rise to meet future payment increases). Instead, try setting your sights on a property that you can afford to buy with a fixed-rate mortgage.

How many years do you expect to stay put?

Saving interest on most adjustables is usually a certainty in the first two or three years. By nature, an adjustable-rate mortgage starts at a lower interest rate than a fixed-rate mortgage. However, if rates rise while you hold an ARM, you can end up giving back the savings that you achieve in the early years of the mortgage.

If you aren’t going to keep your mortgage for more than five to seven years, you’ll probably end up paying more interest to carry a fixed-rate mortgage. Also consider a hybrid loan, which combines features of fixed-and adjustable-rate mortgages. For example, the initial rate may hold constant for several years and then adjust once a year or every six months thereafter. Such loans may make sense for you if you foresee a high probability of keeping your loan seven years or less but want some stability in your monthly payments. The longer the initial rate stays locked in, the higher the interest rate.

Landing a great fixed-rate mortgage

You may think that comparing one fixed-rate loan to another is quite simple because the interest rate on a fixed-rate loan is the rate that you pay every month over the entire life of the loan. And as with your golf score and the number of times that your boss catches you showing up late for work, a lower number (or interest rate) is better, right?

Unfortunately, banks generally charge an upfront interest fee, known as *points,* in addition to the ongoing interest over the life of the loan. Points are actually percentages: One point is equal to 1 percent of the loan amount. So when a lender tells you a quoted loan has 1.5 points, you pay 1.5 percent of the amount you borrow as points. On a $100,000 loan, for example, 1.5 points cost you $1,500. The interest rate on a fixed-rate loan must always be quoted with the points on the loan, if the loan has points.

You may want to take a higher interest rate on your mortgage if you don’t have enough cash to pay for a lot of points, which you pay upfront when you close the loan. On the other hand, if you’re willing and able to pay more points, you can lower your interest rate. You may want to pay more points because the interest rate on your loan determines your payments over a long period of time — 15 to 30 years.

Suppose that one lender quotes you a rate of 5.75 percent on a 30-year fixed-rate loan and charges one point (1 percent). Another lender, which quotes 6 percent for 30 years, doesn't charge any points. Which is better? The answer depends on how long you plan to keep the loan.

The 5.75 percent loan is 0.25 percent less than the 6 percent loan. However, it takes you about four years to earn back the savings to cover the cost of that point because you have to pay 1 percent (one point) upfront on the 5.75 percent loan. So if you expect to keep the loan more than four years, go with the 5.75 percent option. If you plan to keep the loan less than four years, go with the 6 percent option.

To make it easier to perform an apples-to-apples comparison of mortgages from different lenders, get interest rate quotes at the same point level. For example, ask each lender for the interest rate on a loan for which you pay one point. And, remember that if a loan has no points, it's sure to have a higher interest rate. I'm not saying that no-point loans are better or worse than comparable loans from other lenders. Just don't get sucked into a loan because of a no-points sales pitch. Lenders who spend big bucks on advertising these types of loans rarely have the best mortgage terms.

All things being equal, no-point loans make more sense for refinances because points aren't immediately tax-deductible as they are on purchases. (You can deduct the points that you pay on a refinance *only* over the life of the mortgage.) On a mortgage for a property that you're purchasing, a no-point loan may help if you're cash poor at closing.

Consider a no-point loan if you can't afford more out-of-pocket expenditures now or if you think that you'll keep the loan only a few years. Shop around and compare different lenders' no-point loans.

Finding a suitable adjustable-rate mortgage

Selecting an ARM has a lot in common with selecting a home to buy. You need to make trade-offs and compromises. In the following sections, I explain the numerous features and options — *caps, indexes, margins,* and *adjustment periods* — that you find with ARMs (these aren't issues with fixed-rate loans).

Getting off to a good start rate

Just as the name implies, your *start rate* is the rate that your adjustable mortgage begins with. Think of the start rate as a teaser rate — the initial rate on ARMs is often set artificially low to entice you. Don't judge an ARM by this rate alone. You won't pay this attractively low rate for long. With ARMs, interest rates generally rise as soon as the terms of the mortgage allow. Even if the market level of interest rates doesn't change, your adjustable rate is destined to increase. An increase of one or two percentage points is common.

The formula for determining the rate caps and the future interest rates on an adjustable-rate mortgage (see the following section) are far more important in determining what a mortgage will cost you in the long run. For more on rate caps, see the section "Analyzing adjustments," later in this chapter.

Determining your future interest rate

The first thing you need to ask a mortgage lender or broker about an adjustable rate is the exact formula they use for determining the future interest rate on your particular loan. You need to know how a lender figures your interest rate changes over the life of your loan. All adjustables are based on the following general formula, which specifies how the interest rate is set on your loan in the future:

index + margin = interest rate

The *index* determines the base level of interest rates that the mortgage contract specifies in order to calculate the specific interest rate for your loan. Indexes are generally (but not always) widely quoted in the financial press.

For example, suppose that the current index value for a given loan is equal to the six-month treasury bill index, which is, say, 2 percent. The *margin* is the amount added to the index to determine the interest rate that you pay on your mortgage. Most loans have margins of around 2.5 percent. Thus, the rate of a mortgage driven by the following formula

6-month Treasury bill rate + 2.5 percent

is set at 2 + 2.5 = 4.5 percent. This figure is known as the *fully indexed rate.* If the advertised start rate for this loan is just 3 percent, you know that if the index (six-month treasuries) stays at the same level, your loan will increase to 4.5 percent.

Compare the fully indexed rate to the current rate for fixed-rate loans. During particular time periods, you may be surprised to discover that the fixed-rate loan is at about the same interest rate or even a tad lower. This insight may cause you to reconsider your choice of an adjustable-rate loan, which can, of course, rise to an even higher rate in the future.

Looking at common indexes for adjustable-rate mortgages

The different indexes vary mainly in how rapidly they respond to changes in interest rates. Some common indexes include the following:

- **Treasury bills:** *Treasury bills,* which are often referred to as T-bills, are IOUs (bonds) that the U.S. government issues. Most adjustables are tied to the interest rate on 6-month or 12-month T-bills. T-bill interest rates move relatively quickly.
- **Certificates of deposit:** *Certificates of deposit,* or CDs, are interest-bearing bank investments that lock you in for a specific period of time. ARMs are usually tied to the average interest rate that banks are currently paying on six-month CDs. Like T-bills, CDs tend to respond quickly to changes in the market's level of interest rates.
- **The 11th District cost of funds:** The *cost of funds index* (COFI) is among the slower-moving indexes. Adjustable-rate mortgages tied to the 11th District (a Western region of several states) cost of funds index tend to start out at a higher interest rate. A slower-moving index has the advantage of moving up less quickly when rates are on the rise. On the other hand, you have to be patient to benefit from falling interest rates.

If you select an adjustable-rate mortgage that's tied to one of the faster-moving indexes, you take on more of a risk that the next adjustment may reflect interest rate increases. Because you take on more of the risk that interest rates may increase, lenders cut you breaks in other ways, such as through lower caps or points. If you want the security of an ARM tied to a slower-moving index, you pay for that security in one form or another, such as through a higher start rate, caps, margin, or points.

Trying to predict interest rates is risky business. When selecting a mortgage, keeping sight of your own financial situation is far more important than trying to guess future interest rates.

Analyzing adjustments

After the initial interest rate expires, the interest rate on an ARM fluctuates based on the loan formula that I discuss earlier in the chapter. Most ARMs adjust every 6 or 12 months, but some may adjust as frequently as monthly. In advance of each adjustment, the lender sends you a notice telling you your new rate.

All things being equal, the less frequently your loan adjusts, the less financial uncertainty you have in your life. However, less-frequent adjustments usually have a higher starting interest rate.

Almost all adjustables come with an *adjustment cap,* which limits the maximum rate change (up or down) at each adjustment. On most loans that adjust every six months, the adjustment cap is 1 percent. In other words, the interest rate that the loan charges can move up or down no more than one percentage point in a given adjustment period.

Loans that adjust more than once per year usually limit the maximum rate change that's allowed over the entire year as well. On the vast majority of such loans, 2 percent is the annual rate cap. Likewise, almost all adjustables come with *lifetime caps.* These caps limit the highest rate allowed over the entire life of the loan. It's common for adjustable loans to have lifetime caps 5 to 6 percent higher than the initial start rate.

Never take an ARM without rate caps! Doing so is worse than giving a credit card with an unlimited line of credit to your teenager for the weekend — at least you get the credit card back on Monday! When you want to take an ARM, you must identify the maximum payment that you can handle. If you can't handle the highest allowed payment, don't look at ARMs.

Avoiding negative amortization ARMs

As you make mortgage payments over time, the loan balance you still owe is gradually reduced or *amortized. Negative amortization* — increasing your loan balance — is the reverse of this process. Some ARMs allow negative amortization. How can your outstanding loan balance grow when you continue to make mortgage payments? This phenomenon occurs when your mortgage payment is less than it really should be.

Some loans cap the increase of your monthly payment but don't cap the interest rate. Thus, the size of your mortgage payment may not reflect all the interest that you owe on your loan. So rather than paying the interest that you owe and paying off some of your loan balance (or principal) every month, you end up paying off some, but not all, of the interest that you owe. Thus, lenders add the extra, unpaid interest that you still owe to your outstanding debt.

Negative amortization resembles paying only the minimum payment that your credit card bill requires. You continue to rack up finance charges (in this case, greater interest) on the balance as long as you make only the artificially low payment. Taking a loan with negative amortization defeats the whole purpose of borrowing an amount that fits your overall financial goals.

Avoid adjustables with negative amortization. Most lenders and mortgage brokers aren't forthcoming about telling you, so the only way to know whether a loan includes negative amortization is to explicitly ask. You find negative amortization more frequently on loans that lenders consider risky. If you have trouble finding lenders that will deal with your financial situation, make sure you're especially careful.

Examining other mortgage fees

In addition to points and the ongoing interest rate, lenders tack on all sorts of other upfront charges when processing your loan. Get an itemization of these other fees and charges in writing from all lenders that you're seriously considering. (I explain how to find the best lenders for your needs in the next section.) You need to know the total of all lender fees so you can accurately compare different lenders' loans and determine how much closing on your loan will cost you. These other mortgage fees can pile up in a hurry. Here are the common ones you may see:

- **Application and processing fees:** Most lenders charge a few hundred dollars to work with you to complete your paperwork and funnel it through their loan evaluation process. If your loan is rejected, or if it's approved and you decide not to take it, the lender needs to cover its costs. Some lenders return this fee to you upon closing with their loan.
- **Credit report charge:** Most lenders charge you for the cost of obtaining your credit report, which tells the lender whether you've repaid other loans on time. Credit report fees typically run about $20.
- **Appraisal fee:** The property for which you borrow money needs to be valued. If you default on your mortgage, a lender doesn't want to get stuck with a property that's worth less than you owe. The cost for an appraisal typically ranges from several hundred dollars for most residential properties to as much as $1,000 or more for larger investment properties.

Some lenders offer loans without points or other lender charges. However, remember that if they don't charge points or other fees, they charge a higher interest rate on your loan to make up the difference. Such loans may make sense for you when you lack the cash to close a loan or when you plan to keep the loan for just a few years.

To minimize your chances of throwing money away applying for a loan that you may not qualify for, ask the lender whether he sees any reason your loan request may be denied. (Also consider getting pre-approved.) Be sure to disclose any problems on your credit report or any problems with the property that you're aware of. Lenders may not take the time to ask about these sorts of things in their haste to get you to complete their loan applications.

Finding the best lenders

You can easily save thousands of dollars in interest charges and other fees if you shop around for a mortgage deal. It doesn’t matter whether you do so on your own or hire someone to help you, but you definitely should shop because a lot of money is at stake!

Shopping through a mortgage broker

A competent mortgage broker can be a big help in getting you a good loan and closing the deal, especially if you're too busy or disinterested to dig for a good deal on a mortgage. A good mortgage broker also stays abreast of the many different mortgages in the marketplace. She can shop among lots of lenders to get you the best deal available. The following list presents some additional advantages to working with a mortgage broker:

- An organized and detail-oriented mortgage broker can help you through the process of completing all those tedious documents that lenders require.
- Mortgage brokers can help polish your loan package so the information you present is favorable yet truthful.
- The best brokers can help educate you about various loan options and the pros and cons of available features.

Be careful when you choose a mortgage broker, because some brokers are lazy and don't shop the market for the best current rates. Even worse, some brokers may direct their business to specific lenders so they can take a bigger cut or commission.

A mortgage broker typically gets paid a percentage, usually 0.5 to 1 percent, of the loan amount. This commission is completely negotiable, especially on larger loans that are more lucrative. So be sure to ask what the commission is on loans that a broker pitches. Some brokers may be indignant that you ask — that's their problem. You have every right to ask. After all, it's your money.

Even if you plan to shop on your own, talking to a mortgage broker may be worthwhile. At the very least, you can compare what you find with what brokers say they can get for you. But, again, be careful. Some brokers tell you what you want to hear — that they can beat your best find — and then can't deliver when the time comes.

If your loan broker quotes you a really good deal, ask who the lender is. (However, do be aware that most brokers refuse to reveal this information until you pay the necessary fee to cover the appraisal and credit report.) You can then check with the actual lender to verify the interest rate and points that the broker quotes you and make sure that you're eligible for the loan.

Shopping by yourself

Many mortgage lenders compete for your business. Although having a large number of lenders to choose from is good for keeping interest rates lower, it also makes shopping a chore, especially if you're going it alone (instead of using a broker). But there's no substitute for taking the time to speak with numerous lenders and exploring the range of options.

Real estate agents may refer you to lenders with whom they've done business. Just keep in mind that those lenders won't necessarily offer the most competitive rates — the agent simply may have done business with them in the past or received client referrals from them.

> You can start searching for a good deal by looking in the real estate section of a large, local Sunday newspaper for charts of selected area lender interest rates. You also can visit Internet sites that advertise rates. However, newspaper tables and Internet sites are by no means comprehensive or reflective of the best rates available. In fact, many of these rates are sent to newspapers for free by firms that distribute mortgage information to mortgage brokers. Use them as a starting point and then call the lenders that list the best rates.

Refinancing for a better deal

When you buy a property, you take out a mortgage based on your circumstances and available loan options at that time. But things change. Maybe interest rates have dropped, or you have access to better loan options now than when you first purchased. Or perhaps you want to tap into some of your real estate equity for other investments.

If interest rates drop and you’re able to refinance, you can lock in interest rate savings. But getting a lower interest rate than the one you got when you took out your original mortgage isn’t reason enough to refinance your mortgage. When you refinance a mortgage, you have to spend money and time to save money. So you need to crunch a few numbers to determine whether refinancing makes sense for you.

> Calculate how many months it will take you to recoup the costs of refinancing, such as appraisal costs, loan fees and points, title insurance, and so on. You also have to consider tax issues. For example, if the refinance costs you $2,000 to complete and reduces your monthly payment by $100, it may appear that you can recoup the cost of the refinance in 20 months. However, because you lose some tax write-offs if you reduce your mortgage interest rate and payment, you can’t simply look at the reduced amount of your monthly payment.

If you want a better estimate but don’t want to spend hours crunching numbers, take your tax rate as specified in Chapter 3 (for example, 28 percent) and reduce your monthly payment savings on the refinance by this amount. That means, continuing with the preceding example, that if your monthly payment drops by $100, you’re actually saving only around $72 a month after you factor in the lost tax benefits. So it takes about 28 months ($2,000 divided by

$72), not 20 months, to recoup the refinance costs.

Consider refinancing when you can recover the costs of the refinance within a few years or less and you don't plan to move in that time frame. If it takes longer to recoup the refinance costs, refinancing may still make sense if you anticipate keeping the property and mortgage that long. If you estimate that breaking even will take more than five to seven years, refinancing is probably too risky to justify the costs and hassles.

When to consider a home equity loan

Home equity loans, also known as *second mortgages,* allow you to borrow against the equity in your home in addition to the mortgage that you already have (a first mortgage).

A home equity loan may benefit you if you need more money for just a few years or if your first mortgage is at such a low interest rate that refinancing it to get more cash would be too costly. Otherwise, I advise you to avoid home equity loans.

If you need a larger mortgage, why not refinance the first one and wrap it all together? Home equity loans have higher interest rates than comparable first mortgages because they're riskier from a lender's perspective. They're riskier because the first mortgage lender gets first claim against your property if you file bankruptcy or you default on the mortgage.

Interest on home mortgage loans of up to $1 million (first or second residences) is tax-deductible for loans taken out after October 13, 1987. (Loans taken before that date have no monetary limit.) Interest deduction on home equity loans is limited to the first $100,000 of such debt.

Refinancing a piece of real estate that you own to pull out cash for some other purpose can make good financial sense because under most circumstances, mortgage interest is tax-deductible. Perhaps you want to purchase another piece of real estate, start or purchase a business, or get rid of an auto loan or some high-cost credit card debt. The interest on consumer debt isn't tax-deductible and is usually at a much higher interest rate than what mortgage loans charge you.

Be careful that you don't borrow more than you need to accomplish your financial goals. For example, just because you can borrow more against the equity in your real estate doesn't mean you should do so to buy an expensive new car or take your dream vacation.

Working with Real Estate Agents

If you're like most people, when you purchase real estate, you enlist the services of a real estate agent. A good agent can help screen property so you don't spend all your free time looking at potential properties, negotiating a deal, helping coordinate inspections, and managing other preclosing items.

Recognizing agent conflicts of interest

All real estate agents (good, mediocre, and awful) are subject to a conflict of interest because of the way they're compensated — on commission. I respect real estate agents for calling themselves what they are. They don't hide behind an obscure job title, such as "shelter consultant." (Many financial "planners," "advisors," or "consultants," for example, actually work on commission and sell investments and life insurance and, therefore, are really stockbrokers and insurance brokers, not planners or advisors.)

Real estate agents aren't in the business of providing objective financial counsel. Just as car dealers make their living selling cars, real estate agents make their living selling real estate. Never forget this fact as a buyer.

The pursuit of a larger commission may encourage an agent to get you to do things that aren't in your best interest, such as the following:

- **Buy, and buy sooner rather than later:** If you don't buy, your agent doesn't get paid for all the hours she spends working with you. The worst agents fib and use tricks to motivate you to buy. They may say, for example, that other offers are coming in on a property that interests you, or they may show you a bunch of dumps and then one good listing to motivate you to buy the nicer property.
- **Spend more than you should:** Because real estate agents get a percentage of the sales price of a property, they have a built-in incentive to encourage you to spend more on a property than what fits comfortably with your other financial objectives and goals. An agent doesn't have to consider or care about your other financial needs.

- **Purchase their company's listings:** Agents also have a built-in incentive (higher commission) to sell their own listings. So don't be surprised when an agent pushes you in the direction of one of her own company's properties.
- **Buy in their territory:** Real estate agents typically work a specific territory. As a result, they usually can't objectively tell you the pros and cons of the surrounding region.
- **Use people who scratch their backs:** Some agents refer you to mortgage brokers, lenders, inspectors, and title insurance companies that have referred customers to them. Some agents also solicit and receive referral fees (or bribes) from mortgage lenders, inspectors, and contractors to whom they refer business.

Picking out a good agent

A mediocre, incompetent, or greedy agent can be a real danger to your finances. Whether you’re hiring an agent to work with you as a buyer or as a seller, you want someone who’s competent and with whom you can get along. Working with an agent costs a good deal of money, so make sure you get your money’s worth out of him.

Interview several agents and check references. Ask agents for the names and phone numbers of at least three clients with whom they’ve worked in the past six months in the geographical area in which you’re looking. By narrowing the period during which they worked with these references, you maximize the chances of speaking with clients other than the agent’s all-time-favorite clients.

As you speak with an agent’s references, ask about these traits in any agent that you’re considering working with, whether as a buyer or as a seller:

- **Full-time employment:** Some agents work in real estate as a second or even third job. Information in this field changes constantly, so keeping track of it is difficult enough on a full-time basis. It’s hard to imagine a good agent being able to stay on top of the market while moonlighting elsewhere.
- **Experience:** Hiring someone with experience doesn’t necessarily mean looking for an agent who’s sold real estate for decades. Many of the best agents come into the field from other occupations, such as business and teaching. Agents can acquire some sales, marketing, negotiation, and communication skills in other fields. However, keep in mind that some experience in real estate does count.
- **Honesty and integrity:** You need to trust your agent with a

lot of information. If the agent doesn't level with you about what a neighborhood or particular property is really like, you suffer the consequences.

- **Interpersonal skills:** An agent must get along not only with you but also with a whole host of other people who are involved in a typical real estate deal: other agents, property sellers, inspectors, mortgage lenders, and so on. An agent needs to know how to put your interests first without upsetting others.
- **Negotiation skills:** Putting a real estate deal together involves negotiation. Is your agent going to exhaust all avenues to get you the best deal possible? Most people don't like the sometimes aggravating process of negotiation, so they hire someone else to do it for them. Be sure to ask the agent's former client references how the agent negotiated for them.
- **High quality standards:** Sloppy work can lead to big legal or logistical problems down the road. If an agent neglects to recommend an inspection, for example, you may get stuck with undiscovered problems after the deal is done and paid for.

Agents who pitch themselves as buyers' brokers claim that they work for your interests. However, agents who represent you as a buyer's broker still get paid only when you buy. And agents still get paid a commission that's a percentage of the purchase price. So they still have an incentive to sell you a piece of real estate that's more expensive because their commission increases.

BEWARE

Some agents market themselves as *top producers,* meaning that they sell a relatively larger volume of real estate. This title doesn't matter much to you, the buyer. In fact, you may use this information as a potential red flag for an agent who focuses on completing as many deals as possible. Such an agent may not be able to give you the time and help that you need to get the house you want.

When you buy a home, you need an agent who is patient and allows you the necessary time to educate yourself and who helps you make the decision that's best for you. The last thing you need is an agent who tries to push you into making a deal.

You also need an agent who's knowledgeable about the local market and community. If you want to buy a home in an area where you don't currently live, an informed agent can have a big impact on your decision.

Finding an agent with financing knowledge is a plus for buyers, especially first-time buyers or those with credit problems. Such an agent may be able to refer you to lenders that can handle your type of situation, which can save you a lot of legwork.

Buying without a real estate agent

You can purchase property without an agent if you're willing to do some additional legwork. You need to do the things that a high-quality real estate agent does, such as searching for properties, scheduling appointments to see those properties, determining fair market value, negotiating the deal, and coordinating inspections.

If you don't work with an agent, have a real estate attorney review the various contracts. Having someone else not vested in the transaction look out for your interests helps your situation. Real estate agents generally aren't legal experts, so getting legal advice from an attorney is generally better. (In fact, in some states, you need to hire an attorney in addition to the real estate agent.)

One possible drawback to working without an agent is performing the negotiations yourself. Negotiating can be problematic if you lack these skills or get too caught up emotionally in the situation.

Closing the Deal

After you locate a property that you want to buy and you understand your financing options, the real fun begins. At this point, you have to put the deal together. The following sections discuss key things to keep in mind.

Negotiating 101

When you work with an agent, she usually carries the burden of the negotiation process. But even if you delegate that responsibility to your agent, you still should have a strategy in mind. Otherwise, you may overpay for real estate. Here's what you should do:

- **Find out about the property and the owner before you make your offer.** How long has the property been on the market? What are its flaws? Why is the owner selling? The more you understand about the property you want to buy and the seller's motivations, the better your ability to draft an offer that meets everyone's needs. Some listing agents love to talk and will tell you the life history of the seller. Either you or your agent may be able to get a listing agent to reveal helpful information about the seller.
- **Bring facts to the bargaining table. Get comparable sales data to support your price.** Too often, homebuyers and their agents pick a number out of the air when they make an offer. If you were the seller, would you be persuaded to lower your asking price? Pointing to recent and comparable home sales to justify your offer price strengthens your case.

  Price is only one of several negotiable items. Sometimes sellers fixate on selling their homes for a certain amount. Perhaps they want to get at least what they paid for it several years ago. You may get a seller to pay for certain repairs or improvements or to offer you an attractive loan without all the extra fees that a bank charges. Also, be aware that the time for closing on the purchase is a bargaining point. Some sellers may need cash fast and may concede other terms if you can close quickly. Likewise, the real estate agent's commission is negotiable.

- **Try to leave your emotions out of any property purchase.** Being objective rather than emotional regarding a purchase is easier said than done, and it's hardest to do when buying a home in which you'll live. So do your best not to fall in love with a property. Keep searching for other properties even when you make an offer because you may be negotiating with an unmotivated seller.

Inspecting the property

Unless you've built homes and other properties and performed contracting work yourself, you probably have no idea what you're getting yourself into when it comes to furnaces and termites.

Spend the money and take the time to hire inspectors and other experts to evaluate the major systems and potential problem areas of the home. Because you can't be certain of the seller's commitment, I recommend that you do the inspections *after* you've successfully negotiated and signed a sales contract. Even though you won't have the feedback from the inspections to help with this round of negotiating, you can always go back to the seller with the new information. Make your purchase offer contingent on a satisfactory inspection.

Hire people to help you inspect the following features of the property:

- Overall condition of the property (for example, look for peeling paint, level floors, appliances that work properly, and so on)
- Electrical, heating and air conditioning, and plumbing systems
- Foundation
- Roof
- Pest control and dry rot
- Seismic/slide/flood risk

With multiunit rental property, be sure to read Chapter 11 for other specifics that you need to check out, such as parking.

Inspection fees often pay for themselves. If you uncover problems that you weren't aware of when you negotiated the original purchase price, the inspection reports give you the information you need to go back and ask the property seller to fix the problems or reduce the property's purchase price.

Never accept a seller's inspection report as your only source of information. When a seller hires an inspector, he may hire someone who isn't as diligent and critical of the property. Review the seller's inspection reports if available, but also get your own evaluation. Also, beware of inspectors who are popular with real estate agents. They may be popular because they don't bother to document all the property's problems.

As with other professionals whose services you retain, interview a few different inspection companies. Ask which systems they inspect and how detailed a report they can prepare for you. Consider asking the company that you're thinking of hiring for customer references. Ask for names and phone numbers of three people who used the company's services within the past six months. Also request from each inspection company a sample of one of its reports.

The day before you close on the purchase, take a brief walk-through of the property to make sure that everything is still in the condition it was before and that all the fixtures, appliances, curtains, and other items the contract lists are still there. Sometimes, sellers ignore or don't recall these things, and consequently, they don't leave what they agreed to leave in the sales contract.

Shopping for title insurance and escrow services

Mortgage lenders require *title insurance* to protect against someone else claiming legal title to your property. For example, when a husband and wife split up, the one who remains in the home may decide to sell and take off with the money. If the title lists both spouses as owners, the spouse who sells the property (possibly by forging the other's signature) has no legal right to do so. The other spouse can come back and reclaim rights to the home even after it has been sold. In this event, both you and the lender can get stuck holding the bag. (If you're in the enviable position of paying cash for a property, buying title insurance is still wise to protect your investment, even though a mortgage lender won't prod you to do so.)

> Title insurance and escrow charges vary from company to company. (*Escrow charges* pay for neutral third-party services to ensure that the instructions of the purchase contract or refinance are fulfilled and that everyone gets paid.) Don't simply use the company that your real estate agent or mortgage lender suggests — shop around. When you call around for title insurance and escrow fee quotes, make sure that you understand all the fees. Many companies tack on all sorts of charges for things such as courier fees and express mail. If you find a company with lower prices and want to use it, consider asking for an itemization in writing so you don't receive any unpleasant surprises.

An insurance company's ability to pay claims is always important. Most state insurance departments monitor and regulate title insurance companies. Title insurers rarely fail, and most state departments of insurance do a good job of shutting down financially unstable ones. Check with your state's department if you're concerned. You can also ask the title insurer for copies of its ratings from insurance-rating agencies.

Selling Real Estate

Buying and holding real estate for the long term really pays off. If you do your homework, buy in a good area, and work hard to find a fairly priced or underpriced property, why sell it quickly and incur all the selling costs, time, and hassle to locate and negotiate another property to purchase (and a seller to buy your current property)?

Some real estate investors like to buy properties in need of improvement, fix them up, and then sell them and move on to another. Unless you're a contractor or experienced real estate investor and have a real eye for this type of work, don't expect to make a windfall or even to earn back more than the cost of the improvements. The process of buying, fixing, and flipping can be profitable, but it's not as easy as the home-improvement television shows and some books would have you believe. In fact, it's more likely that you'll erode your profit through the myriad costs of frequent buying and selling. The vast majority of your profits should come from the long-term appreciation of the overall real estate market in the communities in which you own property.

Use the reasons that you bought in an area as a guide if you think you want to sell. Use the criteria that I discuss in Chapter 11 as a guideline. For example, if the schools in the community are deteriorating and the planning department is allowing development that will hurt the value of your property and the rents that you can charge, you may have cause to sell. Unless you see significant problems like these in the future, holding good properties over many years is a great way to build your wealth and minimize transaction costs.

Negotiating real estate agents’ contracts

Most people use an agent to sell real estate. As I discuss in “Picking out a good agent,” earlier in this chapter, selling and buying a home demand agents with different strengths. When you sell a property, you want an agent who can get the job done efficiently and for as high a sales price as possible.

As a seller, seek agents who have marketing and sales expertise and who are willing to put in the time and money necessary to sell your house. Don’t be impressed by an agent just because she works for a large company. What matters more is what the agent can do to market your property.

When you list a property for sale, the contract that you sign with the listing agent includes specification of the commission that you pay the agent if she succeeds in selling your property. In most areas of the country, agents usually ask for a 6 percent commission for single-family homes. In an area that maintains lower-cost housing, agents may ask for 7 percent. For small multifamily properties and commercial properties, commissions often hover around the 3 to 5 percent range.

Regardless of the commission an agent says is “typical,” “standard,” or “what my manager requires,” always remember that you can negotiate commissions. Because the commission is a percentage, you have a much greater ability to get a lower commission on a higher-priced property. If an agent makes 6 percent selling both a \$200,000 and a \$100,000 property, the agent makes twice as much on the \$200,000 property. Yet selling the higher-priced property doesn’t usually take twice as much work.

If you live in an area with generally higher-priced properties, you may be able to negotiate a 5 percent commission. For really expensive properties, a 4 percent commission is reasonable. You may find, however, that your ability to negotiate a lower commission is greatest when an offer is on the table. Because of the cooperation of agents who work together through the multiple listing service (MLS), if you list your real estate for sale at a lower commission than most other properties, some agents won't show it to prospective buyers. For this reason, you're better off having your listing agent cut his take instead of cutting the commission that you pay to a real estate agent who brings a buyer for your property.

In terms of the length of the listing agreement, three months is reasonable. If you give an agent too long to list your property (6 to 12 months), the agent may simply toss your listing into the multiple listing database and not expend much effort to get your property sold. Practically speaking, you can fire your agent whenever you want, regardless of the length of the listing agreement, but a shorter listing may motivate your agent more.

Forgoing a real estate agent

The temptation to sell real estate without an agent is usually to save the commission that an agent deducts from your property's sale price. If you have the time, energy, and marketing experience, you can sell sans agent and possibly save some money.

The major problem with attempting to sell real estate on your own is that you can't list it in the MLS, which, in most areas, only real estate agents can access. If you're not listed in the MLS, many potential buyers never know that your home is for sale. Agents who work with buyers don't generally look for or show their clients properties that are for sale by owner or listed with discount brokers.

Besides saving you time, a good agent can help ensure that you're not sued for failing to disclose known defects of your property. If you decide to sell on your own, contact a local real estate legal advisor who can review the contracts. Take the time to educate yourself about the many facets of selling property for top dollar. Read the latest edition of *House Selling For Dummies,* which I coauthored with Ray Brown (published by John Wiley & Sons, Inc.).

Chapter 13

Assessing Your Appetite for Small Business

In This Chapter

- Knowing what it takes to be a successful entrepreneur
- Exploring alternatives to starting your own company
- Looking at small-business investment options
- Mapping out your small-business plans

Many people dream about running their own companies, and for good reason. If you start your own business, you can pursue something that you're passionate about, *and* you have more control over how you do things. Plus, successful business owners can reap major economic bounties.

But tales of entrepreneurs becoming multimillionaires focus attention on the financial rewards without revealing the business and personal challenges and costs associated with being in charge. Consider what your company has to do well to survive and succeed in the competitive business world:

- Develop products and services that customers will purchase
- Price your offerings properly and promote them
- Deal with the competition
- Manage the accounting
- Interpret lease contracts and evaluate office space
- Stay current with changes in your field
- Hire, train, and retain good employees

Business owners also face personal and emotional challenges, which rarely get airtime among all the glory of the rags-to-riches tales of multimillionaire entrepreneurs. Major health problems, divorces, fights and lawsuits among family members who are in business together, the loss of friends, and even suicides have been attributed to the passions of business owners who are consumed with winning or become overwhelmed by their failures. I'm not trying to scare you, but I do want you to be realistic about starting your own business.

In this chapter, I help you to assess whether starting a company fits with your goals and aptitude. I also present numerous alternatives that may better fit you and your situation.

Testing Your Entrepreneurial IQ

The keys to success and enjoyment as an entrepreneur vary as much as the businesses do. But if you can answer yes to most of the following questions, you probably have the qualities and perspective needed to succeed as a small-business owner:

1. Are you a self-starter? Do you like challenges? Are you persistent? Are you willing to do research to solve problems?

Most of the time, running your own business isn't glamorous, especially in the early years. You have many details to remember and many things to do. Success in business is the result of doing lots of little things well. If you're accustomed to working for large organizations where much of the day is spent attending meetings and keeping up on office politics and gossip, with little accountability, running your own business may come as a bit of a shock at first.

2. Do you value independence and self-control?

Particularly in the early days of your business, you need to enjoy working on your own. When you leave a company environment and work on your own, you give up a lot of socializing. Of course, if you work in an unpleasant environment or with people you don't really enjoy socializing with, venturing out on your own may be a plus.

If you're a people person, many businesses offer lots of contact. But you must recognize the difference between socializing for fun with co-workers versus the often more demanding and goal-oriented networking with business contacts and customers.

3. Can you develop a commitment to an idea, a product, or a principle?

If you work about 50 hours per week over 50 or so weeks per year, you'll work around 2,500 hours per year. If the product, service, or cause you're pursuing doesn't excite you and you can't motivate others to work hard for you, you're going to have a long year!

One of the worst reasons to start your own business is for the pursuit of great financial riches. Don't get me wrong — if you're good at what you do and you know how to market your services or products, you may make more money working for yourself. But for most people, money isn't enough of a motivation, and many people make the same or less money on their own than they did working for a company.

4. Are you willing to make financial sacrifices and live a reduced lifestyle before and during your early entrepreneurial years?

"Live like a student, before and during the start-up of your small business" was the advice that my best business school professor, James Collins, gave me before I started my business. With most businesses, you expend money during the start-up years and likely have a reduced income compared to the income you receive while working for a company. You also have to buy your own benefits.

To make your entrepreneurial dream a reality, you need to live within your means both before and after you start your business. But if running your own business really makes you happy, sacrificing expensive vacations, overpriced luxury cars, the latest designer clothing, and $4 lattes at the corner cafe shouldn't be too painful.

5. Do you recognize that when you run your own business, you must still report to bosses?

Besides the allure of huge profits, the other reason some people mistakenly go into business for themselves is that they're tired of working for other people. Obnoxious, evil bosses can make anyone want to become an entrepreneur.

When you run your own business, you may have customers and other people to please who are miserable to deal with. Fortunately, even the worst customers usually can't make your life anywhere near as miserable as the worst bosses. (And, if you have enough customers, you can simply decide not to do business with such misfits.)

6. Can you withstand rejection, naysayers, and negative feedback?

"I thought every no that I got when trying to raise my funding brought me one step closer to a yes," says Alex Popov, an entrepreneur I once met. Unless you come from an entrepreneurial family, don't expect your parents to endorse your "risky, crazy" behavior. Even other entrepreneurs can ridicule your good ideas. Two of my entrepreneurial friends were critical of each other's ideas, yet both have succeeded! Some people (especially parents) simply think that working for a giant company makes you safer and more secure (which, of course, is a myth, because corporations can lay you off in a snap). It's also easier for them to say to their friends and neighbors that you're a big manager at a well-known corporation (such as IBM, GE, Enron, or WorldCom) than to explain that you're working on some kooky business idea out of a spare bedroom. (How secure do you think those former employees of Enron and WorldCom feel now about having lost their jobs at their former large company?)

7. Are you able to identify your shortcomings and hire or align yourself with people and organizations that complement your skills and expertise?

To be a successful entrepreneur, you need to be a bit of a jack-of-all-trades: marketer, accountant, customer service representative, administrative assistant, and so on. Unless you get lots of investor capital, which is rare for a true start-up, you can't afford to hire help in the early months, or perhaps even years, of your business.

Partnering with or buying certain services or products rather than trying to do everything yourself may make sense for you. And over time, if your business grows and succeeds, you should be able to afford to hire more help. If you can be honest with yourself and surround and partner yourself with people whose skills and expertise complement yours, you can build a winning team!

8. Do you deal well with ambiguity? Do you believe in yourself?

When you're on your own, determining whether you're on the right track is difficult. Some days, things don't go well — and such days are much harder to take flying solo. Therefore, being confident, optimistic, and able to work around obstacles are necessary skills.

9. Do you understand why you started the business or organization and how you personally define success?

Many business entrepreneurs define success by such measures as sales revenue, profits, number of branch offices and employees, and so on. These are fine measures, but other organizations, particularly nonprofits, have other measures. For example, the Jacksonville, Florida–based nonpartisan Wounded Warrior Project was founded by a ". . . group of veterans and friends who took action to help the injured service men and women of this generation."

Money is necessary for the Wounded Warrior Project to accomplish its purpose, but such a cause-focused organization has a "bottom line" that's very different from a for-profit organization.

10. Can you accept lack of success in the early years of building your business?

A few rare businesses are instant hits, but most businesses take time to build momentum — it may take years, perhaps even decades. Some successful corporate people suffer from anxiety when they go out on their own and encounter the inevitable struggles and lack of tangible success as they build their companies.

Don’t be deterred by the questions that you can’t answer in the affirmative. A perfect entrepreneur doesn’t exist. Part of succeeding in business is knowing what you can and can’t do and then finding creative ways (or people) to help you achieve your goals.

Myths of being an entrepreneur

Many myths persist about what it takes to be an entrepreneur, partly because those who aren't entrepreneurs tend to hang out with others who aren't. The mass media's popularization of "successful" entrepreneurs such as Bill Gates, Donald Trump, and Oprah Winfrey leads to numerous misperceptions and misconceptions, including these often-cited nuggets:

- **You have to be well-connected or know "important" people.** I think that being a decent human being is far more important. Enough rude, inconsiderate, and self-centered people are in the business world (and, yes, some of them do succeed in spite of their character flaws), and if you're not that way, you'll be able to meet people who can help you in one way or another. But remember that looking in the mirror shows you your best and most trusted resource.

- **You need to have an MBA or some other fancy degree.** Many successful entrepreneurs — Bill Gates and Steve Jobs, for example — don't even have the most basic college degrees. Perusing *Forbes* magazine's lists of the most financially successful small companies shows that about 15 percent of the CEOs didn't earn a college degree and about half don't have advanced degrees! These statistics are even more amazing when you consider that a relatively large number of entrepreneurs with humble backgrounds leave or are forced out of the successful enterprises they started.

  I'm not saying that a good education isn't worthwhile in general and that it can't help you succeed in your own business. (For example, Ivy Leaguers run about 6 percent of the 200 best small businesses, yet Ivy League college grads make up less than 1 percent of all graduates.) What I am saying is that a formal education isn't necessary.

- **You need to be a genius.** Intelligence is admittedly a difficult thing to measure, but the majority of entrepreneurs have IQs under 120, and a surprising percentage have IQs under the average of 100. In fact, more entrepreneurs have IQs under 100 than have IQs greater than 130!

- **You must be a gregarious, big-egoed extrovert.** Although some studies show that more entrepreneurs are extroverted, many entrepreneurs are not.

- **You have to be willing to take a *huge* risk.** Some people focus on the potential for failure. But, consider the worst-case scenario: If your venture doesn't work out, you can probably go back to a job similar to the one you left behind (although you've lost some income in the interim). Also, recognize that risk is a matter of perception, and as with investments, people completely overlook some risks. What about the risk to your happiness and career if you stay in a boring, claw-your-way-up-the-corporate-ladder kind of job? You also risk a layoff when you work for a company. An even greater risk is that you'll wake up in your 50s and 60s and think that it's too late to do something on your own and wish you had tried sooner.

Considering Alternative Routes to Owning a Small Business

Sometimes entrepreneurial advocates imply that running your own business or starting your own nonprofit is the greatest thing in the world and that all people would be happy owning their own businesses if they just set their minds to it.

REMEMBER

The reality is that some people won't be blissful as entrepreneurs. If you didn't score highly on my ten-question entrepreneur assessment in the preceding section, don't despair. You can probably be happier and more successful doing something other than starting your own business. Some people are better off working for someone else. If you're one of these people, consider the options in the following sections.

Being an entrepreneur inside a company

A happy medium is available for people who want the challenge of running their own show without giving up the comforts and security that come with a company environment. For example, you can manage an entrepreneurial venture at a company. That's what John Kilcullen, president and chief executive officer of IDG Books Worldwide (former publisher of this book), did when he helped launch the book publishing division of IDG in 1990. (IDG Books was subsequently bought by John Wiley & Sons, Inc., in 2001.)

Kilcullen had publishing industry experience and wanted to take on the responsibility of growing a successful publishing company. But he also knew that being a player in the book publishing industry takes a lot of money and resources. Because he was a member of the founding team of the new IDG Books division, Kilcullen had the best of both worlds.

Kilcullen always had a passion to start his own business but found that most traditional publishers weren't interested in giving autonomy and money to a division and letting it run with the ball. "I wanted the ability to build a business on my own instincts . . . the appeal of IDG was that it was decentralized. IDG was willing to invest and provide the freedom to spend as we saw fit."

If you're able to secure an entrepreneurial position inside a larger company, in addition to significant managerial and operational responsibility, you can also negotiate your share of the financial success that you help create. The parent company's senior management wants you to have the incentive that comes from sharing in the financial success of your endeavors. Bonuses, stock options, and the like are often tied to a division's performance.

Investing in your career

Some people are happy or content as employees. Companies need and want lots of good employees, so you should be able to find a job if you have skills, a solid work ethic, and the ability to get along with others.

You can improve your income-earning ability and invest in your career in a variety of ways:

- **Work:** Be willing to work extra hours and take on more responsibility. Those who take extra initiative and then deliver really stand out in a company where many people working on a salary have a time-clock, 9-to-5 mentality. But be careful that the extra effort doesn't contribute to *workaholism,* a dangerous addiction that causes too many people to neglect important personal relationships and their own health. Don't bite off more than you can chew; otherwise, your supervisors won't have faith that they can count on you to deliver. Find ways to work smarter, not just longer, hours.
- **Read:** One of the reasons you don't need a PhD, master's degree, or even an undergraduate college degree from a top college to succeed in business is that you can find out a lot on your own. You can gain insight by doing, but you can also gain expertise by reading a lot. A good bookstore has no entrance requirements, such as an elevated high school grade point average or high SAT scores — you only have to walk through the doors. A good book isn't free, but it costs a heck of lot less than taking college or graduate courses!
- **Study:** If you haven't completed your college or graduate degree and the industry you're in values those who have,

consider investing the time and money to finish your education. Speak with others who have taken that path and see what they have to say.

Exploring Small-Business Investment Options

Only your imagination limits the ways you can make money with small businesses. Choosing the option that best meets your needs isn't unlike choosing other investments, such as in real estate (see Part III) or in the securities markets (see Part II). In the following sections, I discuss the major ways you can invest in small business, including what's attractive and not about each option.

Starting your own business

Of all your small-business options, starting your own business involves the greatest amount of work. Although you can perform this work on a part-time basis in the beginning, most people end up working in their business full time.

For most of my working years, I've run my own business, and overall, I really like it. In my experience counseling small-business owners, I've seen many people of varied backgrounds, interests, and skills achieve success and happiness running their own businesses.

> Most people perceive starting their own business as the riskiest of all small-business investment options. But if you get into a business that uses your skills and expertise, the risk isn't nearly as great as you may think. Suppose, for example, that as a teacher you make $35,000 per year, and now you decide you want to set up your own tutoring service, making a comparable amount of money. If you find through your research that others who perform these services charge $40 per hour, you need to tutor about 20 or so hours per week, assuming that you work 50 weeks per year. Because you can run this business from your home (which can possibly generate small tax breaks) without purchasing new equipment, your expenses should be minimal.

Instead of leaving your job cold turkey and trying to build your business from scratch, you can start moonlighting as a tutor. Over a couple of years, if you can build the tutoring up to ten hours per week, you're halfway to your goal. If you leave your job and focus all your energies on your tutoring business, getting to 20 hours per week of billable work shouldn't be a problem. Still think starting a business is risky?

You can start many businesses with little money by leveraging your existing skills and expertise. If you have the time to devote to building "sweat equity," you can build a valuable company and job. As long as you check out the competition and offer a valued product or service at a reasonable cost, the principal risk with your business is that you won't do a good job marketing what you have to offer. If you can market your skills, you should succeed. See Chapter 14 for more details on starting and running your own business.

Don't start a business for tax write-offs

"Start a small business for fun, profit, and huge tax deductions," a financial advice book declares, adding that "the tax benefits alone are worth starting a small business." A seminar company offers a course titled "How to Have Zero Taxes Deducted from Your Paycheck." This tax seminar tells you how to solve your tax problems: "If you have a sideline business, or would like to start one, you're eligible to have little or no taxes taken from your pay."

All this sounds too good to be true — and of course it is. Not only are the strategies sure to lead to IRS-audit purgatory, but such books and seminars may also seduce you to pony up $100 or more for audiotapes or notebooks of "inside information."

Unfortunately, many self-proclaimed self-help gurus state that you can slash your taxes simply by finding a product or service that you can sell on the side of your regular employment. The problem, they argue, is that as a regular wage earner who receives a paycheck from an employer, you can't write off many of your other (personal) expenses. Open a sideline business, they say, and you can deduct your personal expenses as business expenses.

The pitch is enticing, but the reality is something quite different. You have to spend money to get tax deductions, and the spending must be for legitimate purposes of your business in its efforts to generate income. If you think that taking tax deductions as a hobby is worth the risk because you won't get caught unless you're audited, the odds are stacked against you. The IRS audits an extraordinarily large portion of small businesses that show regular losses.

The bottom line is that you need to operate a real business for the purpose of generating income and profits, not tax deductions. The IRS considers an activity a hobby (and not a business) if it shows a loss for three or more of the preceding five tax years. (Exception: The IRS considers horse racing and breeding a hobby if it shows a loss for at least six of the preceding seven tax years.) Some years, a certain number of businesses lose money, but a real business can't afford to do so year after year and remain in operation. Even if your sideline business passes this hobby test, as well as other IRS requirements, deducting any expenses that aren't directly applicable to your business is illegal.

If these loss rules indicate that you're engaging in a hobby but you still want to claim your losses, you must convince the IRS that you're seriously trying to make a profit and run a legitimate business. The IRS wants to see that you're actively marketing your services, building your skills, and accounting for income and expenses. The IRS also wants to see that you don't derive too much pleasure from an activity. If you do, the IRS says that what you're doing is a hobby and not a business. Business isn't supposed to give you too much enjoyment!

Buying an existing business

If you don't have a specific idea for a business that you want to start but you have business management skills and an ability to improve existing businesses, consider buying an established business. Although you don't have to go through the riskier start-up period if you take this route, you'll likely need more capital to buy a going enterprise.

You also need to be able to deal with potentially sticky personnel and management issues. The history of the organization and the way things work predates your ownership of the business. If you don't like making hard decisions, firing people who don't fit with your plans, and coercing people into changing the way they did things before you arrived on the scene, buying an existing business likely isn't for you. Also realize that some of the good employees may be loyal to the old owner and his style of running the business, so they may split when you arrive.

Some people perceive that buying an existing business is safer than starting a new one, but buying someone else's business can actually be riskier. You have to put out far more money upfront, in the form of a down payment, to buy a business. And if you don't have the ability to run the business and it does poorly, you may lose much more financially. Another risk is that the business may be for sale for a reason — perhaps it's not very profitable, it's in decline, or it's generally a pain in the posterior to operate.

Good businesses that are for sale don't come cheaply. If the business is a success, the current owner has removed the start-up risk from the business, so the price of the business should include a premium to reflect this lack of risk. If you have the capital to buy an established business and the skills to run it, consider going this route. Chapter 15 discusses how to buy a good business.

Investing in someone else's business

If you like the idea of profiting from successful small businesses but don't want the day-to-day headaches of being responsible for managing the enterprise, you may want to invest in someone else's small business. Although this route may seem easier, fewer people are actually cut out to be investors in other people's businesses.

Choosing to invest for the right reasons

Consider investing in someone else's business if you meet the following criteria:

- **You have sufficient assets.** You need enough assets so that what you invest in small privately held companies is a small portion (20 percent or less) of your total financial assets.
- **You can afford to lose what you invest.** Unlike investing in a diversified stock mutual fund (see Chapter 8), you may lose all of your investment when you invest in a small, privately held company.
- **You're astute at evaluating financial statements and business strategies.** Investing in a small, privately held company has much in common with investing in a publicly traded firm. A main difference is that private firms aren't required to produce comprehensive, audited financial statements that adhere to certain accounting principles the way that public companies are. Thus, you have a greater risk of not receiving sufficient or accurate information when you evaluate a small private firm. (There are also liquidity differences; with a small, private company, you may not be able to sell out when you want and at a fair current price.)

Putting money into your own business (or someone else's) can be a high-risk — but potentially high-return — investment. The best options are those that you understand well. If you hear about a great business idea or company from someone you know and trust, do your research and make your best judgment. That company or idea may be a terrific investment.

Before you invest, ask to see a copy of the business plan and compare it with the business plan model that I suggest later in this chapter. Thoroughly check out the people running the business. Talk to others who don't have a stake in the investment; you can benefit from their comments and concerns. But don't forget that many a wise person has rained on the parade of what turned out to be a terrific business idea. See the sidebar in this chapter "Wet blankets throughout history" for some amusing rejections that turned out to be huge mistakes.

Avoiding investing mistakes

Although some people are extra careful when they invest other people's money, others aren't. For example, many small-business owners seek investors' money for the wrong reasons, including the following:

- They are impatient and perhaps don't understand the feasibility of making do with a small amount of capital (a process called *bootstrapping,* which I discuss in Chapter 14).
- They need money because they're in financial trouble. One small furniture retailer in my area conducted a stock offering to raise money. On the surface, everything seemed fine, and the company made it onto the *Inc. 500* list of fast-growing small companies. But it turns out that the company wanted to issue stock because it expanded too quickly and didn't sell enough merchandise to cover its high overhead. The company ended up in bankruptcy.

Here's another problem with small businesses that seek investors: Many small-business owners take more risk and do less upfront planning and homework with other people's money. In fact, many well-intentioned people fail at their businesses.

An MBA I know from a top business school — I'll call him Jacob — convinced an investor to put up about $300,000 to purchase a small manufacturing company. Jacob put a small amount of his own money into the business and immediately blew about $100,000 on a fancy computer-scheduling and order-entry system. Jacob wasn't interested much in sales (a job that the previous owner managed), so he also hired a sales manager. The sales manager he hired was a disaster — many of the front-line salespeople fled to competitors, taking key customers with them. He tried to cut costs, but doing so hurt the quality and timeliness of the company's products. By the time Jacob came to his senses, it was too late. The business dissolved, and the investor lost everything.

Drawing Up Your Business Plan

If you’re motivated to start your own business, the next step is to figure out what you want to do and how you’re going to do it. In other words, you need a *business plan.* You need a general plan that helps you define what you think you want to do and the tasks that you need to perform to accomplish your goal. The business plan — which you use to plan your goals, obtain loans, and show potential investors — should be a working document or blueprint for the early days, months, and years of your business.

You don’t need a perfectly detailed plan that spells out all the minutiae. Making such an involved plan is a waste of your time because things change and evolve. The amount of detail that your plan needs depends on your goals and the specifics of your business. A simple, more short-term focused plan (ten pages or so) is fine if you don’t aspire to build an empire. However, if your goal is to grow, hire employees, and open multiple locations, your plan needs to be longer (20 to 50 pages) to cover longer-term issues. If you want to pick up outside investor money, a longer business plan is a necessity.

As you put together your plan and evaluate your opportunities, open your ears and eyes. Expect to do research and speak with other entrepreneurs and people in the industry. Most folks will spend time talking with you as long as they realize that you don’t want to compete with them. For more details on crafting a business plan, check out the latest edition of my book *Small Business For Dummies,* written with Jim Schell and published by John Wiley & Sons, Inc.

Identifying your business concept

What do you want your business to do? What product or service do you want to offer? Maybe, for example, your business goal is to perform tax-preparation services for small-business owners. Or perhaps you want to start a consulting firm, open a restaurant that sells healthy fast-food, run a gardening service, or design and manufacture toys.

Your concept doesn’t need to be unique to survive in the business world. Consider the legions of self-employed consultants, plumbers, tax preparers, and restaurant owners. The existence of many other people who already do what you want to do validates the potential for your small-business ideas. I know many wage slaves who say they would love to run their own business if they could only come up with “the idea.” Most of these people still dream about their small-business plans as they draw their Social Security checks. Being committed to the idea of running your own business is more important than developing the next great product or service. In the beginning, the business opportunities that you pursue can be quite general to your field of expertise or interest. What you eventually do over time will evolve.

I’m not saying that an innovative idea lacks merit. Indeed, a creative idea gives you the chance to hit a big home run, and being the first person to successfully develop a new idea can help you achieve big success.

Even if you aspire to build the next billion-dollar company, you can put a twist on older concepts. Suppose that you’re a veterinarian, but you don’t want a traditional office where people must bring their cats and dogs for treatment. You believe that because many people are starved for free time or have pets that despise a trip to the vet’s office, they want a vet who makes house calls. Thus, you open your Vet on Wheels business. You may also want to franchise the business and open locations around the country. However, you can also succeed by doing what thousands of other vets are now doing and have done over the years with a traditional office.

Outlining your objectives

The reasons for starting and running your own small business are as varied as the entrepreneurs behind their companies. Before you start your firm, it's useful to think about your *objectives,* or what you're seeking to achieve. Your objectives need not be cast in concrete and will surely change over time. If you like, you can write a short and motivating mission statement.

Wet blankets throughout history

"This 'telephone' has too many shortcomings to be seriously considered as a means of communication. The device is inherently of no value to us." — Western Union internal memo in response to Alexander Graham Bell's telephone, 1876.

"The concept is interesting and well formed, but in order to earn better than a C, the idea must be feasible." — A Yale University management professor in response to Fred Smith's paper proposing reliable overnight delivery service. Smith went on to found Federal Express Corporation.

"We don't tell you how to coach, so don't tell us how to make shoes." — A large sporting shoe manufacturer to Bill Bowerman, inventor of the waffle shoe and cofounder of NIKE, Inc.

"So we went to Atari and said, 'Hey, we've got this amazing thing, even built with some of your parts, and what do you think about funding us? Or we'll give it to you. We just want to do it. Pay our salary, we'll come work for you.' And they said, 'No.' So then we went to Hewlett-Packard, and they said, 'Hey, we don't need you. You haven't got through college yet.'" — Steve Jobs, speaking about attempts to get Atari and Hewlett-Packard interested in his and Steve Wozniak's personal computer. Jobs and Wozniak founded Apple Computer.

"'You should franchise them,' I told them. 'I'll be your guinea pig.' Well, they just went straight up in the air! They couldn't see the philosophy. . . . When they turned us down, that left Bud and me to swim on our own." — Sam Walton, describing his efforts to get the Ben Franklin chain interested in his discount retailing concept in 1962. Walton went on to found Wal-Mart.

"We don't like their sound, and guitar music is on the way out." — Decca Recording Company when rejecting The Beatles, 1962.

In 1884, John Henry Patterson was ridiculed by his business friends for paying $6,500 for the rights to the cash register — a product with "limited" or no potential. Patterson went on to found National Cash Register (NCR) Corporation.

"What's all this computer nonsense you're trying to bring into medicine? I've got no confidence at all in computers and I want nothing whatsoever to do with them." — A medical professor in England to Dr. John Alfred Powell, about the CT scanner.

"That is good sport. But for the military, the airplane is useless." — Ferdinand Foch, Commander in Chief, Allied Forces on the Western Front, World War I.

"The television will never achieve popularity; it takes place in a semidarkened room and demands continuous attention." — Harvard Professor Chester L. Dawes, 1940.

These quotes were reprinted with permission from *Beyond Entrepreneurship: Turning Your Business into an Enduring Great Company,* James C. Collins and William C. Lazier (Prentice Hall).

Introductory economics courses teach students that the objective of every for-profit firm is to maximize profits. As with many things taught in economics courses, this theory has one problem — it doesn't hold up in reality. Most small-business owners I know don't manage their businesses maniacally in the pursuit of maximum profits. The following list gives you some other possible objectives to consider:

- **Working with people you like and respect:** Some customers may buy your products and services, and some employees and suppliers may offer you their services for a good price, but what if you can't stand working with them? If you have sufficient business or just have your own standards, you can choose whom you do business with.

- **Educating others:** Maybe part of your business goal is to educate the public about something that you're an expert in. I know that when I started my financial counseling and writing business, I saw education as a core part of my company's purpose.

- **Improving an industry or setting a higher standard:** Perhaps part of your goal in starting your business is to show how your industry can better serve its customers. John Bogle, who founded the Vanguard Group of mutual funds, is a good example of someone who wanted to improve an industry. When he started Vanguard, Bogle structured the company so the shareholders (customers) of the company's individual mutual funds would own the company.

  Because he relinquished ownership of his company, Bogle gave up the opportunity to build a personal net worth that would easily be worth several billion dollars today. But Bogle wanted to build a mutual fund company that kept operating costs to a minimum and returned profits to the customers in the form of lower operating fees, which are deducted from a mutual fund's returns. He's also been outspoken about how owners of many mutual fund companies operate their funds too much out of self-interest instead of keeping their customers in mind.

Of course, you can't accomplish these objectives without profits, and doing these things isn't inconsistent with generating greater profits. But if your objectives are more than financial or your financial objectives aren't your number-one concern, don't worry — that's usually a good sign. Remember the expression, "Do what you love, the money will follow."

Analyzing the marketplace

The single most important area to understand is the marketplace in which your business competes. To be successful, your business must not only produce a good product or service, but it must also reach customers and convince them to buy your product at a price at which you can make a profit. You should discern what the competition has to offer as well as its strengths and vulnerabilities. In most industries, you also need to understand government regulations that affect the type of business that you're considering.

Meeting customer needs

If the market analysis is the most important part of the business plan, understanding your potential customers is the most important part of your market analysis. Understanding your desired customers and their needs is one key to having a successful business.

If you’re in a business that sells to consumers, consider your customers’ characteristics, including gender, age, income, geographic location, marital status, number of children, education, living situation (rent or own), and the reasons they want your product or service. In other words, find out who your prospective customers are. Find out where they live and what they care about. If you sell to businesses, you need to understand similar issues. For instance, what types of businesses may buy your product or services? Why?

> The best way to get to know your potential customers is to get out and talk to them. Even though they’re more time consuming, live interviews allow you to go with the flow of the conversation, improvise questions, and probe more interesting areas. Although you can mail, e-mail, or fax paper-based surveys to many people with a minimal investment of your time, the response rate is usually quite low, and the answers aren’t usually as illuminating. To encourage better response, offer a product or service sample or some other promotional item to those who help you with your research. Doing so attracts people who are interested in your product or service, which helps you define your target customers.

Also try to get a sense of what customers do pay and will pay for the products or services that you offer. Analyzing the competition’s offerings helps, too. Some products or services require follow-up or additional servicing. Understand what customers need and what they’ll pay for your services.

If you want to raise money from investors, include some estimates as to the size of the market for your product or services. Of course, such numbers are ballpark estimates, but sizing the market for your product helps you estimate profitability, the share of the market needed to be profitable, and so on.

Besting the competition

Always examine the products, services, benefits, and prices that competitors offer. Otherwise, you go on blind faith that what you offer stacks up well to the alternatives in the industry.

Examine your competitors' weaknesses so you can exploit them. Rather than trying to beat them on their terms, maybe you've identified a need for a neighborhood pet supply store that offers a more specialized range of pet supplies than the big-selling brands of dog and cat food that warehouse stores sell. Providing knowledgeable customer sales representatives to answer customer questions and make product suggestions can also give you a competitive edge. Thus, you may be able to surpass the warehouse stores on three counts: convenience of location for people in your neighborhood, breadth of product offerings, and customer assistance.

Even if you have a completely innovative product or service that no other business currently offers, don't make the mistake of thinking that you don't have competitors. All businesses have competitors. In the event that you've developed something truly unique that has little competition, your success will surely breed competition as imitators follow or attempt to leapfrog your lead.

Complying with regulations

Most businesses are subject to some sort of regulation. If you want to start a retail business, for example, few communities permit you to run it out of your home. If you lease or purchase a private location, the zoning laws in that location may restrict you. Therefore, you need to check what you can and can’t sell at that location. Check with your city’s or town’s zoning department — don’t simply believe a real estate broker or property owner who says, “No problem!” That person’s goal, after all, is to sell the property.

If, for instance, you were going to start a veterinary practice, you would quickly discover that special zoning is required to use a piece of real estate for a vet’s office. Convincing a local zoning board to allow a new location to get such special zoning is quite difficult, if not impossible, in some areas.

Many businesses face other local, state, and even federal regulatory issues, including ordinances, laws, and the need for specific licenses and filings. For example, if you were opening a restaurant, you’d have to heed ordinances and laws that regulate everything from signage to operating hours to your ability to serve alcohol. And you’d be subject to an amazing array of health codes, building codes, and fire codes, to name a few.

> If you enter an industry that you’re relatively new to, ask questions and open your ears to find out more about where you should locate and how you should design and run your business. Speak to people who are currently in the field and to your local chamber of commerce to see what, if any, licenses or filings you must complete. Read books and trade magazines that may deal with your questions. Libraries have books and online services that can help you locate specific articles on topics that interest you.

Delivering your service or product

Every business has a product or service to sell. How are you going to provide this product or service to your customers? Suppose, for example, that you want to start a business that delivers groceries and runs errands for busy people or older and disabled people who can't easily perform daily tasks for themselves. Delineate the steps that you'll take to provide the service.

When potential customers call to inquire about your business, what kinds of information do you want to record about their situation? Contact software can assist with this task. Also, you can create a pricing sheet and other marketing literature (discussed in the next section) that you can send to curious potential customers.

If you want to manufacture a product, you definitely need to scope out the process that you're going to use. Otherwise, you have no idea how much time the manufacturing process may take or what the process may cost.

As your business grows and you hire employees to provide services or create your products, the more you codify what you do and the better your employees can replicate your good work.

Marketing your service or product

After you determine more in-depth information about delivering your company's services or products, you need to decide on specific marketing information. Answer the following questions:

- **How much will you charge for your services and products?** Look at what competing products and services cost. Estimating your costs helps you figure out what you need to charge to cover your costs and make a reasonable profit.
- **How will you position your products and services compared to the competition?** Consider, for example, how books position themselves in the book marketplace. I hope, in your mind, that my financial books are down-to-earth, practical, answer-oriented, and educational.
- **Where will you sell your product or service?** Business consultants label this decision the *distribution channel* question. For example, if you have a toy to sell, you may consider selling via mail order and the Internet, through toy stores, or through discount warehouse stores. Selling through each of these different distribution channels requires unique marketing and advertising programs. If you market a product or service to companies, you need to find out who the key decision makers are at the company and what will persuade them to buy your product or service.

Having a great product or service isn't enough if you keep it a secret — you gotta get the word out. You likely won't have the budget or the desire to reach the same region that television and radio reach. So start marketing your product to people you know. Develop a punchy, informative one-page letter that announces your company's inception and the products or services it offers, and then mail it to your contacts. Include an envelope with a reply form that allows recipients to provide the addresses of others who may be interested in what you have to offer. Send these folks a mailing as well, referencing who passed their names along to you.

Finding and retaining customers is vital to any business owner who wants his company to grow and be profitable. One simple, inexpensive way to stay in touch with customers you've dealt with or others who have made inquiries and expressed interest in your company's offerings is via a mailing list. Once a quarter, once a year, or whatever makes sense for your business, send out a simple, professional-looking postcard or newsletter announcing new information about your business and the customer needs you can fulfill. Such mailings allow you to remind people that you're still in business and that you provide a wonderful product or service. Computer software and websites (for example, Constant Contact) give you fast, efficient ways to keep customer mailing lists up to date and print mailing labels.

> E-mailing your marketing information has the attraction of no out-of-pocket expenses. However, due to the deluge of junk e-mail most people get, your e-mail is likely to be deleted without being opened. At least a snail-mailed postcard gets a prospective customer's attention, even if only for a brief period.

Organizing and staffing your business

Many small businesses are one-person operations. So much the better for you — you have none of the headaches of hiring, payroll, and so on. You only have to worry about you — and that may be a handful in itself!

But if you hope to grow your business and would rather manage the work being done instead of doing all of it yourself, you eventually want to hire people. (I explain the best way to fill your personnel needs in Chapter 14.) Give some thought now to the skills and functional areas of expertise that future hires need. If you want to raise money, the employment section of your business plan is essential to show your investors that you're planning long-term.

Maybe you want an administrative assistant, researcher, marketing director, or sales representative. What about a training specialist, finance guru, or real estate manager if your company expands? Consider the background that you want in those you hire, and look at the types of people that similar companies select.

You should also consider what legal form of organization — for example, a sole proprietorship, partnership, S corporation, limited liability company, and so on — your business will adopt. The legal form of your organization impacts, among other important issues, how the business is taxed and what its liabilities are in the event of a lawsuit. See Chapter 14 for details.

Projecting finances

An idea may become a business failure if you neglect to consider, or are unrealistic about, the financial side of the business that you want to start. If you're a creative or people-person type who hates numbers, the financial side may be the part of the business plan that you most want to avoid. Don't — doing so can cost you tens of thousands of dollars in avoidable mistakes. Ignoring the financial side can even lead to the bankruptcy of a business founded with a good idea.

Before you launch your business, do enough research so you can come up with some decent financial estimates. Financial projections are mandatory, and knowledgeable investors will scrutinize them if you seek outside money. You also need to think through how and when investors can cash out.

Start-up and development costs

Spending money to get your business from the idea stage to an operating enterprise is inevitable. Before the revenue begins to flow in, you incur expenditures as you develop and market your products and services. Therefore, you need to understand what you must spend money on and the approximate timing of the needed purchases.

If you were going to build a house, you would develop a list of all the required costs. How much are the land, construction, carpeting, landscaping, and so on going to cost? You can try to develop all these cost estimates yourself, or you can speak with local builders and have them help you. Likewise, with your business, you can hire a business consultant who knows something about your type of business. However, I think you're best served by doing the homework yourself — you discover a lot more, and it's cheaper.

If you're going to work in an office setting, whether at home or in outside space, you need furniture (such as a desk, chair, filing cabinets, and so on), a computer, printer, and other office supplies. Don't forget to factor in the costs of any licenses or government registrations that you may need.

If you run a retailing operation, you also need to estimate your cost for establishing and maintaining an inventory of goods. Remember, selling your inventory takes time, especially when you first start up, and you need to have adequate stock on hand to fulfill reasonable customer orders in a timely fashion. And as a new business, suppliers won't give you months on end to pay. Be realistic — otherwise, the money that you tie up in inventory can send you to financial ruin.

Income statement

Preparing an estimated *income statement* that summarizes your expected revenue and expenses is a challenging and important part of your business plan. (I explain the elements of an income statement in Chapter 6.) Many estimates and assumptions go into it. As you prepare your estimated income statement, you may discover that making a decent profit is tougher than you thought. This section of your business plan helps you make pricing decisions.

Consider the Vet on Wheels business idea that I discuss in the "Identifying your business concept" section earlier in this chapter. What range of veterinary services can you provide if you make house calls? You can't perform all the services that you can in a larger office setting, so decide which ones are feasible. What equipment do you need to perform the services? How much should you charge for the services? You need to estimate all these things to develop a worthwhile income statement. You should be able to answer these questions from the insights and information you pulled together regarding what customers want and what your competitors are offering.

With service businesses in which you or your employees sell your time, be realistic about how many hours you can bill. You may end up being able to bill only a third to half of your time, given the other management activities that you need to perform.

Because building a customer base takes several years, try to prepare estimated income statements for the first three years. In the earlier years, you have more start-up costs, so creating income statements more often ensures you have a good handle on this typically lean period. In later years, you reap more profits as your customer rolls expand. Doing income statements over several years is also essential if you're seeking investor money.

Balance sheet

An income statement measures the profitability of a business over a span of time, such as a year, but it tells you nothing of a business's resources and obligations. That's what a *balance sheet* does. Just as your personal balance sheet itemizes your personal assets (for example, investments) and liabilities (debts you owe), a business balance sheet details a company's assets and liabilities.

If you operate a cash business — you provide a service and are paid for that service, and you don't hold any inventory, for example — a balance sheet has limited use. An exception is if you're trying to get a bank loan for your service business.

> A detailed balance sheet isn't as important as tracking your available cash, which will likely be under pressure in the early years of a business because expenses can continue to exceed revenue for quite some time.

A complete balance sheet is useful for a business that owns significant equipment, furniture, inventory, and so on. The asset side of the balance sheet provides insight into the financial staying power of the company. For example, how much cash does your business have on hand to meet expected short-term bills? Conversely, the liability side of the ledger indicates the obligations, bills, and debts the company has coming due in the short and long term. See Chapter 6 for more information on all the elements of a balance sheet.

Writing an executive summary

An *executive summary* is a two-to three-page summary of your entire business plan that you can share with interested investors who may not want to first wade through a 40-to 50-page plan. The executive summary whets the prospective investor's appetite by touching on the highlights of your entire plan. Although this summary should go in the front of your plan document, I list this element last because you can't write an intelligent summary of your plan until you flesh out the body of your business plan.

Chapter 14

Starting and Running a Small Business

In This Chapter

- Preparing to start your business
- Figuring out how to finance your business
- Deciding whether you should incorporate
- Attracting and retaining customers
- Finding and equipping your business space
- Keeping track of the money

After you research and evaluate the needs of your prospective business (see Chapter 13 for more information), at some point you need to decide whether to actually start your business. In reference to his business plan, Alex Popov, founder of Smart Alec's, a healthy fast-food restaurant, says, "Something just clicked one day, and I said to myself, 'Yes, this is a business that is viable and appropriate now.'"

Most entrepreneurs experience this sudden realization, including me — I've experienced it with every business that I've ever started. If you really want to, you can conduct and analyze market research and crunch numbers until the cows come home. Even if you're a linear, logical, analytic, quantitative kind of person, you ultimately need to make a gut-level decision: Do you jump in the water and start swimming, or do you stay on the sidelines and remain a spectator? In my opinion, watching isn't nearly as fun as doing. If you feel ready but have some trepidation, you're normal — just go for it!

Starting Up: Your Preflight Check List

When you take off into the world of small-business ownership, you need to make decisions about a number of important issues. Just like a pilot before he launches an airplane into flight, you need to make sure that all systems are in order and ready to do the job. If your fuel tanks aren't adequately filled, your engines clean and in working order, and your wing flaps in the proper position, you may never get your business off the ground.

Preparing to leave your job

You may never discover that you have the talent to run your own business, and perhaps have a good idea to boot, unless you prepare yourself financially and psychologically to leave your job. Financial and emotional issues cause many aspiring entrepreneurs to remain chained to their employers and cause those who do break free to soon return to their bondage.

The money side of this self-exploration is easier to deal with than the emotional side, so I'll focus on finances. Dealing with a net reduction in the income that you bring home from work — at least in the early years of your business — is a foregone conclusion for the vast majority of small-business opportunities that you may pursue. Accept this fact and plan accordingly.

Do all you can to reduce your expenses to a level that fits the entrepreneurial life that you want to lead. Examine your monthly spending patterns to make your budget lean, mean, and entrepreneurially friendly. Determine what you spend each month on your rent (or mortgage), groceries, eating out, phone calls, insurance, and so on. Unless you're someone who keeps all this data detailed, you need to whip out your checking transactions, ATM receipts, credit card statements, and anything else that documents your spending habits. Don't forget to estimate your cash purchases that don't leave a trail, like when you eat lunch out or spend $35 on gas.

Beyond the bare essentials of food, shelter, healthcare, and clothing, most of what you spend money on is *discretionary* — that is, you spend money on luxuries. Even the amount that you spend on the necessities, such as food and shelter, is probably only part necessity and may include a fair amount of luxury and waste. So make sure you question all expenditures! If you don't, you'll have to continue working as an employee, and you'll never be able to pursue your entrepreneurial dream. If you need a helping hand and an analyst's eye in preparing and developing strategies for reducing your spending, pick up a copy of the latest edition of my book *Personal Finance For Dummies* (John Wiley & Sons, Inc.).

In addition to reducing your spending before and during the period that you start your business, also figure how to manage the income side of your personal finances. The following list gives you some proven strategies to ensure that you have sufficient income:

- **Transition gradually.** One way to pursue your entrepreneurial dreams (and not starve while doing so) is to continue working part time in a regular job while you work part time at your own business. If you have a job that allows you to work part time, seize the opportunity. Some employers may even allow you to maintain your benefits. In addition to ensuring a steady source of income, splitting your time allows you to adjust to a new way of making a living. Some people have a hard time adjusting to their new lifestyle if they quit their jobs cold turkey and plunge headfirst into full-time entrepreneurship.

  Another option is to completely leave your job but line up a chunk of work that provides a decent income for a portion of your weekly work hours. Consulting for your old employer is a time-tested first "entrepreneurial" option with low risk.

- **Get (or stay) married.** Actually, as long as you're attached (married or not) to someone who maintains a regular job and you manage your spending so you can live on that person's income alone, you're golden! Just make sure you talk things through with the love of your life to minimize misunderstandings and resentments. Maybe someday you can return the favor — that's what my wife and I did. She was working in education (no big bucks there!) when I started an entrepreneurial venture after business school. We lived a

Spartan lifestyle and made do just fine on her income. Several years later, when things were going well for me, she left her job to work on her own business.

Valuing and replacing your benefits

For many people, walking away from their employer’s benefits, including insurance, retirement funds, and paid days off, is both financially and emotionally challenging. Benefits are valuable, but you may be surprised by how efficiently you can replicate them in your own business.

Health insurance

Some prospective entrepreneurs fret over finding new health insurance. However, unless you have a significant existing medical problem (known as a *preexisting condition*), getting health insurance as an individual isn't difficult. If you have such a condition, many states have high-risk pools that offer coverage options. And you also will have new protections under the newest health care bill (see the sidebar, "The 2010 Federal Health Care Bill").

The first option to explore is whether your existing coverage through your employer's group plan can be converted into individual coverage. Just don't act on this potentially attractive option until you've explored other health plans on your own, which may offer similar benefits at lower cost. Also, get proposals for individual coverage from major health plans in your area.

> Take a high deductible, if available, to keep costs down. Having a *high-deductible health plan,* which is defined as an individual plan with a deductible of at least $1,200 or a family plan with a minimum $2,400 deductible for tax year 2011 (this amount increases over time with inflation), qualifies you to contribute money into a Health Savings Account (HSA). The contribution limits are up to $3,050 for individuals and $6,150 for families for tax year 2011, and these amounts increase over time with inflation. (Folks age 55 or older can put away an extra $1,000 per year.) Contributions to an HSA reduce your current year's taxable income, and the money compounds without taxation over time. Withdrawals aren't taxed so long as you use the money for qualified healthcare expenses, which are fairly broadly defined and include traditional out-of-pocket medical expenses (doctors and hospital care) as well as dental care, prescription drugs, psychologist expenses, vision care, vitamins, and so on.

Government regulations called *COBRA* require an employer with 20 or more employees to continue health insurance coverage (at your own expense) for up to 18 months after terminating employment. Moreover, if you have or develop a health problem while covered under COBRA, the law enables you to purchase an individual policy at the same price that a healthy individual can. These laws create a nice buffer zone for the budding entrepreneur, but don't get lazy and wait until the last minute of the 18th month to start shopping for your individual plan — COBRA plans can be costly. Shopping around and locking in an individual plan as soon as possible can save money and prevent headaches.

Long-term disability insurance

For most working people, their greatest asset is their ability to earn money. If you suffer a disability and can't work, how would you manage financially? Long-term disability insurance protects your income in the event of a disability.

Before you leave your job, secure an individual long-term disability policy. After you leave your job and are no longer earning steady income, you won't qualify for a policy. Most insurers want to see at least six months of self-employment income before they'll write you a policy. If you become disabled during this time, you're uninsured and out of luck — that's a big risk to take!

Check with any professional associations that you belong to or could join to see whether they offer long-term disability plans. Association plans are sometimes less expensive because of the group's purchasing power.

Life insurance

If you have dependents who count on your income, you need life insurance. And unlike with disability insurance, you can generally purchase a life insurance policy at a lower cost than you can purchase additional coverage through your employer.

The 2010 Federal Health Care Bill

In 2010, Congress passed two large bills, signed into law by President Barack Obama, to enact comprehensive health care reform. This bill included numerous provisions affecting small businesses. Here are the highlights.

Effective in 2011, employer group health plans:

- Must offer non-taxable coverage to adult children up to age 26 who aren't eligible for coverage under another employer's health plan. In 2014, the requirement that the nondependent child must not be eligible for coverage under another employer's plan would no longer apply.

- May not impose lifetime limits and could impose only "restricted" annual limits. No annual limits would be permitted beginning in 2014.

- May not impose preexisting condition exclusions on children younger than 19 years old. No preexisting conditions would be permitted for any participants beginning in 2014.

Effective in 2014, the following group health plan provisions take effect:

- "Pay or play" responsibility begins. Companies must offer minimum essential coverage to full-time employees or make nondeductible payments to the government.

- Must remove all annual dollar limits on all participants.

- Must limit cost sharing and deductibles to levels that don't exceed those applicable to a health savings account–eligible, high-deductible health plan.

- Must remove all preexisting condition exclusions on all participants.
- Must remove waiting periods longer than 90 days.

For updated information on this topic, please visit my website at www.erictyson.com.

Retirement plans

If your employer offers retirement savings programs, such as a 401(k) plan or a pension plan, don’t despair about not having these in the future. (Of course, what you’ve already earned and accumulated while employed is yours.) One of the best benefits of self-employment is the availability of retirement savings plans — SEP-IRAs (Simplified Employee Pension Individual Retirement Accounts) and Keoghs — that allow you to sock away a hefty chunk of your earnings on a tax-deductible basis.

Retirement plans are a terrific way for you and your employees to shield a sizeable portion of earnings from taxation. If you don’t have employees, regularly contributing to one of these plans is usually a no-brainer. With employees, the decision is a bit more complicated but often still a great idea. Small businesses with a number of employees can also consider 401(k) plans. I explain retirement plans in more detail in Chapter 3.

Other benefits

Besides insurance and retirement plans, employers also offer other benefits that you may value. But, don't get too bummed yet. These benefits aren't true benefits, so you won't miss much if you branch out on your own. For example, you *seem* to get paid holidays and vacations. In reality, though, your employer simply spreads your salary over all 52 weeks of a year, thus paying you for actually working the other 47 weeks or so out of the year. You can do the same by building the cost of this paid time off into your product and service pricing.

Another "benefit" of working for an employer is that the employer pays for half of your Social Security and Medicare taxes. Although you must pay the entire tax when you're self-employed, the IRS allows you to take half of this amount as a tax deduction on your annual tax Form 1040. So, really, this tax isn't as painful as you think. As with vacations and holidays, you can simply build the cost of this tax into your product and service pricing. Just think: Your employer could pay you a higher salary if it weren't paying half of these taxes as a benefit.

Some employers offer other insurance plans, such as dental or vision care plans. Ultimately, these plans only cover small out-of-pocket expenditures that aren't worth insuring. Don't waste your money purchasing such policies when you're self-employed.

Financing Your Business

When you create your business plan (which I explain how to do in Chapter 13), you should estimate your start-up and development costs. Luckily, you can start many worthwhile small businesses with little capital. The following sections explain methods for financing your business.

Going it alone by bootstrapping

Making do with a small amount of capital and only spending what you can afford is known as *bootstrapping.* Bootstrapping is just a fancy way of saying that a business lives within its own means and without external support. This strategy forces a business to be more resourceful and less wasteful. Bootstrapping is also a great training mechanism for producing cost-effective products and services. It offers you the advantage of getting into business with little capital.

Millions of successful small companies were bootstrapped at one time or another. Like small redwood saplings that grow into towering trees, small companies that had to bootstrap in the past can eventually grow into hundred million–dollar (and even multi-billion-dollar) companies. For example, Hewlett-Packard's founders started their company out of a garage in Palo Alto, California. Microsoft, Motorola, Sony, and Disney were all bootstrapped, too.

Whether you want to maintain a small shop that employs just yourself, hire a few employees, or dream about building the next large company, you need capital. However, misconceptions abound about how much money a company needs to achieve its goals and sources of funding.

"There's an illusion that most companies need tons of money to get established and grow," says James Collins, former lecturer at the Stanford Graduate School of Business and coauthor of the best-sellers *Built to Last* and *Good to Great: Why Some Companies Make the Leap . . . and Others Don't.* "The Silicon Valley success stories of companies that raise gobs of venture capital and grow 4,000 percent are very rare. They are statistically insignificant but catch all sorts of attention," he adds.

Studies show that the vast majority of small businesses obtain their initial capital from personal savings and family and friends rather than outside sources, such as banks and venture capital firms. A

Harvard Business School study of the *Inc. 500* (500 large, fast-growing private companies) found that more than 80 percent of the successful companies started with funds from the founder's personal savings. The median start-up capital was a modest $10,000, and these are successful, fast-growing companies! Slower-growing companies tend to require even less capital.

With the initial infusion of capital, many small businesses can propel themselves for years after they develop a service or product that brings in more cash flow. Jim Gentes, the founder of Giro, the bike helmet manufacturer, raised $35,000 from personal savings and loans from family and friends to make and distribute his first product. He then used the cash flow from the first product for future products.

Eventually, a successful, growing company may want outside financing to expand faster. Raising money from investors or lenders is much easier after you demonstrate that you know what you're doing and that a market exists for your product or service. (Check out the following section for more on getting a bank loan.)

As I explain in the earlier section "Preparing to leave your job," aspiring entrepreneurs must examine their personal finances for opportunities to reduce their own spending. If you want to start a company, the best time for you to examine your finances is years before you want to hit the entrepreneurial path. As with other financial goals, advance preparation can go a long way toward helping start a business. The best funding source and easiest investor to please is you.

Alan Tripp, founder and CEO of Score Learning, a chain of storefront interactive learning centers, planned for seven years before he took the entrepreneurial plunge. He funded his first retail center fully from personal savings. He and his wife lived frugally to save the necessary money. Tripp's first center proved the success of his business concept: retail learning centers where kids can use computers to improve their reading, math, and science skills. With a business plan crafted over time and hard numbers to demonstrate the financial viability of his operation, Tripp then successfully raised funds from investors to open many more centers. (Kaplan Inc. ultimately bought his company.)

Some small-business founders put the cart before the horse and don't plan and save for starting their business the way Tripp did. And in many cases, small-business owners want capital but don't have a clear plan or need for it.

Taking loans from banks and other outside sources

If you're starting a new business or have been in business for just a few years, borrowing, particularly from banks, may be difficult. Borrowing money is easier when you don't really need to do so. No one knows this fact better than small-business owners.

> Small-business owners who successfully obtain bank loans do their homework. To borrow money from a bank, you generally need a business plan, three years of financial statements and tax returns for the business and its owner, and projections for the business. Seek out banks that are committed to and understand the small-business marketplace.

The Small Business Administration (SBA) guarantees some small-business loans that banks originate. Because many small businesses lack collateral and pose a higher loan risk, banks wouldn't otherwise make many of these loans. The SBA, in addition to guaranteeing loans for existing businesses, grants about 20 percent of its loans to start-up businesses, which must have founders who put up at least a third of the funds needed and demonstrate a thorough understanding of the business, ideally through prior related industry experience.

The SBA offers a number of workshops and counseling services for small-business owners. Its SCORE (Service Corps of Retired Executives) consulting services (www.score.org; 800-634-0245) provide free advice and critiques of business plans as well as advice on raising money for your business. The SBA charges a nominal fee for seminars. To get more information on SBA's services and how to contact a local office, call 800-827-5722 or visit its website at www.sba.gov.

If you don't have luck with banks or the SBA, consider the following:

- **Credit unions can be a source of financial help.** They're often more willing to make personal loans to individuals.
- **Borrowing against the equity in your home or other real estate is advantageous.** This strategy is helpful because real estate loans generally entail lower and tax-deductible interest.
- **Retirement savings plans can bridge the gap.** You may be able to borrow against your investment balance, and such loans are usually available at competitive rates through employer-based plans. Just make sure you don't take on too much debt and jeopardize your retirement savings.
- **Credit cards may be useful as a last resort.** If you've got the itch to get your business going but can't wait to save the necessary money and lack other ways to borrow, the plastic in your wallet may be your ticket to operation. You can acquire some credit cards at interest rates of 10 percent or less. ***Remember:*** Because credit cards are unsecured loans, if your business fails and you can't pay back your debt, your home equity and assets in retirement accounts aren't at risk.

No matter what type of business you have in mind and how much money you think you need to make it succeed, be patient. Start small enough that you don't need outside capital (unless you're in an unusual situation where your window of opportunity is now and will close if you don't get funding quickly). Starting your business without outside capital instills the discipline required for building a business piece by piece over time. The longer you can wait to get a loan or an equity investment, the better the terms are for you and your business because the risk is lower for the lender or investor.

Borrowing from family and friends

Because they know you and hopefully like and trust you, your family and friends may seem like good sources of investment money for your small business. They also likely have the added advantage of offering you better terms than a banker, wealthy investor, or a venture capitalist.

However, before you solicit and accept money from those you love, consider the following pitfalls:

- **Defaulting on a loan can cause hard feelings.** If your business hits the skids, defaulting on a loan made by a large, anonymous lender is one thing, but defaulting on a loan from your dear relatives can make future Thanksgiving meals mighty uncomfortable!
- **Most entrepreneurs receive surprisingly little encouragement from the people they're close to.** Your parents, for example, may think that you've severed some of your cerebral synapses if you announce your intention to quit your job, which provides a lofty job title, decent pay, and benefits. The lack of emotional support can discourage you far more than the lack of financial support.
- **You lose out on the experience of a seasoned investor.** Family and friends may lack important practical experience with similar ventures and may be unable to provide the type of guidance that a venture capitalist or other seasoned investor could.

Family investments in a small business work best under the following conditions:

- **You prepare and sign a letter of agreement that spells out the terms of the investment or loan.** In other words, you act as if you're doing business with a banker or some other investor you know for business purposes only. I also recommend clearly disclosing in writing the risk of losing one's entire investment. As time goes on, people have selective recall. Putting things in writing reminds everyone what was agreed to.
- **You're quite certain that you can repay the loan.** Otherwise, you run into the issue I discuss earlier: You default on the loan and burn bridges with your closest loved ones. No business is worth losing your family or friends.
- **You can start your business with an equity investment.** With an equity investment, a person is willing and able to lose all the money invested but hopes to hit a home run while helping you with your dream. (Check out the next section for more on equity investments.)

Courting investors and selling equity

Beyond family members and friends, private individuals with sufficient funds — also known as wealthy individuals — are your next best source of capital if you want an equity investor (and not a loan from a lender). However, before you approach wealthy people, you must have a solid business plan, which I explain how to prepare in Chapter 13.

A worthwhile *angel investor* (a wealthy individual who invests in small companies) has a track record of success with somewhat similar businesses that she's funded and brings other things to the table besides money, such as strategic advice, helpful business contacts, and so on.

Although you want an investor to care about your business, it's best if his investment in your business is no more than 5 to 10 percent of his total investment portfolio. No one wants to lose money, but doing so is less painful when you diversify well. A $50,000 investment from an investor with a five million dollar portfolio is risking 1 percent of his portfolio.

Finding people who may be interested in investing requires persistence and creativity. Consider these approaches:

- Consult tax advisors and attorneys you know who may have contacts.
- Network with successful entrepreneurs in similar fields.
- Think about customers or suppliers who like your business and believe in its potential.

Alex Popov, whom I introduce at the beginning of this chapter, sent hundreds of letters to people who lived in upscale neighborhoods.

The letter, a one-page summary of Alex's investment opportunity, got an astounding 5 percent response for interest in receiving a business plan. Ultimately through this search method, Popov found one wealthy investor who funded his entire deal.

Here's how to determine how much of the business you're selling for the amount invested. Basically, the equity percentage should hinge on what the whole business is worth (see Chapter 15 for details on valuing a business). If your whole business is worth $500,000 and you're seeking $100,000 from investors, that $100,000 should buy 20 percent of the business.

New businesses are the hardest to value — yet another reason you're best off trying to raise money *after* you demonstrate some success. The farther along you are, the lower the risk to an investor and the lower the cost to you (in terms of how much equity you must give up) to raise money.

Deciding Whether to Incorporate

Most businesses operate as *sole proprietorships,* a status limited to one owner or a married couple. If you run a sole proprietorship, you report your business income and costs on your tax return on Schedule C (Profit or Loss From Business), which you attach to your personal income tax return, Form 1040.

Incorporating, which establishes a distinct legal entity under which you do business, takes time and costs money. Therefore, incorporation must offer some benefits. Here are two main benefits of going through the process:

- **Because corporations are legal entities distinct from their owners, they offer features that a proprietorship or partnership doesn't.** For example, corporations can have shareholders who own a piece or percentage of the company. These shares can be sold or transferred to other owners, subject to any restrictions in the shareholder's agreement.
- **Corporations offer continuity of life.** In other words, corporations can continue to exist despite an owner's death or the owner's transfer of her stock in the company.

In the following sections, I detail the other benefits, along with possible drawbacks, of incorporating so you can decide whether it's the right choice for you.

Don't waste your money incorporating if you simply want to maintain a corporate-sounding name. If you operate as a sole proprietor, you can choose to operate under a different business name ("doing business as," or d.b.a.) without the cost and hassles of incorporating.

Looking for liability protection

A major reason to consider incorporation is liability protection. Incorporation effectively separates your business from your personal finances, thereby better protecting your personal assets from lawsuits that may arise from your business.

> Before you incorporate, ask yourself (and perhaps others in your line of business or advisors — legal, tax, and so on — who work with businesses like yours) what can cause someone to sue you. Then see whether you can purchase insurance to protect against these potential liabilities. Insurance is superior to incorporation because it pays claims, and people can still sue you if you're incorporated. If you incorporate and someone successfully sues you, your company must cough up the money for the claim, and doing so may sink your business. Only insurance can cover such financially destructive claims.

People can also sue you if, for example, they slip and suffer an injury while on your property. To cover these types of claims, you can purchase a property or premises liability policy from an insurer.

> Accountants, doctors, and a number of other professionals can buy liability insurance. A good place to start searching for liability insurance is through the associations for your profession. Even if you're not a current member, check out the associations anyway — you may be able to access the insurance without membership, or you can join the association long enough to sign up. (Associations also sometimes offer competitive rates on disability insurance.)

Taking advantage of tax-deductible

insurance and other benefits

A variety of insurance and related benefits are tax-deductible for all employees of an incorporated business. These benefits include the full cost of health and disability insurance as well as up to $50,000 in term life insurance per employee.

A new health insurance premium tax credit is available to qualifying small employers. Among other requirements, employers must have fewer than 25 full-time employees, and the annual employee wages must average less than $50,000. The credit is available for tax years 2010 through 2013 and can be up to 35 percent of the employer's qualifying health insurance premium expenses. The credit is calculated and claimed on IRS Form 8941.

In addition to insurance, incorporated companies can also hold dependent-care plans in which up to $5,000 per employee may be put away on a tax-deductible basis for child care and care for elderly parents. Corporations can also offer cafeteria or flexible spending plans that allow employees to pick and choose which benefits they spend their benefit dollars on.

If your business isn't incorporated, you and the other business owners can't deduct the cost of insurance plans for yourselves. However, you can deduct these costs for your employees as well as your health insurance costs for yourself and covered family members.

Cashing in on corporate taxes

Aside from the tax treatment of insurance and other benefits, another difference between operating as a sole proprietor and as a corporation is that the government taxes a corporation's profits differently than those realized in a sole proprietorship. Which is better for your business depends on your situation.

Suppose that your business performs well and makes lots of money. If your business isn't incorporated, the government taxes all profits from your business on your personal tax return in the year that your company earns those profits. If you intend to use these profits to reinvest in your business and expand, incorporating can potentially save you some tax dollars. (However, this tax-reducing tactic doesn't work for personal service corporations, such as accounting, legal, and medical firms, which pay a higher tax rate.)

Resist the short-term temptation to incorporate just so you can have money left in the corporation taxed at a lower rate. If you want to pay yourself the profits in the future, you can end up paying more taxes. Why? Because you first pay taxes at the corporate tax rate in the year that your company earns the money, and then you pay taxes again on your personal income tax return when the corporation pays you.

Another reason not to incorporate, especially in the early months of a business, is that you can't immediately claim the losses for an incorporated business on your personal tax return. Because most businesses produce little revenue in their early years and have all sorts of start-up expenditures, losses are common.

S corporations and limited liability companies: The best of both worlds?

Wouldn’t it be nice to get the liability protection and other benefits that come with incorporating without the tax complications and hassles? Well, S corporations or limited liability companies may be for you.

Subchapter S corporations provide the liability protection that comes with incorporation. Likewise, the business profit or loss passes through to the owner’s personal tax return, so if the business shows a loss in some years, the owner may claim those losses in the current year of the loss on his personal tax return. If you plan to take all the profits out of the company (instead of reinvesting them), an S corporation may make sense for you.

The IRS allows most small businesses to operate as S corporations, but not all. In order to be an S corporation, a company must be a U.S. company, have just one class of stock, and have no more than 35 shareholders (who are all U.S. residents or citizens and who are not partnerships, corporations, or, with certain exceptions, trusts).

Limited liability companies (LLCs) offer business owners benefits similar to those of S corporations but are even better in some cases. Like an S corporation, an LLC offers liability protection for the owners. LLCs also pass the business’s profits and losses through to the owner’s personal income tax returns.

But limited liability companies have fewer restrictions regarding shareholders. For example, LLCs have no limits on the number of shareholders, and the shareholders in an LLC can be foreigners, corporations, and partnerships.

Compared with S corporations, the only additional restriction LLCs carry is that sole proprietors and professionals can’t always form an LLC (although they can in some states). Most state laws require you to have at least two partners and not be a professional service firm (for example, accounting, legal, or medical firms).

Making the decision to incorporate

If you’re totally confused about whether to incorporate because your business is undergoing major financial changes, it’s worth getting competent professional help. The hard part is knowing where to turn, because finding one advisor who can put together all the pieces of the puzzle (including the financial, legal, and tax-related aspects) is challenging. Also be aware that you may get wrong or biased advice.

> Although most attorneys and tax advisors don’t understand the business side of business, some do. So try to find one who does. Or, if necessary, you may need to hire a business advisor along with your attorney or tax advisor. Attorneys who specialize in advising small businesses can help explain the legal issues. Tax advisors who perform a lot of work with business owners can help explain the tax considerations.

If you’ve weighed the factors and you still can’t decide, my advice is to keep your business simple — don’t incorporate. Why? Because after you incorporate, unincorporating takes time and money. Start off your business as a sole proprietorship and then take it from there. Wait until the benefits of incorporating your business clearly outweigh the costs and drawbacks.

Finding and Keeping Customers

When you write your business plan (see Chapter 13), you need to think about your business's customers. Just as the sun is the center of the solar system, everything in your business revolves around your customers. If you take care of your customers, they'll take care of you and your business for many years.

Obtaining a following

When you're ready to attract customers, put together a mailing list of people you know who may be interested in what you're offering. Draft and mail an upbeat, one-page letter that provides an overview of what your business offers. As you have news to report — successes, new products and services, and so on — do another mailing.

Short letters are read more than glossy advertising newsletters. Most people are busy and don't care about your business enough to read a lengthy piece of mail. E-mail lists may work as well and are attractive due to their lower costs. Use a service like Constant Contact, which enables you to track how many people actually open and click on links in your e-mails.

In addition to mailings, other successful ways to get the word out and attract customers are limited only to your imagination and resourcefulness. Consider the following ideas:

- **If your business idea is innovative or somehow different, or if you have grand expansion plans, add some local media people to your mailing list.** Newspaper, radio, and even television business reporters are always looking for story ideas. So include them in your mailings, and send them the one-page updates as well. Just remember to make your press releases information pieces and not advertisements.

- **If your business seeks customers in a specific geographic area, blanket that area by mailing your one-page letter or delivering it door to door.** You can include a coupon that offers your products or services at a reduced cost (perhaps at the cost you pay) to get people to try them. Make sure that people know this deal is a special opening-for-business bargain.

Providing solid customer service

After you attract customers, treat them as you would like to be treated by a business. If customers like your products and services, they not only come back to buy more when the need arises, but they also tell others. (However, keep in mind that they're even more likely to tell others when they have a bad experience!) Satisfied customers are every business's best cost-effective marketers.

I never cease to be amazed by how many businesses have mediocre or poor customer service. One reason for poor service is that as your business grows, your employees are on the customer service front lines. If you don't hire good people and give them the proper incentives to serve customers, many of them won't do it. For most employees on a salary, the day-to-day task of assisting customers may be just an annoyance for them.

One way to make your staff care about customer service is to base part of their pay on the satisfaction of the customers they work with. Tie bonuses and increases at review time to this issue. You can easily measure customer satisfaction with a simple survey form.

Treating the customer right starts the moment that the selling process begins. Honesty is an often-underused business tool. More than a few salespeople mislead and lie in order to close a sale. Many customers discover after their purchase that they've been deceived, and they get angry. These unethical businesses likely lose not only future business from customers but also surely — and justifiably — referrals.

If your business doesn't perform well for a customer, apologize and bend over backward to make the customer happy. Offer a discount on the problem purchase or, if possible, a refund on product purchases. Also, make sure you have a clear return-and-refund policy. Bend that policy if doing so helps you satisfy an unhappy customer or rids you of a difficult customer.

Setting Up Shop

No matter what type of business you have in mind, you need space to work from, whether it's a spare room in your home, shared office space, or a small factory. You also need to outfit that space with tools of your trade. This section explains how to tackle these tasks.

Finding business space and negotiating a lease

Unless you can run your business from your home, you may be in the market for office or retail space. Finding good space and buying or leasing it both take tons of time if done right.

In the early years of your business, buying an office or a retail building generally doesn't make sense. The down payment consumes important capital, and you may end up spending lots of time and money on a real estate transaction for a location that may not interest you in the long term. Buying this type of real estate rarely makes sense unless you plan to stay put for five or more years. Leasing a space for your business is far more practical.

Renting office space is simpler than renting retail space because a building owner worries less about your business and its financial health. Your business needs more credibility to rent a retail building because your retail business affects the nature of the strip mall or shopping center where you lease. Owners of such properties don't want to move in quick failures or someone who does a poor job of running his business.

If you and your business don't have a track record with renting space, getting references is useful. If you seek well-located retail space, you must compete with national chains like Walgreens, so you better have a top-notch credit rating and track record. Consider subletting — circulate flyers to businesses that may have some extra space in the area in which you want to locate your business. Also prepare financial statements that show your personal and business creditworthiness.

Brokers list most spaces for lease. Working with a broker can be useful, but the same conflicts exist as with residential brokers (see Chapter 12). So also examine spaces for lease without a broker, and deal with the landlord directly. Such landlords may give you a better deal, and they don't worry about recouping a brokerage commission.

The biggest headaches with leasing space are understanding and negotiating the lease contract. Odds are that the lessor presents you with a standard, preprinted lease contract that she says is fair and is the same lease that everyone else signs. Don't sign it! This contract is the lessor's first offer. Have an expert review it and help you modify it. Find yourself an attorney who regularly deals with such contracts.

Should you work from home?

You may be able to run a relatively simple small business from your home. If you have the choice of running your business out of your home versus securing outside office space, consider the following issues:

- **Cost control:** As I discuss earlier in this chapter, bootstrapping your business can make a lot of financial and business sense. If you have space in your home that you can use, you've found yourself a rent-free business space. (However, if you're considering buying a larger home to have more space, you can't really say that your home office is rent-free.)

- **Business issues:** What are the needs of your business and customers? If you don't require fancy office space to impress others or to meet with clients, work at home. If you operate a retail business that requires lots of customers coming to you, getting outside space is probably the best (and legally correct) choice. Check with the governing authorities of your town or city to find out what local regulations exist for home-based businesses.

- **Discipline:** At home, do you have the discipline to work the number of hours that you need and want, or will the kitchen goodies tempt you to make half a dozen snack trips? Can you refrain from turning on the television every hour for late-breaking news or constantly surfing the Internet for stock quotes, personal research, and entertainment? The sometimes amorphous challenge of figuring out how to grow the business may cause you to focus your energies elsewhere.

- **Family matters:** Last, but not least, your home life should factor into where you decide to work. One advantage to working at home when you're a parent is that you can be a more involved parent. If nothing else, you can spend the one to two hours per day with your kids that you would have spend commuting! Just make sure you try to set aside work hours during which time your office is off limits.

  Ask other family members how they feel about your working at home. Be specific about what you plan to do, where, when, and how. Will clients come over? What time of day and where in the home will you meet with them? You may not think that your home office is an imposition, but your spouse may. Home business problems come between many couples. If you're single and living alone, home life is less of an issue.

Office leases are usually simpler than retail leases. About the most complicated issue you face with office leases is that they can be *full service,* which includes janitorial benefits. Retail leases, however, are usually *triple-net,* which means that you as the tenant pay for maintenance (for example, resurfacing the parking lot, cleaning, and gardening), utilities, and property taxes. You're correct to worry about a triple-net retail lease because you can't control many of these expenses. For example, if the property is sold, property taxes can jump.

Here are provisions to keep in mind when dealing with a triple-net lease:

- Compare your site's costs to other sites to evaluate the deal that the lessor offers you.
- Your lease contract needs to include a cap for the triple-net costs at a specified limit per square foot.
- Try to make sure that the lease contract doesn't make you responsible for removal costs for any toxic waste you may discover during your occupation. Also exclude increased property taxes that the sale of the property may cause.
- If feasible, get your landlord to pay for remodeling. It's cheaper for the landlord to do it and entails fewer hassles for you.
- With retail leases, get an option for renewal. This renewal option is critical in retail, where location is important. The option should specify the cost — for example, something like 5 percent below market, as determined by arbitration.
- Get an option that the lease can be transferred to a new owner if you sell the business.

If you really think you want to purchase (not lease) because you can see yourself staying in the same place for at least five years, head to Chapter 11.

Equipping your business space

You can easily go overboard spending money when leasing or buying office space and outfitting that space. The most common reason that small-business owners spend more than they should is to attempt to project a professional, upscale image. You can have an office or retail location that works for you and your customers without spending a fortune if you observe some simple rules:

- **Buy — don't lease or finance — equipment.** Unless you're running a manufacturing outfit where the cost of buying equipment is prohibitive, try to avoid borrowing and leasing. If you can't buy office furniture, computers, cash registers, and so on with cash, you probably can't afford them! Buying such things on credit or leasing them — leasing is invariably the most expensive way to go — encourages you to spend beyond your means.

  Consider buying used equipment, especially furniture, which takes longer to become obsolete. The more popular a piece of equipment, the more beneficial it is for you to purchase rather than lease: If many other businesses would be willing to buy the equipment, you'll have an easier time unloading it if you ever want to sell it. Leasing may make more sense with oddball-type equipment that is more of a hassle and costly for you to unload after a short usage period.

- **Don't get carried away with technological and marketing gadgets.** Some small-business owners spend excessively on the latest tech gadgets that they don't really need because they feel the need to be "competitive" and "current." Don't forget the virtues of picking up the phone or meeting in person — these forms of communication are much more personal ways of doing business.

Bootstrap-equipping your office makes sense within certain limits (see “Going it alone by bootstrapping,” earlier in this chapter). If customers come to you, of course, you don’t want a shabby-looking store or office. However, you don’t have to purchase the Rolls Royce equivalent of everything that you need for your office.

Accounting for the Money

One of the less glamorous aspects of running your own business is dealing with accounting. Unlike when you work for an employer, you must track your business's income, expenses, and taxes (for you *and* your employees). Although you may be able to afford to hire others to help with these dreary tasks, you still must know the inner workings of your business to keep control of your company, to stay out of trouble with the tax authorities, and to minimize your taxes. The following sections show you how to handle the accounting aspect of your business.

Maintaining tax records and payments

With revenue hopefully flowing into your business and expenses surely heading out, you must keep records to help satisfy your tax obligations and keep a handle on the financial status and success of your business. You can't accurately complete the necessary tax forms for your business if you don't properly track your income and expenses. And should the IRS audit you (the probability of being audited as a small-business owner is about four times higher than when you're an employee at a company), you may need to prove some or even all of your expenses and income.

In order to keep your sanity, and keep the IRS at bay, make sure you do the following:

- **Pay your taxes each quarter and on time.** When you're self-employed, you're responsible for the accurate and timely filing of all taxes that you owe on your income on a quarterly basis. You must pay taxes by the 15th of January, April, June, and September. (If the 15th falls on the weekend, payment is due the Monday that follows the 15th.) Call the IRS at 800-TAX-FORM (800-829-3676) and ask for Form 1040-ES (Estimated Tax for Individuals), or download this form from www.irs.gov. This form comes with an easy-to-use estimated tax worksheet and four payment coupons that you send in with your quarterly tax payments. Mark the due dates for your quarterly taxes on your calendar so you don't forget!

  If you have employees, you also need to withhold taxes from each paycheck they receive. You must then use the money that you deduct from their paychecks to make timely payments to the IRS and the appropriate state authorities. In addition to federal and state income tax, you also need to withhold and send in Social Security and any other state or locally mandated payroll taxes. Pay these taxes immediately after withholding them from your employees' paychecks and *never* use the money to fund your business needs.

I recommend using a payroll service to ensure that your payments are made correctly and on time to all the different places that these tax filings need to go.

- **Keep your business accounts separate from your personal accounts.** The IRS knows that small-business owners have more opportunity to hide business income and inflate business expenses. Thus, the IRS looks skeptically at business owners who use and commingle funds in personal checking and credit card accounts for business transactions.

  Although you may find opening and maintaining separate business accounts bothersome, do so. And remember to pay for only legitimate business expenses through your business account. You'll be thankful come tax preparation time to have separate records. Having separate records can also make the IRS easier to deal with if you're audited.

- **Keep good records of your business income and expenses.** You can use file folders, software, or a shoebox to collect your business income and expenses. Whatever your method, just do it! When you're ready to file your annual return, you need the documentation that allows you to figure your business income and expenses.

  Charging expenses on a credit card or writing a check can make the documentation for most businesses easier. These methods of payment leave a paper trail that simplifies the task of tallying up your expenses come tax time, and they also make the IRS auditor less grumpy in the event that he audits you. (Just make sure you don't overspend, as many people do with credit cards!)

In addition to keeping good records, you also need to decide on what basis, cash or accrual, you want your company to keep its books. Here’s the lowdown on the options:

- **Cash:** Most small-business owners use the *cash* method, which simply means that for tax purposes, you recognize or report income in the year it’s received and expenses in the year they’re paid.
- **Accrual:** The *accrual* method, by contrast, records income when the sale is made, even if the customer hasn’t yet paid; expenses are recognized when incurred even if your business hasn’t paid the bill yet.

Sole proprietorships, partnerships, and S and personal service corporations generally can use the cash method. C corporations and partnerships that have C corporations as partners may not use the cash accounting method.

The advantage of operating on a cash basis is that you can have some control over the amount of your business income and expenses that your business reports for tax purposes year to year. Doing so can lower your tax bill. Suppose that, looking ahead to the next tax year, you have good reason to believe that your business will make more money, pushing you into a higher tax bracket. You can likely reduce your tax bill if you pay more of your expenses in the next year. For example, instead of buying a new computer late this year, you can wait until early next year. (***Note:*** The IRS recognizes credit card expenses by the date when you make the charges, not when you pay the bill.) Likewise, you can somewhat control when your customers pay you. If you expect to make less money next year, simply don’t invoice customers in December of this year. Wait until January so you receive the income from those sales next year.

Paying lower taxes (legally)

Every small business must spend money, and spending money in your business holds the allure of lowering your tax bill. But don't spend money on your business just for the sake of generating tax deductions. Spend your money to make the most of the tax breaks that you can legally take. The following are some examples of legal tax breaks:

- **Take it all off now or spread it around for later.** As a small-business owner, if you have net income, you can deduct up to $500,000 (for tax year 2011) per year for equipment purchases (for example, espresso machines, computers, desks, and chairs) for use in your business. By deducting via a Section 179 deduction, you can immediately deduct the entire amount that you spend on equipment for your business. Normally, equipment for your business is depreciated over a number of years. With *depreciation,* you claim a tax deduction yearly for a portion of the total purchase price of the equipment. For example, if you drop two grand on a new computer, you can take a $400 deduction annually for this computer's depreciation (if you elect straight-line depreciation). If you elect the special 179 deduction, you can claim the entire $2,000 outlay at once (as long as you haven't exceeded the $500,000 annual cap).

  Taking all the deduction in one year by using the Section 179 deduction method is enticing, but you may pay more taxes in the long run that way. Consider that in the early years of most businesses, profits are low. When your business is in a low tax bracket, the value of your deductions is low. If your business grows, you may come out ahead if you depreciate your early-year big-ticket expenses, thereby postponing to higher-tax-bracket years some of the deductions that you can take off.

- **Make the most of your auto deductions.** If you use your car for business, you can claim a deduction, but don't waste a lot of money on a new car, thinking that the IRS pays for it — because it doesn’t. The IRS limits how large an annual auto expense you can claim for depreciation. Another advantage of purchasing a more reasonably priced car: You won’t be burdened with documenting your actual auto expenses and calculating depreciation. You can use the auto expense method of just claiming a flat 51 cents per mile (for tax year 2011).

- **Deduct travel, meal, and entertainment expenses.** For the IRS to consider your expense deductible, your travel must be for a bona fide business purpose. For example, if you live in Chicago, fly to Honolulu for a week, and spend one day at a seminar for business purposes and then the other six days snorkeling and sunning, you can deduct only the expenses for the one day of your trip that you devoted to business. (An exception to this rule enables you to write off more of your trip: If you extend a business trip to stay over a Saturday night to qualify for a lower airfare and you save money in total travel costs, you can claim the extra costs that you incurred to stay over through Sunday!)

  Don’t waste your money on meal and entertainment expenses. You can deduct only 50 percent of your business expenses; by all means, take that 50 percent deduction when you can legally do so, but don’t spend frivolously on business trips and think that you can deduct everything. The IRS doesn’t allow business deductions for club dues (such as for health, business, airport, or social clubs) or entertainment (such as executive boxes at sports stadiums).

Keeping a Life and Perspective

David Packard, co-founder of Hewlett-Packard, said, “You are likely to die not of starvation for opportunities, but of indigestion of opportunities.”

Most small businesses succeed in keeping their owners more than busy — in some cases, too busy. If you provide needed products or services at a fair price, customers will beat a path to your door. Your business will grow and be busier than you can personally handle. You may need to start hiring people. I know small-business owners who work themselves into a frenzy by putting in 70 or more hours a week.

If you enjoy your work so much that it’s not really work, and you end up putting in long hours because you enjoy it, terrific! But success in your company can cause you to put less energy into other important aspects of your life that perhaps don’t come as easily.

Although careers and business successes are important, don’t place these successes higher than fourth on your overall priority list. You can’t replace your health, family, and friends, but you can replace a job or a business.

Chapter 17

Perusing Periodicals, Radio, and Television

In This Chapter

- Sifting through financial magazines and newspapers
- Surveying radio and television programs
- Steering clear of most investment newsletters

Newspapers, magazines, newsletters, and radio and television programs inundate you and other investors with a constant barrage of investing information and advice. In this chapter, I explain what to look for — and what to look out for — when you tune in to these traditional media sources in the hopes of investing better.

In Print: Magazines and Newspapers

Visit a newsstand, and you find many investing publications as well as general interest publications with investing columns. I've written investing articles for various magazines and newspapers. Some of the experiences have been enjoyable, others okay, and a few miserable. The best publications and editors I've written for take seriously their responsibility to provide quality information and advice to their readers.

Taking the scribes to task

Perusing high-quality publications is fun, but reading those that include tons of hype and inaccurate information is mind-numbing. In this section, I discuss the problems with magazine and newspaper investment articles so you can easily recognize and avoid them.

Highlighting hype and horror

Whenever the stock market suffers a sharp decline, many in the media bring out the gloom and doom. For example, when the stock and real estate markets slid sharply in the late 2000s, scores of "Great Depression II" pieces populated the pages. First came talk that the "real" unemployment rate was actually closer to 20 percent instead of the reported (and already high) 10 percent. Other similar negative stories weren't far behind.

Then came the news stories that the local, state, and federal governments were so laden with debts that bankruptcy loomed and the very existence of the United States was in jeopardy. (Global stock prices, meanwhile, doubled from their lows in early 2009, once again proving that the best values and opportunities come to those brave enough to buy when others are fearful of doing so and when bad news is easy to find.)

Another particularly popular subject for such hyped-up reporting is the cost of a college education. (See, you can write a sentence about the cost of education without including the word *skyrocketing*.) Scores of these articles horrify parents with estimates of the expected costs associated with sending Junior to campus. The typical advice they provide goes like this: Start saving and investing early so you don't have to tell Junior that you can't afford to send him to college.

Cost-of-college stories typify another failing of the media's horror stories. The *horror* is that the story and the accompanying advice can be shortsighted. Completely overlooked and ignored are the tax and financial aid consequences of the recommended investment strategies. For example, if parents don't take advantage of tax-deductible retirement accounts and instead save outside of them to pay for expected college costs, they not only pay more in taxes but also generally qualify for less financial aid. Sound investing decisions require a holistic approach that acknowledges that people have limited money and must make trade-offs. And, unfortunately, magazines and newspapers can't always supply that type of advice.

Quoting "experts" who don't know their stuff

Historically, one way that finance journalists have attempted to overcome technical gaps in their knowledge is to interview and quote financial experts. Although these quotes may add to the accuracy and quality of a story, journalists who aren't experts themselves often have difficulty telling qualified experts from hacks. (See Chapter 16 for a discussion on examining the qualifications of writers who offer up financial guidance.)

One glaring example of this phenomenon that continues to amaze me is how many newspaper and magazine financial writers quote unproven advice from investment newsletter writers. As I discuss in the section "Fillers and Fluff: Being Wary of Investment Newsletters," later in this chapter, the predictive advice of many newsletter writers is often poor and causes investors to earn lower returns and miss more investment gains due to frequent trading than if they simply bought and held. Journalists who simply parrot this type of information and provide an endorsement that unqualified sources are "experts" do readers an immense disservice.

Focusing on noise and minutiae

Daily financial press writers contribute to today's shortsighted investment environment and encourage readers to adopt similarly misguided outlooks. A focus on the noise of the day causes nervous investors to make panicked, emotionally based decisions, such as deciding to sell *after* major stock market falls.

Of course, the daily print media aren't the only ones chronicling the minutiae. As I discuss elsewhere, other media, including television, radio, and the Internet, cause many investors to lose sight of the long term and the big picture. (I discuss television and radio resources later in this chapter; you can read about Internet resources in Chapter 19.)

REMEMBER The short length of newspaper and magazine articles can easily lead writers to oversimplify complex issues and offer flawed advice, so make sure to be judicious when reading them. For example, some pieces on mutual funds focus on a fund's returns and investment philosophies, devoting little, if any, space to the risks or tax consequences of investing in the recommended funds.

Making the most of periodicals

So what should you do if you want to find out more about investing but don't want to be overloaded with information? Educate yourself and be selective. If you're considering subscribing to financial publications, review some old issues and articles first. Try to determine whether the information and advice was useful and error free. The more you know, the easier it is to separate the wheat from the chaff.

Shy away from publications that claim to be able to predict the future — few people have a knack for forecasting financial numbers, and those who do are usually busy managing money. Unfortunately, as the financial markets got more volatile in the late 1990s and early 2000s, and then again in the late 2000s, I witnessed more and more publications promoting columnists and headlines that attempted to prognosticate the future.

Read bylines and biographies and get to know writers' strengths and weaknesses. Ditto for the entire publication. Any writer or publisher can make mistakes. Some make many more than others, however. So follow their advice at your own peril. Start by evaluating advice in the areas that you know the most about. For example, if you're interested in investing in Microsoft or Intel and are reasonably familiar with the computer industry, find out what the publications say about technology investments.

And remember that you're not going to outfox the financial markets, because they're reasonably efficient (see Chapter 4). Spend your time seeking out information and advice that help you flesh out your goals and develop a plan rather than hunting for the next hot stock tip or worrying about short-term trends.

Broadcasting Hype: Radio and Television Programs

As you move from the world of magazines and newspapers to radio and television, the entertainment component usually increases. In this section, I highlight some common problems with radio and television programs.

I've been a guest on hundreds of radio and television programs. Just as Dorothy discovered in *The Wizard of Oz,* seeing how things work behind the scenes tends to deglamorize these mediums. Here are the main problems I've discovered from my years observing radio and television.

You often get what you pay for

Not surprisingly, some of the worst financial advice is brought to you for "free." Nationally, thousands of radio stations have financial and money talk shows. Money and investing shows are proliferating on television cable channels. Because listeners don't pay for these shows, advertising often drives who and what gets on the air, as I discuss in Chapter 16.

I've found that some of the worst offenders are local — and even national — radio advice programs. Some of these shows are "hosted" by a person who is nothing more than a financial salesperson. That person's first, and sometimes only, motivation for hosting the show is to pick up clients. Many local radio investing programs are hosted by a local stockbroker (who usually calls himself a financial consultant or planner). A broker who reels in just one big fish a month — a person with, say, $300,000 to invest — can generate commissions totaling $15,000 by selling investments with a 5 percent commission.

> I know from personal experience what too many radio stations look for in the way of hosts for financial programs. The host's integrity, knowledge, and lack of conflict of interest don't matter. Willingness to work for next to nothing helps. In fact, one radio station program director told me that she liked the broker who was hosting a financial talk show because the broker was willing to work for so little compensation from the radio station. Never mind the fact that the broker rarely gave useful advice and was obviously trolling for new clients. Those things didn't matter to the program director, who told me, "We're in the entertainment business."

Information and hype overload

At 9:30 a.m. EST, the New York Stock Exchange opens, and transactions start streaming across the bottom of television screens that are tuned to financial cable stations. Changes in the major market indexes — the Dow Jones Industrial Average, the S&P 500, and the NASDAQ index — also flash on the screen. In fact, these indexes are updated almost every *second* on the screen. Far more exciting than a political race or sporting event, this event never ends and offers constant change and excitement. Even after the markets close, reporting of still-open overseas markets continues. The performance of futures of U.S. stock market indexes then appears on the screen.

This constant reporting doesn't make people better investors. Although the conventionally accepted notion is that this information overload levels the playing field for the individual investor, I know too many investors who make emotionally based decisions prodded by all this noise, prognostication, opinion, and hearsay.

Poor method of guest selection

Some journalists, often in an effort to overcome their own lack of knowledge, interview "experts." A classic example of this problem is the media exposure that author Charles Givens used to receive. Givens became a darling of the media and the public following an unprecedented, consecutive three-day appearance on NBC's *Today* show.

"When Charles Givens talks, everyone listens," said Jane Pauley, then co-host of the *Today* show. Bryant Gumbel, the other co-host, said of Givens, "Last time he was here, the studio came to a complete stop. . . . Everyone started taking notes, and I was asking for advice." Givens regularly held court on the talk show circuit with the likes of Larry King and Oprah Winfrey.

The Givens case highlights some of the media's inability to distinguish between good and bad experts. It's relatively easy for the financially sophisticated to see the dangerous, oversimplified, and biased advice that Givens offers in his books. In his first best-seller, *Wealth Without Risk,* Givens recommended investing in limited partnerships and provided a phone number and address of a firm, Delta Capital Corp. in Florida, where readers could buy the partnerships. Those who bought these products ended up paying hefty sales commissions and owning investments worth half or less of their original value. Besides the problematic partnerships he recommended, court proceedings against Givens in a number of states uncovered that he owned a major share of Delta Capital.

Other investing advice from Givens that gives true experts pause: In his chapters on investing, he said that the average yearly return you earn investing in mutual funds will be 25 percent or 30 percent. The reality: An investor would be fortunate to earn half of these inflated returns.

So how did Givens get on all these national programs? He had a shrewd publicist, and the show producers either didn't read his books or were financially illiterate themselves. Talk shows and many reporters often don't take the time to check out people like Givens. Most of the time, they never read the books these so-called experts write. Producers, who themselves usually don't know much about investing, often decide to put someone on the air on the basis of a press kit or a call from a publicist.

Fillers and Fluff: Being Wary of Investment Newsletters

Particularly in the newsletter business, prognosticators fill your mailbox and e-mail inbox with promotional material making outrageous claims about their returns. Private money managers, not subject to the same scrutiny and auditing requirements as mutual fund managers, can do the same.

Be especially wary of any newsletters making claims of high returns. Stephen Leeb's *Personal Finance* newsletter ads, for example, claim that he has developed a brilliant proprietary model, which he calls the "Master Key Indicator." His model supposedly has predicted the last 28 consecutive upturns in the market without a single miss. The odds of doing this, according to Leeb, are more than 268 million to 1! The ad goes on to claim that Leeb's "Master Key" market-timing system could have turned a $10,000 investment over 12 years into $39.1 million, a return of 390,000 percent!

Turns out that this outrageous claim was based on *backtesting,* looking back over historic returns and creating "what if" scenarios. In other words, Leeb didn't turn anyone's $10,000 into $39 million. Much too late after that ad appeared, the SEC finally charged Leeb with false advertising. (Leeb settled out of court.)

According to the *Hulbert Financial Digest,* the worst investment newsletters have underperformed the market averages by dozens of percentage points; some would even have caused you to lose money during decades (like the 1980s and 1990s) when the financial markets performed extraordinarily well. Newsletter purveyor Joe Granville, for example, has long been known for making outrageous and extreme stock market predictions and is often quoted in financial publications. He claims to have the number-one-rated newsletter, but he fails to mention that it was number one for one year only (in 1989). Over the subsequent decade — one of the best decades ever for the stock market (with U.S. stocks more than quadrupling in value) — followers of Granville's advice *lost* 99 percent of their investments!

Be highly suspicious of past investment performance claims made by investment newsletters. Don’t believe a track record unless a reputable accounting firm with experience doing such audits has audited it. You don’t need predictions and soothsayers to make sound investing choices. If you choose to follow this “expert” advice and you’re lucky, little harm will be done. But more often than not, you can lose lots of money by following a prognosticator’s predictions. Stay far away from publications that purport to be able to tell what’s going to happen next. No one has a crystal ball.

The best investment publications can assist you with research and ideas. For individual stock selection, please see my recommended resources in Chapter 6.

Chapter 21

Ten Things to Consider When Weighing an Investment Sale

In This Chapter

- Considering your investment goals and other big-picture issues
- Factoring taxes into your profit

You can and should hold good investments for years and decades. Each year, people sell trillions of dollars' worth of investments. My experience helping folks get a handle on their investments suggests that too many people sell for the wrong reasons (while other investors hold on to investments that they should sell for far too long). In this chapter, I highlight ten important issues to consider when you contemplate selling your investments.

Remembering Your Preferences and Goals

If your life has changed (or you've inherited investments) since the last time you took a good look at your investment portfolio, you may discover that your current portfolio may no longer make sense for you. To avoid wasting time and money on investments that aren't good for you, be sure to review your holdings at least annually. But don't make quick decisions about selling. Instead, take your time and be sure that you understand tax and other ramifications before you sell.

The time that it takes you to manage your portfolio, for example, is a vital matter if you're starved for time or weary of managing time-consuming investments. Leo, for example, loved to research, track, and trade individual stocks — until his daughter was born. Then Leo realized how many hours his hobby was taking away from his family. This realization put his priorities into perspective. Leo now invests in time-friendly mutual funds and exchange-traded funds and doesn't follow them like a hawk.

One of my clients, Mary, loves investing in real estate because she enjoys the challenge of researching, selecting, and managing her properties. She works in a job where she has to put up with lots of controlling, stressed-out bosses. For Mary, real estate isn't just a profitable investment; it's also a way of expressing herself and growing personally.

Maintaining Balance in Your Portfolio

A good reason to sell an investment is to allow yourself to better diversify your portfolio. Suppose, for example, that before reading this book, you purchased a restaurant stock every time you read about one. Now your portfolio resembles several strip malls, and restaurant stocks comprise 80 percent of your holdings. Or maybe, through your job, you've accumulated such a hefty chunk of stock in your employer that this stock now overwhelms the rest of your investments.

If your situation sounds anything like these, it's time for you to diversify. Sell off some of the holdings that you have too much of and invest the proceeds in some of the solid investments that I recommend in this book. If you think your employer's stock is going to be a superior investment, holding a big chunk is your gamble. At a minimum, review Chapter 6 to see how to evaluate a particular stock. But remember to consider the consequences if you're wrong about your employer's stock.

Conservative investors often keep too much of their money in bank accounts, Treasury bills, and the like. Read Chapter 3 to come up with an overall investment strategy that fits with your personal financial situation.

Deciding Which Investments Are Keepers

Often, people are tempted to sell an investment for the wrong reasons. One natural human tendency is to want to sell investments that have declined in value. Some people fear a further fall, and they don't want to be affiliated with a loser, especially when money is involved.

> Instead, step back, take some deep breaths, and examine the merits of the investment you're considering selling. If an investment is otherwise still sound, why bail out when prices are down and a sale is going on? What are you going to do with the money? If anything, you should be contemplating buying more of such an investment. Also, don't make a decision to sell based on your current emotional response, especially to recent news events. If bad news has recently hit, it's already old news. Don't base your investment holdings on such transitory events. Use the criteria in this book for finding good investments to evaluate the worthiness of your current holdings. If an investment is fundamentally sound, don't sell it.

A better reason to sell an investment is that it comes with high fees relative to comparable investments. For example, if you own a bond mutual fund that is socking it to you with fees of 1 percent per year, check out Chapter 8 to discover high-performing, lower-cost funds.

Tuning In to the Tax Consequences

When you sell investments that you hold outside a tax-sheltered retirement account, such as in an IRA or a 401(k), taxes should be one factor in your decision. (See Chapter 3 to find out about tax rates that apply to the sale of an investment as well as to the distributions that investments make.) If the investments are inside retirement accounts, taxes aren't an issue because the accounts are sheltered from taxation until you withdraw funds from them.

Just because you pay tax on a profit from selling a non-retirement account investment doesn't mean you should avoid selling. With real estate that you buy directly, as opposed to publicly held securities like REITs, you can often avoid paying taxes on the profit that you make (see Chapters 10 and 11 for details).

With stocks and mutual funds, you can specify which shares you want to sell. This option makes selling decisions more complicated, but you may want to consider specifying what shares you're selling because you may be able to save taxes. (Read the next section for more information on this option.) If you sell all your shares of a particular security that you own, you don't need to concern yourself with specifying which shares you're selling.

Figuring Out What Shares Cost

When you sell a portion of the shares of a security (for example, stock, bond, or mutual fund) that you own, specifying which shares you're selling may benefit you taxwise. Here's an example to show you why you may want to specify selling certain shares — especially those shares that cost you more to buy — so you can save on your taxes.

Suppose you own a total of 300 shares of a stock and you want to sell 100 shares to pay for a root canal. Suppose further that you bought 100 of these shares a long time ago at $10 per share, 100 shares two years ago at $16 per share, and the last 100 shares one year ago at $14 per share. Today the stock is at $20 per share.

The IRS allows you to choose which shares you want to sell. Electing to sell the 100 shares that you purchased at the highest price — those you bought for $16 per share two years ago — saves you in taxes. To comply with the tax laws, you must identify the shares that you want the broker to sell by the original date of purchase and/or the cost when you sell the shares. The brokerage firm through which you sell the stock should include this information on the confirmation slip that you receive for the sale.

The other method of accounting for which shares are sold is the method that the IRS forces you to use if you don't specify before the sale which shares you want to sell — the *first-in-first-out* (FIFO) method. FIFO means that the first shares that you sell are simply the first shares that you bought. Not surprisingly, because most stocks appreciate over time, the FIFO method usually leads to you paying more tax sooner. The FIFO accounting procedure leads to the conclusion that the 100 shares you sell are the 100 that you bought long, long ago at $10 per share. Thus, you owe a larger amount of taxes than if you sold the higher-cost shares under the specification method.

Although you save taxes today if you specify selling the shares that you bought more recently at a higher price, remember that when you finally sell the other shares, you'll then owe taxes on the larger profit. The longer you expect to hold these other shares, the greater the value you'll likely derive from postponing, realizing the larger gains and paying more in taxes. If you expect your tax rate to decline in the future, you have another good reason to hold off selling the shares in which you have greater profit.

When you sell shares in a mutual fund, the IRS has yet another accounting method, known as the *average cost method,* for figuring your taxable profit or loss when you sell a portion of your holdings in a mutual fund. This method comes in handy if you bought shares in chunks over time or reinvested the fund payouts into purchasing more shares of the fund. As the name suggests, the average cost method allows you to take an average cost for all the shares you bought over time.

Selling Investments with Hefty Profits

Of course, no one likes to pay taxes, but if an investment you own has appreciated in value, someday you'll have to pay taxes on it when you sell — unless, of course, you plan to pass the investment to your heirs upon your death. The IRS wipes out the capital gains tax on appreciated assets at your death.

Capital gains tax applies when you sell an investment at a higher price than you paid for it (see Chapter 3).

Odds are, the longer you've held securities such as stocks, the greater the capital gains you'll have, because stocks tend to appreciate over time. If all your assets have appreciated significantly, you may resist selling to avoid taxes. However, if you need money for a major purchase, sell what you need and pay the tax. Even if you have to pay state as well as federal taxes totaling some 35 percent of the profit, you'll have lots left. (For "longer-term" profits from investments held more than one year, your federal and state capital gains taxes would probably total less than 20 to 25 percent.)

Before you sell, do some rough figuring to make sure you'll have enough money left to accomplish what you want. If you seek to sell one investment and reinvest in another, you'll owe tax on the profit unless you're selling and rebuying real estate (see Chapters 10 and 11).

If you hold a number of assets, in order to diversify and meet your other financial goals, give preference to selling your largest holdings with the smallest capital gains. If you have some securities that have profits and some that have losses, you can sell some of each to offset the profits with the losses.

Cutting Your (Securities) Losses

Perhaps you have some losers in your portfolio. If you need to raise cash for some particular reason, you may consider selling select securities at a loss. You can use losses to offset gains as long as you hold both offsetting securities for more than one year (long term) or you hold both for no more than one year (short term). The IRS makes this delineation because the IRS taxes long-term gains and losses on a different rate schedule than short-term gains and losses (see Chapter 3).

If you need to sell securities at a loss, be advised that you can't claim more than $3,000 in net losses in any one year. If you sell securities with net losses totaling more than $3,000 in a year, you must carry the losses over to future tax years. This situation not only creates more tax paperwork but also delays realizing the value of deducting a tax loss. So try not to have *net losses* (losses + gains) that exceed $3,000 in a year.

Some tax advisors advocate doing year-end tax-loss selling with stocks, bonds, and mutual funds. The logic goes that if you hold a security at a loss, you should sell it, take the tax write-off, and then buy it (or something similar) back.

When selling investments for tax-loss purposes, be careful of the so-called *wash sale* rules. The IRS doesn't allow the deduction of a loss for a security sale if you buy that same security back within 30 days. As long as you wait 31 or more days, you won't encounter any problems. If you're selling a mutual fund or exchange-traded fund, you can purchase a fund similar to the one you're selling to easily sidestep this rule.

Dealing with Investments with Unknown Costs

Sometimes you may not know what an investment originally cost you. Or you may have received some investments from another person, and you're not sure what he or she paid for them. If you don't have the original statement, start by calling the firm where the investment was purchased. Whether it's a brokerage firm or a mutual fund company, the company should be able to send you copies of old account statements, although you may have to pay a small fee for this service.

Also, increasing numbers of investment firms, especially mutual fund companies, can tell you upon the sale of an investment what its original cost was. The cost calculated is usually the average cost for the shares you purchased.

Recognizing Broker Differences

If you're selling securities such as stocks and bonds, you need to know that some brokers charge more — in some cases, lots more —

to sell. Luckily, even if the securities that you want to sell currently reside at a high-cost brokerage firm, you can transfer them to a discount brokerage firm. Head to Chapter 9 to read about the different types of brokerage firms and how to select the best one for your situation.

Finding a Trustworthy Financial Advisor

If you delegate your investment decision-making to an advisor, you may be disappointed in your returns. Few financial advisors offer objective and knowledgeable advice. Unfortunately, if you're grappling with a selling decision, finding a competent and impartial financial advisor to help with the decision is about as difficult as finding a politician who doesn't accept special-interest money. 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.

If you need advice about whether to sell some investments, turn to a tax or financial advisor who works on an hourly basis.

Chapter 22

Ten Tips for Investing in a Down Market

In This Chapter

- Taking care of your investments when the market is on the decline
- Keeping a level head amid the doom and gloom

Unless a lot of other breaking news occurs on a particular day, sharp drops in the stock market make headlines — stock market gyrations are great media fodder. Every day the market environment is different, and new stocks are always plunging and rising. And now, with more individuals holding stocks (including mutual funds and exchange-traded funds) through company and personal retirement plans, most folks watch financial market movements. In this chapter, I discuss how to maximize your chances for investing success when stocks take an extended turn for the worse.

Don't Panic

No one enjoys turning on his car radio, clicking on his television set, or logging on to the Internet and getting this news: "Stocks plunge. The Dow Jones Industrial plummeted 400 points today." When you hear this news, don't panic — it's just one day's events. (In 2008, the market seemingly had day after day of such drops, and the events could accurately be described as a financial panic, the likes of which the nation hadn't experienced in generations. I describe this situation more in the later section "View Major Declines as Sales.")

Just because a home burned to the ground recently in your town and the news is being broadcast all over the local media, you probably wouldn't start living on the street out of fear of being at home during a fire. But you may take some sensible precautions, such as installing smoke alarms and repairing any malfunctioning appliances that may cause a fire, to ensure that your home isn't likely to become the next fire department statistic.

Likewise, don't shun stocks, which produce terrific long-term returns, just because of the down periods. As I discuss in Chapter 2, risk and return go hand in hand. If you want wealth-building investments that provide superior long-term returns, you must be willing to accept risk (that is, volatility and down periods). You should take sensible precautions — with diversification being the star of the show — to reduce your risk.

Although other wealth-building investments, such as real estate and small business, go through significant declines, you generally see few headlines on their daily price movements. A good reason for this lack of headlines is that no one reports on the pricing of real estate and small businesses minute by minute every business day, as is done with stock prices.

Keep Your Portfolio's Perspective in Mind

If you follow my advice, your portfolio will consist of diversified stock holdings, including some international stocks and some bonds. Having a diversified portfolio can help in a down market because some investments will increase as others decrease, thus balancing the losses.

One of my counseling clients called me when the stock market was dropping precipitously during the summer of 2002. "I just saw that the S&P 500 is now down 28 percent so far this year, and the

NASDAQ is down 34 percent. Should I sell?”

He was quite surprised when I crunched some numbers and determined that *his* portfolio of stocks and bonds was down just 8 percent for the year. Now, mind you, I wasn’t trying to minimize or trivialize the fact that he had lost money so far that year. However, he overlooked the fact that the bonds in his portfolio had actually increased in value, as had some of his stock funds that were invested in value-oriented stocks. See Chapter 8 for tips on how to build a diversified fund portfolio.

View Major Declines as Sales

Unlike retail stores, which experience larger crowds when prices are cut, fewer investors, especially individual investors, want to buy stocks after they’ve suffered a sharp decline. However, when stock prices decline, don’t get swept up in the pessimism. View declines as the financial markets having a sale on stocks. Stocks usually bottom when pessimism reaches a peak. Why? Those who were motivated to sell have done so, and the major selling has exhausted itself.

During the recession and stock market decline that reached a crescendo in 2008, negativity and pessimism were rampant. Global stock prices dropped by half in about one year’s time. The banking and financial system was in crisis and governments were intervening. Talk of a depression became common as U.S. unemployment surged past 10 percent. After bottoming in early 2009, stocks went on an upward rampage that resulted in a doubling in value in just two years — a rare historic event.

Now, I’m not saying you should randomly buy just any stock after a decline. For example, as I discuss in Part II, I’m not an advocate of buying individual stocks, especially a collection of stocks focused in the same industry (such as technology or auto manufacturing). When technology stocks started declining in 2000, some investors made the mistake of buying more of them after prices dropped 10 or 20 percent. What such “buy on the dip” investors didn’t realize was that the technology stocks they were buying were still grossly overpriced when measured by price-earnings ratios and other valuation measures (see Chapter 5).

You’re best off buying stocks gradually over time through well-managed, diversified mutual funds (see Chapter 8). When the broad stock market suffers a substantial decline and stocks are at reduced prices — on sale — you can step up your buying.

Identify Your Portfolio’s Problems

Stock market declines can be effective at quickly exposing problems with your portfolio, such as having too many investments from the same industry.

For example, when technology stocks tumbled in the early 2000s, I started getting lots of e-mails and letters from investors who had loaded up on these stocks and wanted my advice on what they should do with their holdings. Many of these investors kept thinking about how much more their technology stocks were worth at their peak before the decline set in. I urged such investors to acknowledge the huge risk they were taking by putting so many eggs in one basket. I also highlighted the dangers of chasing after a hot sector, and I pointed out that today’s hot sector often becomes tomorrow’s laggard.

In addition to poorly diversified portfolios, a declining stock market can also expose the high fees you may be paying on your investments. Fewer investors care about getting whacked with fees amounting to, say, 2 percent annually when they’re making 20 percent yearly. But after a few years of low or negative returns, such high fees become quite painful and more obvious.

Avoid Growth Stocks If You Get Queasy Easily

In a sustained stock market slide (*bear market*), the stocks that get clobbered the most tend to be the ones that were most overpriced from the period of the previous market rise (*bull market*). Like fads such as hula hoops, pet rocks, and Cabbage Patch dolls, in each bull market, particular types of growth stocks, such as Internet companies or biotechnology companies, can be especially hot.

> Predicting the duration and magnitude of a bear market is nearly impossible. Consequently, it makes sense to focus your stock investing on those stocks that produce solid long-term returns and that tend to decline less in major market declines. For instance, so-called *value stocks* tend to be among the safer types of stocks to hold during a bear market. Value stocks generally have less downside risk because they have relatively greater underlying asset values in comparison to their stock valuations. (Value stocks also typically pay higher dividends.)

As has happened in some other past bear markets, numerous value-oriented stocks actually appreciated during the bear market in the early 2000s. (This didn't happen during the more severe, late-2000s bear market, however.) Check out Chapter 8 for my discussion of the different types of stocks and mutual funds that practice value stock investing.

Tune Out Negative, Hyped Media

When the stock market is crumbling, subjecting yourself to a daily diet of bad news and conflicting opinions about what to do next makes most investors do the wrong things. Just like a steady diet of junk food is bad for your physical health, a continuous stream of negative, hyped news is bad for your financial health. In my observations, dwelling on bad news doesn't do such great things for people's emotional health either.

The economy goes through periods of expansion and occasional periods of decline (with the former generally being longer and stronger than the latter). Conflict is always occurring somewhere in the world. The business world will always have some unethical and corrupt company executives. Holding stocks always carries risk. So those who see the glass as half full and who see the positive and not just the negative build wealth by holding stocks, real estate, and small business over the long term.

Ignore Large Point Declines, but Consider the Percentages

It drives me crazy when the news media show a one-day chart of a major stock market index, such as the Dow Jones Industrial Average, on a day when the index drops a large number of points. In recent years, 200-and 300-point drops in the Dow happened fairly frequently.

Look at an index's percentage decline rather than at its point decline. Although 200 to 300 points sounds like a horrendous drop, such a drop amounts to a move of about 2 percent for an index trading around 12,500. No one likes losing that portion of their wealth invested in stocks in one day, but the percentage of change sounds less horrifying than the point change.

Don’t Believe You Need a Rich Dad to Be a Successful Investor

A young man wrote to me about an interview that he had read about the *Rich Dad, Poor Dad* series, by author Robert Kiyosaki. In the interview, Kiyosaki said that the rich are different from the rest of the population because “They teach their children how to be rich. . . . These get-rich techniques include investing with leverage . . . and staying away from mutual funds and 401(k)s, which are way too risky.”

The young man came from a humble background and had been salting money away in mutual funds through his company’s retirement plan. But he thought that he may be doomed to a lifetime of poverty after reading what the *Rich Dad* guru had to say. Luckily, I was able to set the young man straight.

I’ve known plenty of people over the years who have come from nonwealthy families and have built substantial wealth by living within their means and investing in the three wealth-building assets that I focus on in this book: stocks, real estate, and small business.

In addition to Kiyosaki saying that mutual funds and 401(k)s are way too risky, he also says, “Those vehicles are only good for about 20 percent of the population, people making $100,000 or more.” I couldn’t disagree more. In fact, my experience is that mutual funds and exchange-traded funds are tailor-made for nonwealthy people who don’t have the assets to properly create a diversified portfolio themselves.

Kiyosaki also says that he doesn’t like mutual funds because “Mutual funds have got no insurance from a stock market crash. To me, that’s sad, and I am concerned.” As I discuss in Parts I and II of this book, the best way to reduce the risk of investing in stocks is to diversify your holdings not only in a variety of stocks, which is precisely what good stock mutual funds do, but also in other investments that don't move in tandem with the stock market (such as bond funds).

Kiyosaki claims that he invests with the benefit of insurance when investing in real estate. He says, "My banker requires me to have insurance from catastrophic losses." This is a nonsensical comparison because such an insurance policy would cover losses from say, a fire, but not from a decline in market value of the real estate due to overall market conditions. Interestingly, Kiyosaki followers got clobbered by piling into real estate, which dropped sharply in most areas in the mid-to late-2000s.

Understand the Financial Markets

When the going gets tough in the stock market, you can easily lose perspective and start making rash decisions. Instead, you must have the long-term perspective you need to succeed with stock investing, and you really need to understand how the financial markets work. So, even if you've already read them, go back and read Chapters 4 and 5 again. These chapters explain how the stock market works and what influences stock prices in the short term versus the longer term.

Talk to People Who Care about You

Life's challenging events can be humbling and sometimes depressing. Holding an investment that's dropped a lot in value — whether it's a stock, a mutual fund, real estate, or a small business — is one such event. But you don't have to carry the burden yourself. Talk about your feelings with someone who understands and cares about you. Be clear about and communicate what you're seeking — empathy, good listening, a sounding board, or advice.

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Bestselling author, Investing For Dummies

Mutual Funds For Dummies®
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Wiley Publishing, Inc.

Mutual Funds For Dummies®

Published by
Wiley Publishing, Inc.
111 River St.
Hoboken, NJ 07030-5774
www.wiley.com

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Library of Congress Control Number: 2010929313

ISBN: 978-0-470-62321-3

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1

About the Author

Eric Tyson, MBA, is a bestselling author and syndicated columnist. Through his counseling, writing, and teaching, he teaches people to manage their personal finances better and successfully direct their own investments.

He has been involved in the investing markets in many capacities for the past two decades. Eric first invested in mutual funds back in the mid-1970s, when he opened a mutual fund account at Fidelity. With the assistance of Dr. Martin Zweig, a now-famous investment market analyst and frequent guest on PBS's Wall Street Week, Eric won his high school's science fair for a project on what influences the stock market!

Since that time, Eric has (among other things) worked as a management consultant to Fortune 500 financial service firms and earned his bachelor's degree in economics at Yale and an MBA at the Stanford Graduate School of Business. Despite these handicaps to clear thinking, he had the good sense to start his own company, which took an innovative approach to teaching people of all economic means about investing and money.

An accomplished freelance personal finance writer, Eric is the author of the national bestsellers Personal Finance For Dummies and Investing For Dummies and coauthor of Home Buying For Dummies and Taxes For Dummies and was an award-winning columnist for the San Francisco Examiner. His work has been featured and quoted in dozens of national and local publications, including Newsweek, The Wall Street Journal, Forbes, Kiplinger's Personal Finance Magazine, the Los Angeles Times, and Bottom Line/Personal, and on NBC's Today Show, ABC, CNBC, PBS's Nightly Business Report, CNN, CBS national radio, Bloomberg Business Radio, and Business Radio Network. He's also been a featured speaker at a White House conference on retirement planning.

Despite his "wealth" of financial knowledge, Eric is one of the rest of us. He maintains a large inventory of bumble-bee colored computer books on his desk for those frequent times when his computer makes the (decreasing amount of) hair on his head fall out.

Eric's Web site is www.erictyson.com.

Dedication

To my wife, Judy; my family — especially my parents, Charles and

Paulina; my friends; and to my counseling clients and students of my courses for teaching me how to teach them about managing their finances.

Author's Acknowledgments

Many people contribute to the birth of a book, and this book is no exception. First, I owe a deep debt of gratitude to James Collins, who inspired me when I was a young and impressionable business school student. Jim encouraged me to try to improve some small part of the business world by being an entrepreneur and focusing solely on what customers needed rather than on what made the quickest buck.

The technical reviewer for this edition of the book was Mercer Bullard. He helped to improve each and every chapter, and I am thankful for that.

Thanks to all the good people in the media and other fields who have taken the time to critique and praise my previous writing so that others may know that it exists and is worth reading. And to those too lazy to open the book just because of its bright yellow color and title, I say, "Don't judge a book by its cover!"

And a final and heartfelt thanks to all the people on the front lines and behind the scenes at Wiley who helped to make this book and my others a success. A big round of applause, please, for Kelly Ewing as project editor and as outstanding copy editor. Special thanks to Mike Baker. Thanks also to the Composition, Graphics, Proofreading, and Indexing staff for their great efforts in producing this book.

P.S. Thanks to you, dear reader, for buying my books.

Publisher's Acknowledgments

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Mutual Funds For Dummies®, 6th Edition

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Introduction

Whether you're a regular reader of investing books or this is your first, *Mutual Funds For Dummies,* 6th Edition, which is completely revised and updated, provides practical and profitable techniques of mutual fund investing that you can put to work now and for many years to come.

Mutual funds aren't literally for dummies — in fact, they're a wise investment choice for people from all walks of life. Mutual funds are investment companies that combine your money with that from many other people to create a large pool of assets that can be invested in stocks, bonds, or other securities. Because your assets are part of a much larger whole, the best mutual funds enable you to invest in securities that give you low-cost access to leading professional money managers.

With the best money managers investing your nest egg in top-flight investments that match your financial goals, you can spend your time doing the activities in life that you enjoy and are best at. Mutual funds should improve your investment returns as well as your social life!

I practice what I preach. All my investments that I've devoted to securities (stocks and bonds) are invested through funds. Why? For the simple reason that I'm confident the best fund managers that I recommend in this book can do a superior job (higher returns, less cost) than I could by researching and selecting individual stocks and bonds on my own.

I've enjoyed successfully investing in mutual funds for more than 25 years. As a financial counselor, writer, and lecturer, I've helped investors make informed investing decisions with mutual funds as part of comprehensive personal financial management. So I know the questions and challenges that you face when you invest in funds. I wrote this book to answer, in plain English, your fund-investing questions.

What's New in This Edition

Life and the investment world change. Although the essence of what makes mutual funds worthy of your investment dollars hasn't changed since the last edition of this book was published several years ago, the fund industry has certainly seen new developments. In this newly updated sixth edition, here are the major issues:

- Coverage of the 2008–09 global stock market panic and how funds and fund investors fared and what can be learned from that experience
- Alternatives to mutual funds — growth of exchange-traded funds, shake-out in hedge funds, researching your own stocks and bonds and creating your own fund, private money managers, closed-end funds, and so on
- Increasing numbers of specialized funds, such as those investing in gold, real estate, market-neutral funds, and so on
- Opportunities and pitfalls investing in funds online with expanded and updated coverage of Web sites and software
- New tax laws and their impact on smart fund-investing strategies
- Updates to the funds and resources that I recommend

How This Book Is Different

Many investment books confuse folks. They present you with some newfangled system that you never figure out how to use without the help of mathematicians and a Nobel laureate as your personal tutors. Books that bewilder more than enlighten may be intentional because the author may have another agenda: to get you to turn your money over to him to manage or to sell you his pricey newsletter(s). Writers with an agenda may imply — and sometimes say — that you really can't invest well, at least not without what they're selling.

Going another route, too many investment books glorify rather than advise. They place on a pedestal the elite few who, during decidedly brief periods in the history of the world and financial markets, managed to beat the market averages by a few percentage points or so per year. Many of these books (and their publishers) suggest that reading them shows you the strategies that led Superstar Money Manager of the Moment to the superlative performance that the book glorifies. "He did it his way; now you can, too," trumpets the marketing material. Not so. Reading a book about what made Kobe Bryant a phenomenal basketball player or Shakespeare a great playwright won't help you shoot a basket or versify like these famous folks. By the same token, you can't discover from a book the way to become the next Wall Street investment wizard.

Mutual Funds For Dummies, 6th Edition, helps you avoid fund-investing pitfalls and maximizes your chances for success. When you want to buy or sell a mutual fund, your decision needs to fit your overall financial objectives and individual situation. Fund investors make many mistakes in this regard. For example, they invest in funds that don't fit their tax situation.

This book also covers pesky issues completely ignored by other mutual fund books. For novice fund investors, simply finding and completing the correct application in the blizzard of forms that fund companies offer can be a challenge. And if you invest in mutual funds outside of tax-sheltered retirement accounts, you're greeted by the inevitable headache from figuring out how to report distributions at tax time. This book puts you on the right path in order to avoid these problems.

The truth is, investing isn't all that difficult — and funds are the great equalizer. There's absolutely no reason, except perhaps a lack of time and effort on your part, why you can't successfully invest in mutual funds. In fact, if you understand some basic concepts and find out how to avoid major mistakes that occur for some fairly obvious reasons, you can be even more successful than most so-called investment professionals.

Foolish Assumptions

Whenever an author sits down to write a book, he has to make some assumptions about his audience, and I've made a few that may apply to you:

- You're looking for sensible investments.
- You've done some research (or perhaps thought about doing some) on mutual funds and found the thousands of fund choices to be a bit daunting.
- Your investment portfolio contains or has contained mutual funds, and you're looking for up-to-date information on how changes in the economy and financial markets can affect the decisions you make.

If one or more of these descriptions rings true, you're in the right place. Mutual funds are a huge business, and they can be confusing. Today, thousands of mutual funds account for more than $11 *trillion* under management. Although the basic principle behind mutual funds sounds simple enough — pooled money from many individuals that's invested in stocks, bonds, or other securities — you have to understand the different types of investments, such as stocks and bonds, and the way they work.

Unfortunately, you have too many individual funds from which to choose — hundreds of mutual fund companies, brokerage firms, insurers, banks, and so on are selling thousands of funds. Even experienced investors suffer from information overload. Lucky for you, I present short lists of great funds that meet different needs.

And because no investment, not even one of the better mutual funds, is free of flaws and shortcomings, I explain how to avoid the worst funds — and the numerous mediocre ones — that clutter the investment landscape. I also help you understand when investing in funds may not be appropriate for you and what your best options may be.

How This Book Is Organized

The sections that follow contain a preview, of sorts, of the various sections in this book and what they cover.

Part I: Mutual Funds: Sharing Risks and Rewards

Part I defines and demystifies what mutual funds are and discusses what they're good for. Before you're even ready to start investing in funds, your personal finances need to be in order, so I give you some financial housecleaning tips. You can also discover the importance of fitting mutual funds to your financial goals. Part I also covers how to pick great funds, how to avoid loser funds, where and how to purchase funds, and how to read all those pesky reports that fund companies tend to produce.

Part II: Evaluating Alternatives to Funds

Mutual funds are hardly the only game in town for those folks seeking someone to manage their money. In recent years, exchange-traded funds and hedge funds, for example, have been pitched to many investors. Other investors believe that they can be their own best stock and bond pickers. This part discusses all the fund-investing alternatives and more to help you select which option(s) are best for your situation.

Part III: Separating the Best from the Rest

This part explains what makes a fund and fund company worth investing in. You see how to read and understand common fund documents. I also explain the best venues and avenues for buying funds and help you think through whether to enlist the services of an adviser.

Part IV: Crafting Your Fund Portfolio

This part shows you how to build a portfolio that includes mutual funds to accomplish your specific financial goals. You start off by exploring the basic strategies of portfolio construction. Then for each of the major fund types — money market, bond, and stock — you get specific fund recommendations. I also discuss specialty funds. A chapter of sample fund portfolios based on real-life scenarios brings together the important concepts in this section. Last but not least, I cover how to complete the often-pesky paperwork funds demand of you.

Part V: Keeping Current and Informed

After you have a good fund portfolio up and running, you shouldn't have to devote much time to maintaining it. This part covers what you do need to do, including chapters on how to evaluate your funds' performance and deal with the tax issues that come up on your investments. I also offer some tips on how to minimize aggravations when you deal with fund companies and discount brokers.

If you're still not satisfied, you can find out about the scores of individuals, companies, and publications that rank and predict financial market gyrations. I warn you about the bad ones and the dangers of blindly following gurus, and I reveal which, if any, of them really are gurus. You also discover how to use the best mutual fund information sources, how to tell the difference between good and bad newsletters, and where to turn for more information. You may want to know how to use your computer to track and even invest in mutual funds online — so this part tells you how to do that, too.

Part VI: The Part of Tens

Broaden your thinking with these chapters that offer ten or more ideas about important fund issues and concepts. I discuss common fund-investing mistakes made by investors, ease some fund-investing fears that you may have, and cover issues to consider before hiring an adviser. In the appendix, you find the contact information for all the top-notch funds I recommend.

Icons Used in This Book

Throughout this book, you can find friendly and useful icons that enhance your reading pleasure and flag special types of information. So, when you meet one of these margin-hugging doodads, consider the following:

This icon points out something that can save you time, headaches, money, or all of the above!

The warning icon helps steer you away from mistakes and boo-boos that others have made when investing in mutual funds.

Something around here could really cost you big bucks (maybe even an arm and a leg!) if you don’t devote your attention to these icons.

This icon denotes Eric’s favorite mutual funds.

Eminently skippable stuff here, but if you don't read it, you may not seem as astute at the next cocktail party when mutual fund trivia games begin. Neat but nonessential stuff — read at your leisure.

Eric's told me as much as he can, but he thinks that I may need or want to check it out more on my own before I make a move.

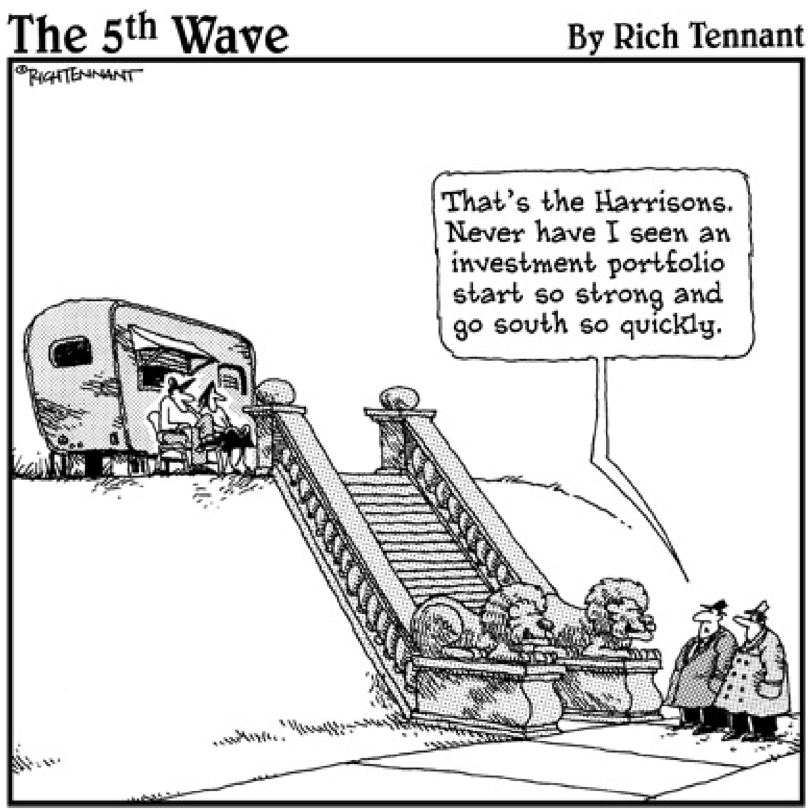
This icon designates something important that I want you to *make sure* you don't forget when you're making your own fund-investing decisions!

Where to Go from Here

You don't need to read this book cover to cover. But if you're a beginner or you want to fully immerse yourself in the world of fund investing, go for it! However, you may have some specific questions today, and you'll want some other information tomorrow. No problem there, either. *Mutual Funds For Dummies,* 6th Edition, is well organized and easier to use than other fund investing books. Use the Table of Contents or the Index to speed your way toward what you need to know and get on with your life.

Part I

Mutual Funds: Sharing Risks and Rewards



In this part . . .

This part gives you an excellent grounding in the fundamentals of mutual fund investing. You also find out how to fit mutual funds neatly with the rest of your finances, and you get an inside look at how and when to invest in the best mutual funds.

Chapter 1

Making More Money, Taking Less Risk

In This Chapter

- Defining mutual funds
- Understanding investments
- Weighing your options
- Seeing the big picture: returns, risks, and risk reduction

In my years of work as a financial adviser 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. And mutual funds can fit nicely in the context of your overall financial plans and goals. This chapter gives you an investment overview so that you can see how mutual funds fit into the overall investment world.

Introducing Mutual Funds

If you already understand stocks and bonds, their risks and potential returns, and the benefits of diversification, terrific. You can skip this chapter. Most people, however, don't really comprehend investment basics, which is one of the major reasons why 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. 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.

Differences in investment objectives are how mutual 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 salesmen take for granted that you know what *sedan* and *sport utility vehicle* mean. But what if the salesman asks you whether you want a Pegasus or a Stegosaurus? If you don't know what those names mean, how can you decide?

Mutual fund terms, such as *municipal bond fund* or *small-cap stock fund,* are thrown around casually. Fact is, thanks to our spending-oriented culture, the average American knows car models better than types of mutual funds! In this chapter (and in Chapter 2), I explain the investment and mutual 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 mutual 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 Coca-Cola. 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, 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 only be worth 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 Bill Gates had approached you many years ago for money to help make computer software, would you rather have loaned him the money or *owned* a piece of the company, Microsoft?

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.

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 his recliner watching football games and guzzling beer. 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 most recently saw in the late 2000s. 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 only two 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 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.

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. 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 5 percent and the market level of interest rates increase to 7 percent for newly issued similar bonds, your bond will decrease in value. Why would anyone want to buy your bond at the price that you paid if it yields just 5 percent and she can get a similar bond yielding 7 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 (treasuries), mortgage holders (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, food manufacturers, hotels, Internet companies, 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 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. I discuss stock mutual funds in Chapter 13 and individual securities (and other alternatives to mutual funds) in Part II.

Overseas investments

Overseas 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, overseas investments are often categorized separately because they come with their own set of risks and rewards.

Here are some good reasons to invest overseas:

- **Diversification:** International securities markets don't move in lock step with U.S. markets, so adding foreign investments to a domestic portfolio 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. The U.S. isn't the world — numerous 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 U.S. 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 U.S. 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 U.S. 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 10 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. If you don't want the headaches that come with purchasing and maintaining a property, you can buy mutual funds that invest in real estate properties and related companies (see Chapter 14).

Gold, silver, 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. See Chapter 14 for all the details and how you might diversify your portfolio using specialty funds investing in this sector.

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 that you put into an annuity compounds without taxation until withdrawal. However, unlike most other types of retirement accounts — 401(k)s, SEP-IRAs, and Keoghs — 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) mutual 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 that combine life insurance protection with an account that has a cash value — usually known as *universal, whole,* or *variable life* policies — generate big commissions for the agents who sell them.

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, IRAs, and Keoghs. Contributions to a cash-value life insurance plan provide you *no* upfront tax benefit. Second, you can earn better investment returns through efficiently managed mutual 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. Through the use of bypass trusts, married couples can pass along double these amounts. 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. Please consult the latest edition of my book, *Personal Finance For Dummies,* 6th Edition (Wiley), which has all sorts of good stuff on insurance and other important personal finance issues.)

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 mutual funds and/or variable annuities that use mutual funds; see Chapters 11 through 15 for the details.)

Limited partnerships

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.

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. What 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, 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.)

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.

Over the past century, ownership investments like stocks and real estate returned around 8 to 10 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 mutual funds' returns, please see Chapter 17.)

Measuring risks: Investment volatility

Obviously, 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?

The greater an investment's potential return, the greater (generally) is 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, in order to earn those generous long-term stock market returns of about 10 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.

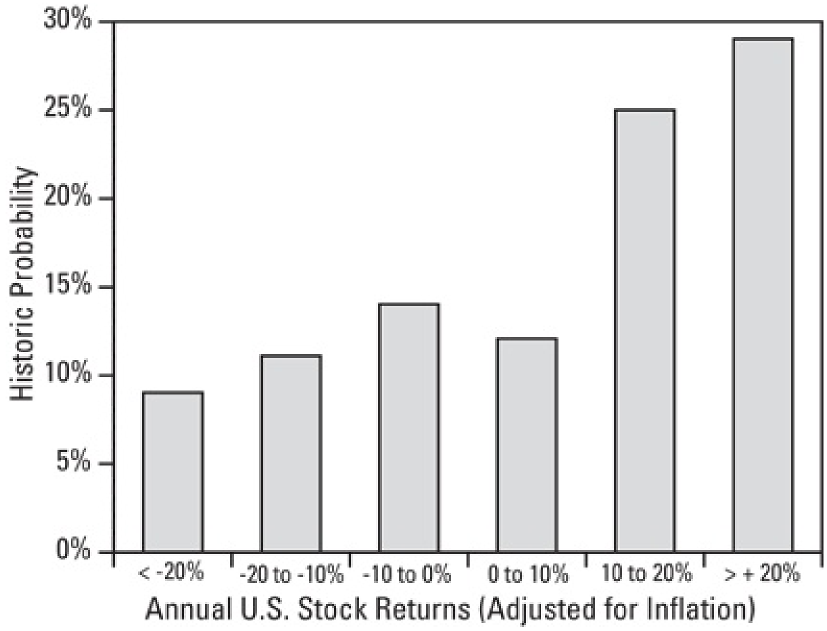


Figure 1-1: Historic probability of different U.S. stock returns.

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.

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.

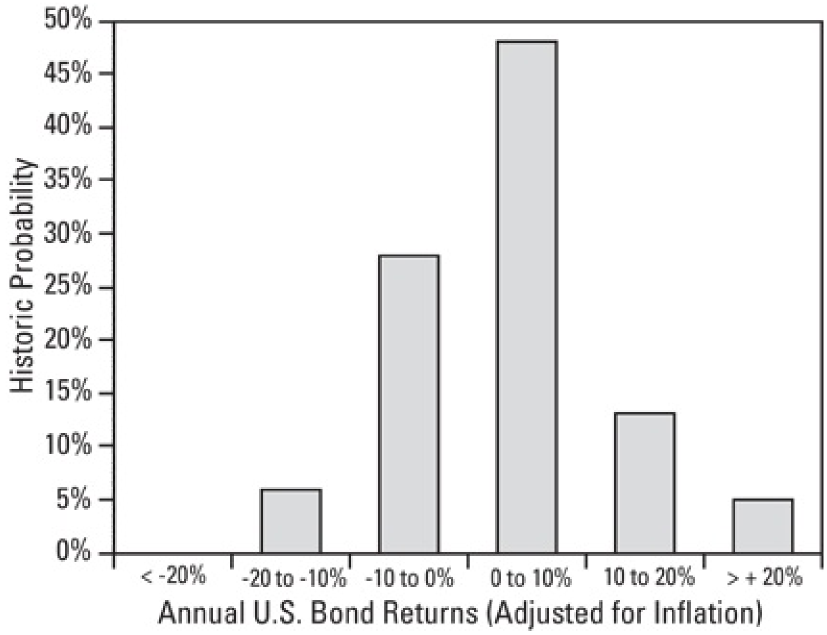


Figure 1-2: Historic probability of different U.S. bond market returns.

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.

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, which are diversified portfolios of securities, are highly useful investment vehicles. You buy into the mutual fund, 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.

Chapter 4

Selecting Your Own Stocks and Bonds

In This Chapter

- Understanding the pros and cons of being your own investment manager
- Exploring how to pick your own stocks and bonds

Investing in stocks and bonds via mutual funds is one of several ways to tap in to stocks and bonds. Some investors believe that they don't need mutual funds and that they should go and directly invest in their own stocks and bonds. However, doing so is often much riskier than relying on mutual funds. This chapter discusses why people choose their own stocks and bonds and what you need to do if you decide to do so.

Choosing Your Own Stocks and Bonds

According to numerous books, newsletters, Web sites, and articles, mutual funds are *not* the place to be. They're boring, conservative, and prone to mediocre returns. According to the pronouncements of these gurus, you can get rich quick by investing in these individual stocks.

Not only do these pundits say that investing in individual stocks provides Himalayan returns . . .

> “How we beat the stock market — and how you can, too. 23.4 percent annual return.” — subtitle of *The Beardstown Ladies’ Common-Sense Investment Guide*

> Novices can “. . . nearly double the S&P 500 posting returns in excess of 20 percent per year . . . you might be able to fish out greater than 30 percent per year on your own without assuming considerably greater risk.” — David and Tom Gardner, *The Motley Fool Investment Guide*

> “Forget bonds . . . real estate . . . build a portfolio entirely of stocks. Returns an annual average of 34 percent.” — Matt Seto, 17 years old, *The Whiz Kid of Wall Street’s Investment Guide*

> “I have been able to obtain fantastic returns on so many stock market plays: 260,000 percent annualized one-hour returns; 10,680 percent annualized in two days and so many more . . . These trades are sort of like a magic trick. At first it seems ‘stupendous’ — otherworldly. But as you learn the trick, you say ‘it’s a piece of cake.’” — Wade Cook, *Stock Market Miracles*

. . . *but they also say that anyone can do it with little effort* . . .

> “It’s not an exaggeration to say that fifth graders can wallop the market after one month of analysis. You can too.” — *The Motley Fool Investment Guide*

> “An amateur who devotes a small amount of study to companies in an industry he or she knows something about can outperform 95 percent of the paid experts who manage mutual funds, plus have fun in doing it.” — Peter Lynch, *Beating the Street*

Do the stock specialists’ claims sound too good to be true? Well, they are.

Beware the claims of stock-picking gurus

It’s easy to dismiss the outrageousness of the claims made by someone like Wade Cook in the previous section. Even if you don't know that Cook was for many years in trouble with securities regulators and the courts (and is now serving prison time), your common sense tells you that five-and six-digit returns are well outside the realm of reasonable expectations for stock performance.

But what about the more believable performance claims, in the range of 20 and 30 percent, that can so easily dupe an investor into thinking they're true — like the annualized return of 23.4 percent claimed by the Beardstown Ladies?

> The Beardstown investment club's claim of 23.4 percent annualized returns made me suspicious. Stocks historically return just 10 percent per year, yet this club, in its book, was claiming to ". . . have been outperforming mutual funds and professional money managers 3 to 1." When the club was unwilling to document its performance claims, I assumed they were false.

Turns out its claims were indeed bogus. Shane Tritsch, a reporter for *Chicago* magazine, wrote a piece entitled "Bull Marketing" in which he exposed gross inaccuracies in how the Beardstown investment club calculated its stock market returns. Tritsch was tipped off to potential problems by a note that was added to the copyright page of the paperback edition of the Beardstown book that said that the club's 23.4 percent annualized returns were determined "by calculating the increase in their total club balance over time. Because this increase includes the dues that the members pay regularly, this return may be different from the return that might be calculated for a mutual fund. . . ."

May be different? Indeed. Translated, the disclosure was saying that the 23-plus percent returns were being goosed by including new investment principal (regular dues' payments). Using documents from the investment club that were provided by a *Wall Street Journal* reporter, a senior research analyst named Jim Raker, from mutual fund publisher Morningstar, told me that he calculates that the investment club earned a return of a mere 9 percent per year — a far cry from the 23-plus percent returns claimed by the club.

Even worse, though, is that the Beardstown investment club *under*performed the market. For the period in question (from 1983 to 1992), while the Beardstown club actually earned just 9 percent per year, the Standard & Poor's 500 index — the widely followed index for the U.S. stock market — returned about 16 percent. In fact, if you'd invested in lower-risk bonds, you would've earned nearly 12 percent per year and still outperformed the stock picks of the Beardstown club!

Whenever an author, an investment newsletter, or an investment manager claims to have produced a particular rate of return, especially a market-beating return, I always ask for proof before I'm willing to put the claim in print myself. Otherwise, how do I know whether the claims are real or advertising hype?

As for Peter Lynch, who states in his book that an amateur stock picker can easily beat 95 percent of the pros, shame on him! Widely regarded as one of the best mutual fund managers in his day, Lynch knows more than anyone how much hard work goes into beating the market. In fact, during the years that Lynch piloted Fidelity's Magellan fund, he was known for his workaholic 70-and 80-hour workweeks. He stated publicly that the primary reason he retired early was to spend more time with his family. That leaves everyone else to question: He worked this hard to do something that he says amateurs can do with ease and that you, as an investor, don't really need his skills for?

The notion that most average people and noninvestment professionals can invest in individual stocks with minimal effort and beat the best full-time, experienced money managers is, how should I say, ludicrous and absurd. But it does seem to appeal to some people's egos — until the returns come in (or don't come in, as the case may be).

Stock picking with Jim Cramer

If you ever watch CNBC, you've likely come across Jim Cramer, a former hedge fund manager, who now hosts an investment show at the network and operates a Web site among other endeavors. If you've seen it, he yells and screams and jumps around while pounding on various sound-producing buttons.

Cramer rose to fame through his strongly opinionated buy-and-sell recommendations on regular CNBC stock market programming and his supposed extraordinary investment returns from his days running a hedge fund bearing his name. But there's a problem: Despite repeated requests from me, Cramer's former and current firms have been unable (and unwilling) to produce any independently audited tracking of Cramer's claimed returns.

Compounding this lack of any proof is a uniformly poor to mediocre track record of his stock picks and pans in recent years. Several independent tracking services have found that his stock market predictions have underperformed the broad market averages. (Please see the "Guru Watch" section of my Web site, www.erictyson.com, for the details on Cramer and other investing pundits.)

Also, I had no trouble finding numerous folks who shelled out $400 yearly for his online newsletter and were greatly disappointed. One reader said, "I got caught up in watching his nightly show and then I paid for his Action Alerts service. That service sends e-mail alerts every day telling you what to buy and sell. Well after nine months, I lost a lot of money, and his portfolio is currently showing a 1.3% gain for the year to date (ever notice he doesn't mention that on his shows!). I could've just purchased the S&P 500 and would be way ahead. His trading ideas do not work, and his recommendations to not use mechanical stop loss trades have resulted in huge losses in my portfolio."

Know the drawbacks of investing in individual securities

The stock-picking cheerleaders cite plenty of reasons and make hyped claims to get you to invest in individual stocks. But they're loath to mention the drawbacks of selecting and trading individual securities. You won't buy their books and newsletters or visit their Web sites if they can't promise you effortless riches, so you may not openly get the following information from the "stock-picking-is-easy" writers:

- **Stock picking takes significant research time and expense.** Before buying an individual security (stock or bond), you should know a great deal about the company you're investing in. Relevant questions that you need to answer include

  • What products or services does the company sell?

  • What are the company's prospects for future growth and profitability?

  • How does the company's performance compare to its competitors' performances — both recently and over the long haul?

  • Are technological or other changes in the works that might harm or improve its business?

  • How much debt does the company have?

  You need to do your homework on these questions, not only before you make your initial investment, but also on a continuing basis as long as you hold an investment. Gathering this information and accessing quality research on a company take time and money. And you have to conduct this legwork for every company that you consider investing in. That's how Lynch filled up his marathon workweeks as a fund manager.

Be honest with yourself. If you're really going to research and monitor your individual securities, the extra work ultimately will take time away from other pursuits. In worst-case situations, I've seen busy people spend almost as many hours on the weekend and in the evenings with their portfolios as they do with family and friends. If you can really afford the time for this type of hobby, more power to you. But remember, no one I know of has ever said on her deathbed, "I wish I had spent more time watching my investments." You only get one chance to live your life — once squandered, your time is gone forever.

- **Stock trading incurs higher transaction costs.** Even when you use a discount broker (described in Chapter 9), the commissions you pay to buy or sell securities are higher (as a percentage of the amount invested) than what a fund company pays. Note two exceptions to the rule that individual security purchases cost too much:
    - You can purchase government bonds directly from the Federal Reserve without charge.
    - Deep-discount brokers (see Chapter 9) can be quite cheap for wealthy investors making large purchases.
- **Individual stocks offer less likelihood of diversification.** Unless you have several hundred thousand dollars to invest in dozens of different securities, you probably can't afford to develop a diversified portfolio. For example, when investing in stocks, you should hold stock in companies belonging to different industries, in different companies within an industry, and so on. Not properly diversifying adds to the risk of losing your shirt.
- **Individual stocks bring more accounting and bookkeeping chores.** When you invest in individual securities outside retirement accounts, you must keep track

of your purchase and dividend history (if you reinvest them). Every time you sell a specific security, you must report that transaction on your tax return.

Even if you pay someone else to complete your tax return, you still have the hassle of keeping track of statements and receipts. (On the plus side, however, *you* control selling decisions with individual securities; with funds, managers who trade can lead to capital gains distributions for you. As I discuss in Chapter 10, you can select mutual funds that are tax friendly for your situation, including funds that are managed, so as to minimize or even eliminate capital gains distributions.)

Understand the psychology of selecting stocks

Some folks just don't, won't, or can't enjoy having all their money tied up in mutual funds. Some people say that funds are, well, kind of boring. It's true that following the trials, tribulations, successes, and failures of a favorite company can provide you plenty of excitement (sometimes more than you want). A fund, on the other hand, is a little more abstract. You pour money into it and don't have specific corporate dramas to follow.

Over the years, among investors who prefer to invest their portfolios in individual securities, I've noticed some common characteristics:

- **The boaster:** You enjoy going to parties and telling of your successes in the stock market. Although the thought has never (hopefully) crossed your mind of sending copies of a brokerage statement to friends and relatives, you've been known on more than a few occasions to offer unsolicited stock tips and investment advice.
- **The controller:** You hate delegating jobs to others,

especially important ones, because no one does as good a job as you do. Investing much or all of your money in mutual funds and leaving all the investment decisions to the fund manager won't make you a happy camper. You may also believe that you can sidestep a market slide and get back in before prices skyrocket.

- **The free spirit:** You're the type who says, "I don't care if there are trillions invested in mutual funds. I don't care if everyone's using word processors rather than typewriters." You like to be just a little bit different and independent.

How to Pick Your Own Stocks and Bonds

If you really want to invest in individual stocks and bonds, I suggest that you limit your purchase of individual securities to no more than 20 percent of the *total* money you've invested in stocks and bonds (including those you've invested in via mutual funds). Be realistic as to why you're investing in them. And before you plunk down too much money in stocks and bonds of your own choosing, remember the sage words of Jack Bogle, who's often called the mutual fund investor's best friend:

> "Attempting to build an investment program around a handful of individual securities is, for all but the most exceptional investors, a fool's errand . . . Specific stock bets should be made, if at all, in small portions, and more for the excitement of the game than for the profit."

Yes, Bogle was the founder and former CEO of a large mutual fund company, Vanguard. But, no, his comments aren't self-serving: Vanguard also operates a discount brokerage company that handles individual securities trades for customers who want to do them.

In the long haul, you're not going to earn higher returns than full-time professional money managers who invest in the securities of the same type and risk level that you are. As with hiring a contractor for home remodeling, you need to do your homework to find good fund managers. Even if you think that you can do as well as the best, remember that even superstar money managers like Peter Lynch have beaten the market averages by only a few percentage points per year.

In my experience, more than a few otherwise smart, fun-loving people choose to invest in individual securities because they think that they're smarter or luckier than the rest. If you're like most people, I can safely say that, in the long run, your individually selected stocks and bonds won't outperform those of a full-time investment professional.

I've noticed a distinct contrast between the sexes on this issue (which is backed up by research). Perhaps because of differences in how people are raised, testosterone levels, or whatever, men tend to have more of a problem taming their egos and admitting that they're better off turning the stock and bond selection over to a pro. Maybe this trait is genetically linked to not wanting to ask for directions!

Before you set out to compete in the investment world, get smarter and wiser. The latest edition of my book, *Investing For Dummies* (Wiley), explains how to analyze company financial statements and compare and select stocks and bonds as well as use the best investment research sources such as Value Line. Also, don't overlook the opportunity to piggyback from all the research and knowledge of the best money managers. By using the lists of best funds recommended in this book, you can use those funds' reports to figure out what stocks and bonds some of the most talented money managers in the world are buying.

(***Note:*** The listing of a fund's portfolio still could be several months out of date because of the way funds issue their reports.)

Should you join an investment club?

Investment clubs are a little bit like having your own hands-on mutual fund. Each club member chips in some money. Then the group gets together for periodic meetings to discuss stocks and to make investment decisions. (Although investment clubs could, of course, select other investments, such as bonds, most clubs choose stocks.)

These groups can be valuable as an educational forum if you utilize good information sources. If the group members are somewhat clueless and the meetings are rambling, these groups can end up degenerating into the blind leading the blind.

Investment clubs may have social or hobby value (which are most clubs' major benefits), but they can hurt your checkbook more than they help:

- The members of investment clubs are part-time amateurs. You could end up making some poor decisions and losing money (or not making nearly as much as you would if you'd been in some good mutual funds).

- It's highly unlikely that everyone in the group is in the same tax situation. Thus, the club's investments may work for some members' tax situations but not for others'.

- Beware of stockbrokers (and others trolling for prospective clients) who've been known to participate in investment clubs and volunteer as leaders. Although their participation may be harmless, more often than not, these brokers have a hidden agenda to reel in new business clients.

Consider forming a financial reading club and discussion group rather than an investment club. You can get together and discuss financial periodicals, books, and investment strategies. This way, you can advance your level of financial knowledge, find out about new resources from others, and enjoy the fun, camaraderie, and other benefits that come from doing things in a group.

Better yet, join a bowling league or a softball team and leave the investing to fund managers!

Chapter 5

Exchange-Traded Funds and Other Fund Lookalikes

In This Chapter

▶ Making sense of the hoopla of exchange-traded funds ▶ Understanding unit investment trusts ▶Creating your own customized funds The hallmarks of the investment and economic system are constant change, innovation, and choice. Index mutual funds, which track a particular market index (see Chapter 10) and the best of which feature low costs, have been around for decades.

Exchange-traded funds (ETFs) represent a twist on index funds — ETFs trade like stocks do and offer some potential advantages over funds. However, some cheerleaders pitching ETFs gloss over drawbacks to ETFs and fail to disclose their agenda in promoting ETFs.

Some other fund wannabes compete for your investment dollars too. This chapter offers the straight scoop on these alternatives.

Understanding Exchange-Traded Funds

For many years after their introduction in the 1970s, index mutual funds got little respect and money. Various pundits and those folks with a vested financial interest in protecting the status quo, such as firms charging high fees for money management, heaped criticism on index funds. (As I explain in Chapter 13, index funds replicate and track the performance of a particular market index, such as the Standard & Poor's 500 index of 500 large company U.S. stocks.) Critics argued that index funds would produce sub-par returns. Investors who've used index funds have been quite happy to experience their funds typically outperforming about 70 percent of the actively managed funds over extended time periods.

In recent years, increasing numbers of financial firms have developed *exchange-traded funds* (ETFs). Most ETFs are, essentially, index funds with one major difference: They trade like stocks on a stock exchange. The first ETF was created and traded on the American Stock Exchange in 1993 and was known as a Spider. (It tracked the Standard & Poor's 500 index.) Now hundreds of ETFs trade comprising about $700 billion — a large sum indeed — but that's less than 7 percent of the total invested in mutual funds.

Before you decide to invest in ETFs, take a moment to read this section. It explains the advantages and disadvantages of investing in ETFs and helps you wade through the many ETFs to find the best one for you.

Understanding ETF advantages

Like index funds, the promise of ETFs is low management fees. I say promise because when evaluating ETFs, you must remember that the companies creating and selling ETFs, which are mostly large Wall Street investment firms, are doing it to make a nice profit for their firm. Although the best index funds charge annual fees of less than 0.2 percent, the vast majority of ETFs actually charge fees much greater than that.

Take a look at Table 5-1 for an analysis that I recently conducted of ETF expense ratios.

Table 5-1 An Analysis of ETF Expense Ratios

Expense Ratio	Percentage of ETFs
0.60% and higher	47%
0.50% to 0.59%	14%
0.40% to 0.49%	12%
0.30% to 0.39%	7%
0.25% to 0.29%	7%
0.20% to 0.24%	6%
0.15% to 0.19%	2%
0.10% to 0.14%	4%
0.07% to 0.09%	1%

The vast majority of ETFs have expense ratios far higher than the best index funds. I compare the best index funds with the best ETFs (which do have low expense ratios) in the section, "Identifying the best ETFs," later in this chapter.

In addition to possible slightly lower expenses, the best ETFs have one possible additional advantage over traditional index funds: Because ETFs may not be forced to redeem shares to cash and recognize taxable gains (which can happen with an index fund), they may be tax friendlier for non-retirement account investors. (***Note:*** ETFs do have to sometimes sell and buy new holdings as adjustments are made to the underlying index that an ETF tracks.) If you can't meet the minimum investment amounts for index funds (which are typically several thousand dollars), you face no minimums when buying an ETF. However, you must factor in the brokerage costs to buy and sell ETF shares through your favorite brokerage firm, and be sure that those fees don't greatly boost your costs. For example, if you pay a $10 transaction fee through an online broker to buy $1,000 worth of an ETF, $10 may not sound like a lot but it represents 1.0 percent of your investment and wipes out the supposed cost advantage of investing in an ETF. Because of the brokerage costs, ETFs aren't a good vehicle for investors who seek to make regular monthly investments.

Eyeing ETF drawbacks

Meanwhile, some of the drawbacks to ETFs include the following:

- **Three-day settlement waiting period:** A possible disadvantage with ETFs is that like stocks, you have a three-day settlement process when selling shares. So, for example, if you sell shares of an ETF on Monday, you won't have the proceeds to invest into a regular mutual fund until Thursday. (This delay wouldn't be a problem if you're going back into another ETF or buying a stock — because a purchase order placed on Monday wouldn't settle until Thursday.) If you're out of the market for several days, the market price can move significantly higher, wiping out any supposed savings from a low-expense ratio.
- **Potential fees for dividend and capital gain reinvestments:** With a traditional mutual fund you can without cost reinvest dividend and capital gains distributions into more shares of the fund. However, with an ETF, you may have to pay for this service, or it may not be available through the broker that you use.
- **Disproportionate amount of stocks:** One problem with a number of the indexes that ETFs track (and with some index funds) is that certain stocks make up a disproportionately large share of the index. For example, I don't care for the Standard & Poor's 500 index because each of the 500 stocks' composition in the index is driven by each stock's portion of total market value. Check out Table 5-2 that shows the composition of the index at the end of 1999. This list mostly represented a who's who of many overpriced technology stocks that subsequently got clobbered in the early 2000s bear market.

Table 5-2 The Companies of the Standard & Poor's 500 Index at the End of 1999

Stock	Rank in Index	Market Value	Percent of Index
Microsoft Corp	1	604,078	4.92%
General Electric	2	507,734	4.14%
Cisco Systems	3	366,481	2.99%
Wal-Mart Stores	4	307,843	2.51%
Exxon Mobil	5	278,218	2.27%
Intel Corp	6	274,998	2.24%
Lucent Technologies	7	234,982	1.91%
IBM	8	194,447	1.58%
Citigroup Inc	9	187,734	1.53%
America Online	10	169,606	1.38%

- **Invested segments too narrow:** Many of the newer ETFs coming out invest in narrow segments, such as one specific industry or one foreign country. As with sector mutual funds (see Chapter 13), such funds undermine the diversification value of fund investing and tend to have relatively high fees. Morningstar, an investment research company, says, ". . . ETFs offer new opportunities to sap returns by racking up transaction costs and/or chasing short-term trends."

- WARNING! **Excessive risks and costs with leverage:** In recent years, ETF issuers have come out with increasingly risky and costly ETFs. One particular class of ETFs I especially dislike are so-called *leveraged ETFs.* What these ETFs purport to do is magnify the move of a particular index — for example, the Standard & Poors 500 stock index — by double or triple. So, a double-leveraged S&P 500 ETF is supposed to increase by 10 percent for every 5 percent increase in the S&P 500 index. *Inverse leveraged ETFs* are supposed to move in the opposite direction of a given index. So, for example, a double-leveraged inverse S&P 500 ETF is supposed to increase by 10 percent for every 5 percent decrease in the S&P 500 index.

My investigations of whether the leveraged ETFs actually deliver on their objectives shows that they don't, not even close. For example, in the two-year period ending in early 2010, one double-inverse S&P 500 ETF (brought to my attention by a reader who owned and asked me about it) fell by 43 percent, a period during which it should have increased about 28 percent because the S&P 500 index actually fell by 14 percent.

Seeing the pros and cons of trading ETFs

One supposed advantage of trading ETFs is that, unlike the regular index mutual funds that I recommend in this book, you can trade (buy or sell) ETFs throughout the day when the stock market is open. When you buy or sell an index mutual fund, your transaction occurs at the closing price on the day that you place the trade (if the trade is placed before the market closes).

Sure, the flexibility sounds alluring, but consider a few drawbacks:

- **Timing your moves in and out of the stocks:** Being able to trade in and out of an ETF during the trading day isn't a necessity, nor is it even a good practice. In my experience of working with individual investors, most people find it both nerve-racking and futile to try to time their moves in and out of stocks with the inevitable fluctuations that take place during the trading day. In theory, traders want to believe that they can buy at relatively low prices and sell at relatively high prices, but that's far easier said than done.

- **Paying a brokerage commission every time you buy or sell shares:** With no-load index funds, you generally don't pay fees to buy and sell. But with ETFs, because you're actually placing a trade on a stock exchange, you pay a brokerage commission every time you trade. For example, if you buy an ETF with a seemingly low expense ratio of 0.1 percent and you pay $10 to trade the ETF through an online broker, that's equal to paying two years' worth of management fees if you invest $5,000 in the ETF!

- **Figuring out if the current price on an ETF is above or below the actual value of the securities it holds:** Because ETFs fluctuate in price based on supply and demand, when placing a trade during the trading day, you face the complication of trying to determine whether the current price on an ETF is above or below the actual value. With an index fund, you know that the price at which your trade was executed equals the exact market value of the securities it holds.

Because ETFs trade like stocks, you can use limit order and stop loss orders as well as sell them short or trade them on margin. I generally don't recommend these strategies for nonprofessional investors.

Identifying the best ETFs

For the vast majority of investors, you don't need to complicate your lives by investing in ETFs. Only use them if you're a more advanced investor who understands index funds and you have found a superior ETF to an index fund you're interested in.

Beware of "financial advisers" in love with ETFs

I began work as a financial adviser in 1990. I was just about the only practitioner at the time who worked solely on an hourly basis. Most of the fee-based advisers at that time managed their client's portfolios by using mutual funds. I was struck by the fact that many advisers didn't use or recommend low-cost index funds. In speaking with some of these advisers, I got the sense that they were somewhat threatened by index funds because the investing process was so simplified that clients might question the value in paying the adviser an ongoing fee of about 1 percent to manage their money among funds.

Interestingly, some advisers today boast that they use ETFs as the investment vehicle to manage their client’s portfolio. Ironically, they crow about the low cost of ETFs. Why do some advisers now embrace and tout ETFs when they didn’t advocate index funds? ETFs are complicated and new enough that advisers feel safer using them and not worry about having clients feel that they could do this on their own. Advisers who charge ongoing management fees while using ETFs aren’t performing low-cost investment management. If the ETFs they’re using average about 0.5 percent in annual fees, paying the adviser 1 percent per year on top of that to shift your money around among various ETFs triples your costs! See Chapter 24 for how to find a good adviser.

Be sure to check whether the ETF you’re considering is selling at a premium or discount to its net asset value. (You can find this information on the ETF provider’s Web site after the market’s close each business day.) I strongly encourage you to employ the buy-and-hold mentality that I advocate throughout this book — don’t hop in and out of ETFs. You should also only buy the ETFs that track the broader market indexes and that have the lowest expense ratios. Avoid those that track narrow industry groups or single, smaller countries. See Chapters 11 through 15 for specific ETFs that I like for specific situations.

If you’re truly interested in investing in ETFs and you’re a more advanced investor, make sure that you know which funds are the best ETFs. The best ETFs, like the best index funds, have low expense ratios. My top picks among the leading providers of ETFs include the following: ✓**Vanguard:** Historically, Vanguard has been the low-cost leader with index funds and now has the lowest cost with their ETFs as well. If you're interested in finding out more about ETFs, be sure to examine Vanguard's ETFs. Vanguard also offers the Admiral Share class for bigger balance customers ($100K+) of its index funds that match the low expense ratio on their ETFs. (www.vanguard.com; 800-662-7447) ✓**Wisdom Tree:** Developed by Wharton business professor Jeremy Siegel, this new family of indexes is weighted toward stocks paying higher dividends. These ETFs have higher fees but offer a broad family of index choices for investors seeking higher-dividend-paying stocks. ***Note:*** Other ETF providers do offer a number of value-oriented and higher-dividend-paying stock funds. (www.wisdomtree.com; 866-909-9473) Two additional and large providers of ETFs include the following firms (beware that many of their ETFs are pricey or too narrowly focused): ✓ **iShares:** BlackRock has competitive expense ratios on some domestic ETFs based on quality indexes, such as Russell, Morningstar, S&P, Lehman, Dow Jones, and so on. (www.ishares.com; 800-474-2737) ✓**State Street Global Advisors:** This group uses indexes from Dow Jones/Wilshire, S&P, Russell, and MSCI, among others. (www.ssgafunds.com; 866-787-2257) Mimicking Closed-End Funds: Unit Investment Trusts

Unit investment trusts (UITs) have much in common with closed-end funds (discussed in Chapter 2). UITs take an amount of money (for example, $100 million) and buy a number of securities (such as 70 large-company United States stocks) that meet the objectives of the UIT. Unlike a closed-end fund (and mutual funds in general), however, a UIT does *not* make any changes to its holdings over time — it simply holds the same, fixed portfolio. This holding of a diversified portfolio can be advantageous because it reduces trading costs and possible tax bills.

With that said, UITs do suffer from the following major flaws: ✓**Significant upfront commissions:** Brokers like to push UITs for the same reason that they like to pitch load mutual funds — for the juicy commission that they ultimately deduct upfront from your investment. Commissions are usually around 5 percent, so for every $10,000 that you invest into a UIT, $500 goes out of your investment and into the broker's pocket. Although UITs do have ongoing fees, their fees tend to be lower than those of most actively managed mutual funds — they're typically in the neighborhood of 0.2 percent per year. As an alternative, you can buy excellent no-load funds (see Chapter 7), which, because you're buying the fund directly from an investment company and without the involvement of a broker, charge you no commission. The best no-load funds also have reasonable management fees, and some charge even less than UITs charge (such as the index funds that I discuss in Chapter 10).

- **Lack of liquidity:** Especially in the first few years after a particular UIT is issued, you won't readily find an active market in which you can easily sell your UIT. In the event that you can find someone who's interested in buying a UIT that you're interested in selling, you may have to sell the UIT at a discount from its actual market value at the time.
- **Lack of ongoing management oversight:** Because UITs buy and hold a fixed set of securities until the UIT is liquidated (years down the road), they're more likely to get stuck holding some securities that end up worthless. For example, compared to the best bond mutual funds (see Chapter 12), bond UITs have had a greater tendency to end up holding bonds in companies that go bankrupt.

Customizing Your Own Funds Online

On some Web sites, various services pitch that you can invest in a chosen basket of stocks for a low fee — and without the high taxes and high fees that come with mutual fund investing. Like most political “Vote for me and not my opponent” ads, these services misrepresent both their own merits and the potential drawbacks of funds.

These “create your own funds” services pitch their investment products as a superior alternative to mutual funds. One such service calls its investment vehicles *folios,* charging you $29 per month ($290 if paid annually) to invest in folios, each of which can hold a few dozen stocks that are selected from the universe of stocks that this service makes available. The fee covers trading in your folios that may only occur during two time windows each day that the stock market is open. The folio service states that orders that are placed between 11 a.m. and 2 p.m. are processed starting at 2 p.m.; orders that are placed between 2 p.m. and 11 a.m. are processed starting at 11 a.m.

So, in addition to the burden of managing your own portfolio of stocks, you have virtually no control over the timing of your trades during the trading day. (You can place traditional orders at whatever time the market is open but you’ll be assessed an additional fee of $3 per trade.) The site also says, “Mutual funds impose fees that can be very high — and hard to calculate.” I agree with that statement. However, without doing too much homework, an investor can easily avoid high-fee funds. For example, an investor can invest in the best index funds for an annual fee of 0.2 percent per year or less. Thus, an investor would need to have in excess of $150,000 invested through this folio service to come out ahead in terms of the explicit fees.

In addition, you need to be aware of additional fees. One folio service’s Web site says (in fine print, of course) that it “. . . does charge for certain special services and does receive payment for order flow.” You must be ready to shell out the dough if you ✓Want to wire money out of your account — $30

- Need a copy of a prior statement or transaction — $10
- Hold any restricted securities (which are subject to SEC

Rule 144) — $75

- Close out an account — $50

The site further warns, “Note: These are today’s prices and fees, which are subject to change periodically.”

You’re simply not going to get the same level of service (and comfort) when dealing with a Web-site-based service as you do when dealing with the leading fund companies that I discuss in this book. The companies that I recommend have trained representatives available by phone. Understanding and evaluating the performance of self-created funds is difficult, and unlike mutual funds, these funds have no standards or easily accessible services that report and track the performance of your customized folio (see Chapter 17 for more information on adjusting your portfolio).

It seems to me that folio services are geared toward those people who want to hold individual stocks, who trade a lot, and who seek to cap their annual trading costs. Although I prefer investing in the best mutual funds, you can invest in stocks of your own choosing — as long as you do so with a long-term perspective. But if you were going to simply buy and hold individual stocks, why would you want to pay a Web-site-based service $290 per year?

Chapter 6

Hedge Funds and Other Managed Alternatives

In This Chapter

- Making sense of hedge funds
- Deciphering wrap or managed accounts
- Placing money with private money managers

Wealthier investors with large amounts to invest (typically well into the six figures) usually have more choices when it comes to investment vehicles. Some financial advisers and money management firms pitch alternatives to mutual funds to these folks.

The unbelievably wide variety of mutual funds enables you to invest in everything from short-term money market securities to corporate bonds, U.S. and international stocks, precious metals and other commodity companies, and even real estate funds. Although funds can fill many investing needs — as I discuss in Chapter 1 — you may be interested in and benefit from directly investing in things such as real estate, your own business, and many other investments.

During the early to mid 2000s, hedge funds were proliferating and promising high returns with less risk. In the prior edition of this book, I warned readers, "As with all sales pitches, you must separate fact from fiction and hype." This chapter can help you do just that if you're rolling in the dough. Plenty of hedge fund investors got burned during the financial market turmoil in the late 2000s.

Other types of privately managed investment accounts, such as wrap accounts, exist that have some things in common with mutual funds. The following sections provide some background that you need to know if you're going to consider these fund alternatives.

Hedge Funds: Extremes of Costs and Risks

Hedge funds, historically an investment reserved for big-ticket investors, are seemingly like mutual funds in that they typically invest in stocks and bonds. They have the added glamour and allure, however, of taking significant risks and gambles with their investments. Hedge funds may take risks by purchasing derivatives (see Chapter 2), or they may bet on the fall in price of particular securities by selling the securities short. (When you *short sell,* you borrow a security from a broker, sell it, and then hope to buy it back later at a lower price.) Some hedge funds even invest in other hedge funds.

This section takes a closer look at hedge funds and gives you a clear idea of what hedge funds are and what you need to know and do before you consider investing in one.

Getting the truth about hedge funds

In the prior edition of this book written in 2007, I warned, "Although hedge funds have recently been the buzz in some investment circles and some wealthier investors have been dropping money into them, they may not be the best choice for you. Hedge funds are typically a far riskier investment than your typical mutual fund. What's the hidden truth about these funds? The following list highlights some of hedge fund's dangers:"

Hedge funds have a much higher risk than mutual funds

When a hedge fund manager bets right, he can produce high returns. When he doesn't, however, the fund manager can have his head handed to him on an expensive silver platter. With short selling, because the value of the security that was sold short can rise an unlimited amount, the potential loss from buying it back at a much higher price can be horrendous. And even the most experienced investing professionals can also lose a pile of money in no time when they invest in derivatives. Hedge fund managers have also been clobbered when a previously fast rising commodity like natural gas or copper futures plunges in value.

A number of hedge funds have gone belly up when their managers guessed wrong. In other words, their investments did so poorly that investors in the fund lost all their money. As I discuss in Chapter 2, the odds of this happening with a mutual fund — particularly from one of the larger, more established companies — are nil.

Hedge funds have much higher fees than mutual funds

Hedge funds charge an annual management fee of about 1 to 2 percent and a performance fee, which typically amounts to a whopping 20 percent of a fund's profits. Veteran investment observer Jack Bogle said of hedge funds and the high fees that are extracted and paid to the hedge fund's managers (and not their customers), "Hedge funds are a compensation strategy not an investment strategy."

Hedge funds aren't subject to the same regulatory scrutiny

A *Forbes* 2004 article on the hedge fund industry entitled "The Sleaziest Show On Earth" referred to the industry as, ". . . a business rife with exorbitant fees, phony numbers, and outright thievery." During the severe stock market decline in the late 2000s, many hedge funds did poorly, and some went under or were exposed to be fraudulent Ponzi schemes, the most notorious being the fund run by the now jailed Bernie Madoff.

If that’s still not enough to convince you from the perspective of one of the nation’s best business magazines that caters to those affluent enough to invest in such funds, consider this: *Forbes* went on to say, “Hedge funds exist in a lawless and risky realm, exempt from the rules governing mutual funds, equities, and most other investments. Hedge funds aren’t even required to keep audited books — and many don’t. These risky funds often are guilty of inadequate disclosure of costs, overvaluation of holdings to goose reported performance and manager pay, and cozy ties between funds and brokers that often shortchange investors.” For more about insufficient regulatory oversight of hedge funds, please see the “Investigating hedge funds” section later in this chapter.

Hedge funds have lower returns compared to mutual funds

Objective studies which I have seen, such as the one conducted by Princeton University’s Burton Malkiel, present an unflattering perspective on hedge fund industry returns. In short, hedge funds have produced lower average annual returns when compared with similar mutual funds.

If you want riskier investments, you can find aggressive mutual funds, or you can buy mutual funds *on margin* through a brokerage account, meaning that you make a down payment but control a larger investment (such as when you purchase a home with a mortgage). See Chapter 16 for more about the risks and rewards of buying on margin.

Investigating hedge funds

Unfortunately, hedge funds aren’t subject to the same regulatory scrutiny from the Securities and Exchange Commission (SEC) that mutual funds are. However, if you go against my advice and consider investing in a hedge fund, I suggest that you adhere to the advice the SEC offers. The following guidelines for evaluating hedge funds can help.

Read all the important documents

Take the time to read the fund's prospectus or offering memorandum and all related materials. Doing so discloses the fees, managers, and overall investment strategy.

Make sure you understand the level of risk involved in the fund's investment strategies and ensure that they're suitable to your personal investing goals, time horizons, and risk tolerance. As with any investment, the higher the potential returns, the higher the risks you must assume.

Understand how a fund's assets are valued

Funds of hedge funds and hedge funds may invest in *highly illiquid* securities (not easily and quickly converted into cash) that may be difficult to value. Moreover, many hedge funds give themselves significant discretion in valuing securities. You should understand a fund's valuation process and know the extent to which a fund's securities are valued by independent sources.

Ask questions about fees

Fees impact your return on investment. Hedge funds typically charge an asset management fee of 1 to 2 percent of assets, plus a performance fee of 20 percent of a hedge fund's profits. A *performance fee* could motivate a hedge fund manager to take greater risks in the hope of generating a larger return. Funds of hedge funds typically charge a fee for managing your assets, and some may also include a performance fee based on profits.

These fees are charged in addition to any fees paid to the underlying hedge funds. If you invest in hedge funds through a fund of hedge funds, you'll pay two layers of fees: the fees of the fund of hedge funds and the fees charged by the underlying hedge funds.

Understand any limitations on redeeming your shares

Hedge funds typically limit opportunities to redeem, or cash in, your shares (for example, to four times a year), and often impose a "lockup" period of one year or more, during which you can't cash in your shares. (By contrast, mutual funds offer daily liquidity). These should be disclosed in the hedge fund's prospectus.

Research the backgrounds of hedge fund managers

Know with whom you're investing. Make sure hedge fund managers are qualified to manage your money and find out whether they have a disciplinary history within the securities industry. You can get this information (and more) by reviewing the adviser's Form ADV. You can search for and view a firm's Form ADV by using the SEC's Investment Adviser Public Disclosure (IAPD) Web site (www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.asp

You also can get copies of Form ADV for individual advisers and firms from the investment adviser, the SEC's Public Reference Room, or (for advisers with less than $25 million in assets under management) the state securities regulator where the adviser's principal place of business is located. If you don't find the investment adviser firm in the SEC's IAPD database, be sure to call your state securities regulator or search the NASD's BrokerCheck database for any information they may have.

Don't be afraid to ask questions

You're entrusting your money to someone else. You should know where your money is going, who is managing it, how it's being invested, how you can get it back, what protections are placed on your investment, and what your rights are as an investor.

The SEC goes on to provide the following comments and suggested protections for those purchasing a hedge fund:

> ✓ **Hedge fund investors don't receive all the federal and state law protections that commonly apply to most**

registered investments. For example, you won't get the same level of disclosures from a hedge fund that you'll get from registered investments. Without the disclosures that the securities laws require for most registered investments, it can be quite difficult to verify representations you may receive from a hedge fund. You should also be aware that, while the SEC may conduct examinations of any hedge fund manager that is registered as an investment adviser under the Investment Advisers Act, the SEC and other securities regulators generally have limited ability to check routinely on hedge fund activities.

- The SEC can take action against a hedge fund that defrauds investors and has brought a number of fraud cases involving hedge funds. Commonly in these cases, hedge fund advisers misrepresented their experience and the fund's track record. Other cases were classic "Ponzi schemes," where early investors were paid off to make the scheme look legitimate. In some of the cases, the hedge funds sent phony account statements to investors to camouflage the fact that their money had been stolen. *That's why it's extremely important to thoroughly check out every aspect of any hedge fund you might consider as an investment.*

- If you encounter a problem with your hedge fund or fund of hedge funds, you can send your complaint by using the SEC's online complaint form at www.sec.gov/complaint.shtml.

Wrap (Or Managed) Accounts: Hefty Fees

Brokerage firms (Prudential, Merrill Lynch, Salomon Smith Barney, PaineWebber, and Morgan Stanley Dean Witter) that used to sell investment products on commission now offer investment management services for an ongoing fee rather than commissions. This change is an improvement for investors because it reduces some of the conflicts of interest caused by commissions.

Wrap accounts, or *managed accounts,* go by a variety of names, but they're the same in one crucial way: For the privilege of investing your money through their chosen money managers, they charge you a percentage of the assets that they're managing for you. These accounts are quite similar to mutual funds except that the accounts don't have the same regulatory and reporting requirements as do mutual funds.

Wrap accounts management expenses are high. In fact, they're up to 2 to 3 percent per year of assets under management. Remember that stocks have historically returned about 10 percent per year before taxes. So if you're paying 2 to 3 percent per year to have the money managed in stocks, 20 to 30 percent of your return (before taxes) is siphoned off. You pay a good chunk of money in taxes on your 10 percent return. So a 2 to 3 percent wrap fee actually ends up depleting up to half of the profits that you get to keep after you pay taxes — ouch!

No-load (commission-free) mutual funds offer investors access to the nation's best investment managers for a fraction of the cost of wrap accounts. You can invest in dozens of top-performing funds for an annual expense of 1 percent per year or less. Many excellent funds are available for far less — 0.1 to 0.5 percent annually.

So why do people invest through wrap accounts if they're such a poor investment? Brokerage firms hoodwink investors into paying so much more for access to investment managers with clever marketing — slick, seductive, deceptive, misleading pitches.

The following are the key components of brokerage firms' pitch for wrap accounts — and then the real truth behind the pitch:

- *"You're accessing investment managers who normally don't take money from small-fry investors like you."* Not a single study shows that the performance of money managers has anything to do with the minimum account size they handle. Besides, no-load mutual funds hire many of the same managers who work at other money management firms. In fact, Vanguard, the nation's largest exclusively load-free investment firm, contracts out to hire money managers who typically handle only multimillion-dollar private-client accounts to run many of their funds. A number of other mutual funds are managed by private money managers who typically have high entrance requirements for their individual private clients.
- *"You'll earn a higher rate of return, so the fees are worth it."* Part of the bait brokers use to hook you into a wrap account is the wonderful rates of returns that these accounts supposedly generate. You could've earned 18 to 25 percent per year, they say, had you invested with the "Star of Yesterday" investment management company. The key word here is "could've." History is history. As I discuss in Chapter 7, in the money management business, many of yesterday's winners become either tomorrow's losers or its mediocre performers.

  You must also remember that, unlike mutual funds, whose performance records are audited by the SEC, wrap account performance records include marketing hype. The SEC doesn't audit wrap accounts. The most common ploy is showing the performance of only selected accounts — which turn out to be (you got it) only the ones that performed the best!

The expenses you pay to have your investments managed have an enormous impact on the long-term growth of your money. If you can have your money managed for 0.5 to 1 percent per year rather than 2 to 3 percent, you have an enormous performance advantage already.

- *“A wrap account is tailored to your personal needs.”* Thousands of different mutual funds are available out there, covering every possible combination of investments and degree of risk. You can find a mutual fund and develop a portfolio of funds that meets your objectives and risk tolerance. Some wrap accounts have only funds that are managed by a particular brokerage firm, making it impossible for you to invest in the best from the universe of all funds.

  Moreover, if your portfolio ever begins to drift from your objectives, buying into a new mutual fund is much easier than ending a relationship with a broker who sold you the wrap account.

- *“There’s little difference in cost between wrap accounts and mutual funds.”* The worst and most inefficient mutual funds can have total costs approaching that of a typical wrap account. But you’re informed, right? You’re not going to invest in the highest-cost funds. Chapters 11 through 14 detail which mutual funds offer both top performance and low cost.

Private Money Managers: One-on-One

In the world of money management, added benefits — snob appeal and ego stroking for many — come with having your own private money manager. First of all, you generally need big bucks, often $1 million or more, to gain entrance. A *private money management* company allows you to sit down and visit with a personal representative and perhaps even the investment manager. The company may lavish you with attention and glossy brochures. You hear how your money not only receives individualized and personalized treatment but also how superb the investment manager's performance has been in prior years.

Even if you have big bucks, you probably don't need a private money manager for two simple reasons:

- **The best, average, and worst private money managers earn returns comparable to their counterparts in the mutual fund business.** And as I mention earlier in this chapter, some mutual fund firms contract out to or are themselves private money managers. This gives you the best of both worlds: the SEC oversight of a mutual fund and access to some money managers that you may not otherwise be able to use.

- **You pay high fees to use these money manager's services.** One bank CEO, speaking at a banking conference about future sources of revenue growth, said private money management for the wealthy, along with the credit card business, are two "high-return, low-risk businesses" in the financial world. Knowing that you're getting soaked with high fees like the average credit card customer shouldn't make you feel so special about having a private money manager!

If you're considering investing through private investment firms, make sure that you

- Ask to see independently audited rates of return. Private managers' holdings and performances aren't subject to the same scrutiny and reporting as mutual funds are.

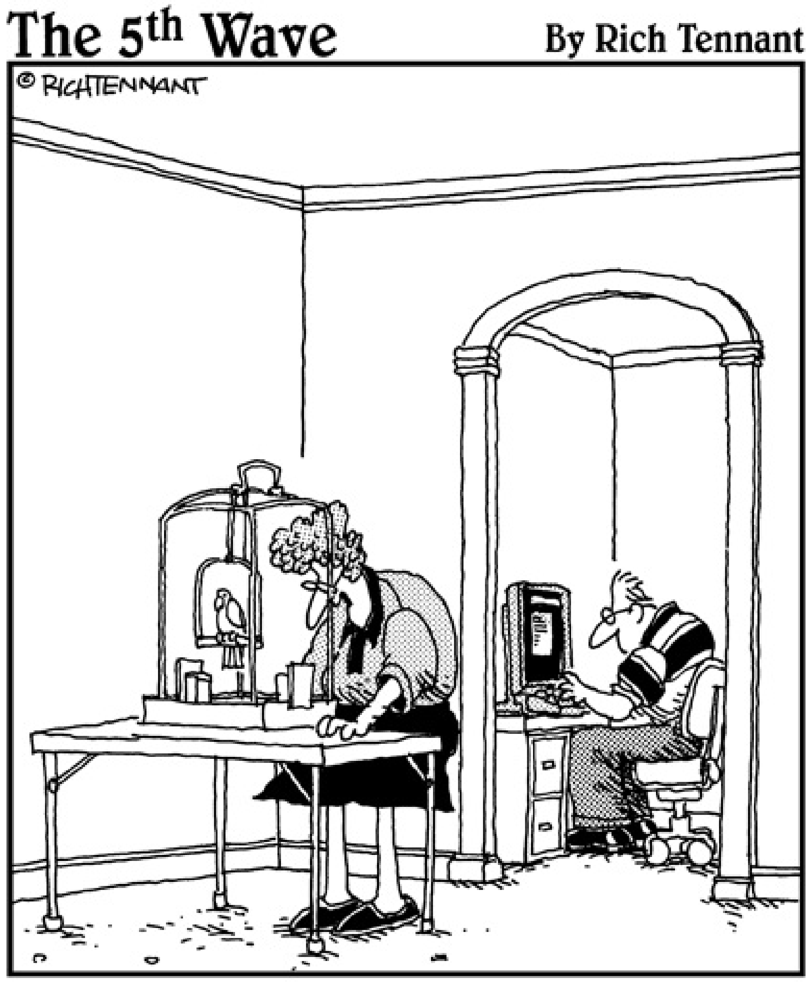
- Check many references.

- Compare the performance and costs of the private money manager with similar mutual funds in this book.

For more ideas about evaluating money managers, see the criteria for selecting mutual funds in Chapter 7.

Part III

Separating the Best from the Rest



"Oh, look! Mr. Peepers just picked the very same mutual funds your investment software did!"

In this part . . .

In this part, I cover the difficult process of narrowing down the multitude of funds to the best funds for your situation. I also discuss how to utilize fund company reports: prospectuses and annual reports. In addition to explaining proven selection techniques, I name names and highlight the best firms with which to conduct your fund investing.

Chapter 9

Buying Funds from the Best Firms

In This Chapter

- Becoming familiar with the best and worst places to buy funds
- Letting discount brokers work for *you*
- Knowing when hiring an adviser is appropriate

Hundreds of investment companies offer thousands of fund options. However, only a handful of these fund companies offer many top-notch funds, so in this chapter, I tell you which companies are the best places for your fund investing.

Some other good individual funds are run by companies not mentioned in this chapter. (I recommend specific funds in Part IV of this book.) In addition to recommending the best parent fund companies, I also recommend the best discount brokers. Although these guys are slightly more expensive, discount brokers make buying the best funds from different fund companies and holding all the funds in a single account a lot easier.

Finding the Best Buys

When studying the different mutual funds companies, you may see a lot of different funds. Some are better than others. Using the criteria in Chapter 7, this chapter presents the best buys. In this section, I discuss the best companies through which to invest in funds directly. Check out the Appendix for each company's contact information. ***Note:*** In the fund company descriptions, I devote more space to those companies whose funds I recommend the most in this book. Some good funds are offered by companies not on this short list — please see Chapters 11 through 14 for all the specific fund picks.

The Vanguard Group

The Vanguard Group is now the largest mutual fund company in America, having surpassed Fidelity. Vanguard's significant growth since the early 1990s has been somewhat of a vindication for a company that was underrated for many years. (At the time that I wrote the first edition of this book in 1994, I went on record as saying that Vanguard, overall, was the best mutual fund company around and wasn't getting the recognition it deserved. My praise led some folks to ask whether I had a vested interest in praising Vanguard and the answer then is the same as today — no!)

One of the reasons for Vanguard's underrating is the fact that its funds are almost never at the very tiptop of the performance charts for their respective categories. As I discuss in Chapter 7, this sign is actually good, because many number-one-performing funds are rarely even above average over the long haul. Although Vanguard offers a broad spectrum of funds in terms of risk, it doesn't take excessive risks with the funds it offers; thus, its funds rarely are ranked number one over short time periods.

Because of Vanguard's unique shareholder-owned structure (see the nearby sidebar "Vanguard's roots: The Bogle difference"), the average operating-expense ratio of its funds — 0.22 percent per year for U.S. stock funds, 0.29 percent for international stock funds, and 0.14 percent for bond funds — is lower than that of any other fund family in the industry. In fact, the average fund family's expense ratio is a whopping four times higher than Vanguard’s. Vanguard also offers its Admiral series of funds with lower expense ratios for higher balance customers and low-cost exchange-traded funds (see Chapter 5).

A pioneer in the field, Vanguard was the first to offer to the public *index funds,* which are unmanaged portfolios of the securities that comprise a given market index. Many fund companies have since added index funds to their lists of offerings. But Vanguard is still the indexing leader with the broadest selection of index funds and the lowest operating expenses in the business. (I talk more about the advantages of index funds in Chapter 10.)

Vanguard’s low expenses translate into superior performance. Especially with money market and bond funds (markets in which even the best fund managers add relatively little value), Vanguard’s funds are consistently near the head of the class.

Vanguard is best at funds appealing to safety-minded investors — those who want to invest in money market, bond, and conservative stock funds. However, Vanguard also offers aggressive stock funds with solid performance and low-expense ratios (see Chapter 13 for the list). In managing stock funds, where performance is supposed to be more closely tied to the genius of the fund manager, Vanguard’s thriftiness enhances performance.

Vanguard’s roots: The Bogle difference

In the early 1970s when Vanguard was formed, John Bogle, its founder and former CEO, made the big decision that to this day clearly differentiates Vanguard from its competition: Vanguard distributes funds and provides shareholder administration on an *at-cost basis* — that is, with no markup.

Bogle insisted that the management of most of the stock funds be contracted out to private money management firms, from whom Vanguard would negotiate the best deals. Thus, Vanguard's mutual fund investors would own the management company. Contrast this arrangement to that of traditional fund companies, in which the parent management company receives the profits from managing the funds.

Bogle felt that this unique corporate structure ensured that fund shareholders would obtain the best deals possible on money managers. "Funds ought to be run for the benefit of shareholders, not for the fund managers," Bogle reasoned. History has proven Bogle not only to be right but also to be a mutual fund investor's best advocate.

Fidelity Investments

Fidelity Investments is the second largest mutual fund company in America. A mutual fund Goliath, Fidelity offers hundreds of funds. As evidence of Fidelity's enormous buying power, representatives from dozens of companies visit its Boston offices every day. Most mutual fund managers have to travel to the companies they're interested in researching; if you're a Fidelity mutual fund manager, however, many companies come to you.

Fidelity's roots trace back to the 1940s, when Edward C. Johnson II took over the then-fledgling Fidelity Fund from its president, who felt that he couldn't make enough money as the head of an investment fund! Johnson's son, Ned (Edward C. Johnson III), assumed Fidelity's top position in 1972 and has clearly proven that you can make a truckload of money operating mutual funds: He's personally worth billions.

If you're venturing to do business with Fidelity on your own, you have your work cut out for you. One of the biggest problems novice investors have at Fidelity is discerning the good funds from the not-so-good ones. (My book separates the best from the rest and highlights which Fidelity funds are worthy of your investment dollars.)

I specifically advise shunning the following types of funds at Fidelity:

- **Bond funds:** Relative to the best of the competition, Fidelity's bond funds charge higher operating expenses that depress an investor's returns. (***Note:*** For larger balance customers, Fidelity offers a decent series of bond funds known as Spartan funds that have lower operating expense ratios — see Chapter 11.)

Funds with branch offices: Even better?

Many mutual fund companies have their offices in one location. If you happen to live in the town or city where they're located and want to do business with them, you can visit them in person. However, odds are that, unless you maintain several homes, you won't be living near the fund companies with which you want to do your fund-investing business.

Some fund companies, such as Fidelity, have greater numbers of branch offices, which are located primarily in densely populated and more affluent areas. You may feel more comfortable dropping a check off or speaking to an investment representative face to face instead of being navigated through an automated voice message system or mouse-clicking through a Web site. However, there's no sound *financial* reason that you need to go in person to a fund company —you can do everything you need to do by phone, mail, or computer.

In most cases, you pay a cost for doing your fund investing through firms with branch offices. Operating all those branch offices in areas where rent and employees don't come cheaply costs a good chunk of money. Ultimately, firms that maintain a large branch network need to build these extra costs into their funds' fees. Higher fees lower your investment returns.

A counterargument that fund companies with many branch offices make is that if the branch offices succeed in enticing more investors to use the funds offered by the company, more total money is brought in. Having more money under management helps to lower the average cost of managing each dollar invested.

- **Adviser funds:** Fidelity sells this family of load funds through investment salespeople; these funds carry high sales loads or high ongoing fees.
- **Sector funds:** You should also avoid Fidelity's sector funds (Select), which invest in just one industry — such as air transportation, insurance, or retailing. These funds have rapid changeover of managers. Being industry focused, these funds are poorly diversified (highly concentrated) and quite risky. Fidelity, unfortunately, encourages a trader mentality with these funds.

One of Fidelity's strengths is its local presence — it operates 100+ branch offices throughout the United States and staffs its phones 24 hours a day, 365 days a year.

Dodge & Cox

Dodge & Cox is a San Francisco–based firm that has been in the fund business since the Great Depression. It's best known for its conservatively managed funds with solid track records and modest fees.

Unfortunately for new investors, from time to time, Dodge & Cox has closed some of its funds. The company did so to keep funds from becoming too bloated with assets to manage, which could undermine the performance of those funds. Thanks to the severe stock market decline in the late 2000s, all its funds were reopened and remain so as of this writing. However, if any of its funds appeal to you, you should establish an account in case it shuts any of its funds again to new investors.

Oakmark

Harris Associates, which has managed money since 1976, is the investment management company that oversees the management of Oakmark, this value-oriented Chicago-based family of funds.

As with the Dodge & Cox funds (see the preceding section), a number of the best Oakmark funds have closed from time to time to new investors. As of this writing, all its funds are open. Be aware that when some of its funds have closed in the past, investors who establish accounts directly with Oakmark can still buy some of the closed funds.

T. Rowe Price

Founded in 1937, T. Rowe Price is one of the oldest mutual fund companies — named after its founder, T. (Thomas) Rowe Price, who's generally credited with popularizing investing in growth-oriented companies. The fund company has also been a fund pioneer in international investing.

T. Rowe Price remained a small company for many years, focusing on its specialties of U.S. growth stocks and international funds. That stance changed in recent decades as the company offered a comprehensive menu of different fund types. It offers 401(k) retirement plans specifically for smaller companies. The fund company also offers a series of lower cost money market and bond funds called Summit funds with a minimum initial investment of $25,000.

TIAA-CREF

This nonprofit organization provides an array of investment services to education, hospitals, and other nonprofit organizations and offers a solid family of funds to the general public. Its funds have low operating expense ratios and are conservatively managed.

Headquartered in New York City, the company has major operations in Charlotte, North Carolina, and Denver, Colorado, as well as about 60 local offices. The organization got its start in 1918 when Andrew Carnegie and his Carnegie Foundation established a pension system for professors. Funding initially came from grants from the foundation and Carnegie Corporation of New York, and regular contributions from participating institutions and individuals. Today, TIAA-CREF invests more than $400 billion on behalf of investors.

The funds' low minimums make them a good choice for investors with smaller sums to invest. They have no-minimum-investment IRAs with no annual administrative fees.

Other fund companies

With so many companies offering mutual funds, the number of them competing for your mutual fund dollars far exceeds those that are worthy of your consideration. But here are some additional noteworthy fund companies:

- **Artisan:** This small family of well-managed stock funds is headquartered in Milwaukee, Wisconsin. Unfortunately, as the popularity of some of its funds has grown over the years, some of them have closed. As of this writing, the Artisan International Small Cap Fund, Artisan Mid Cap Fund, Artisan Mid Cap Value Fund, and Artisan Small Cap Value Fund are closed to new investors.
- **Harbor:** Based in Toledo, Ohio, Harbor Funds contracts with outside money managers who manage money for affluent individuals and institutions. Although Harbor fund managers don't take great risks, their funds are expected to

— and are generally able to — outperform comparable market indexes.

- **Masters' Select:** The investment advisory firm of Litman/Gregory, which manages money for affluent individuals and institutions, developed this unique and small family of funds in 1997. Each of the funds within this family, which is based in Orinda, California, contracts out the actual management of the investment dollars to a handful of top fund managers.
- **USAA:** Headquartered in San Antonio, Texas, USAA is a conservative family of efficiently managed mutual funds (and generally low-cost, high-quality insurance). Although you (or a family member) need to be a military officer, enlistee, or military retiree to gain access to its homeowner and auto insurance, anyone can buy its mutual funds. USAA also offers investors, with small amounts to invest (minimum of $50 monthly) and without several thousand dollars required to meet fund minimum requirements, the ability to invest via electronic monthly transfers. For more info on USAA's funds, check out its Web site at www.usaa.com/inet/ent_utils/McStaticPages?key=investments_mutual_funds_main.

Hundreds of mutual fund companies offer thousands of funds. Many aren't worth your consideration because they don't meet the common-sense selection criteria outlined in Chapter 7. So if you're wondering why I didn't mention a particular fund family, it's probably because the record shows that its funds are high cost, low performance, managed in a schizophrenic fashion, or all of the above. Check them out against the criteria in Chapter 7 to see for yourself. (***Note:*** In Part IV, where I recommend specific funds in varying fund categories, I also mention some other funds offered by companies that aren't specifically written up in this chapter.)

One of the beauties of all the fund choices out there is that you don't have to settle for mediocre or inferior funds. If you're wondering what to do with such funds that you already own, please read Chapter 17.

Discount Brokers: Mutual Fund Supermarkets

For many years, you could only purchase no-load mutual funds directly from mutual fund companies. If you wanted to buy some funds at, say, Vanguard, Oakmark, T. Rowe Price, and Dodge & Cox, you needed to call these four different companies and request each firm's application. So you ended up filling out four different sets of forms and mailing them in with a separate check to each of the companies.

Soon, you received separate statements from each of the four fund companies reporting how your investments were doing. (Some fund companies make this even more of a paperwork nightmare by sending you a separate statement for each individual mutual fund that you buy through them.)

Now suppose that you wanted to sell one of your T. Rowe Price funds and invest the proceeds at Oakmark. Doing so was also a time-consuming pain in the posterior, because you had to contact T. Rowe Price to sell, wait days for it to send you a check for the sale's proceeds, and then send the money with instructions to Oakmark. Shopping this way can be tedious. Imagine wanting to make a salad and having to go to a lettuce farm, a tomato farm, and an onion farm to get the ingredients. That's why we have supermarkets!

In 1984, Charles Schwab came up with the idea to create a supermarket for mutual funds. Charles Schwab is the discount broker pioneer who created the first mutual fund supermarket (which other discount brokers have since copied) where you can purchase hundreds of individual funds from dozens of fund companies — one-stop mutual fund shopping.

The major benefit of such a service is that it greatly simplifies the paperwork involved in buying and selling different companies' mutual funds. No matter how many mutual fund companies you want to invest in, you need to complete just one application for the discount broker. And instead of getting a separate statement from each company, you get one statement from the discount broker that summarizes all your mutual fund holdings. (***Note:*** You still must maintain separate nonretirement and IRA accounts.)

Moving from one company's fund into another's is generally a snap. The discount broker can usually take care of all this with one phone call from you. Come tax time, you receive just one 1099 statement summarizing your fund's taxable distributions to record on your tax return.

You weren't born yesterday, so you know that all this convenience must have a catch. Here's a hint: Because discount brokers serve as intermediaries for the buying and selling of funds and the time and money spent sending you statements, they expect to make some money in return. So guess what? It costs you more to use a discount broker. Discount brokers charge you a transaction fee whenever you buy or sell most of the better funds that they offer. Leading discount brokers typically charge a flat fee of around $35.

Buying direct versus discount brokers

Buying funds directly from fund companies versus buying funds through a discounter's mutual fund supermarket isn't inherently better. For the most part, it's a trade-off that boils down to personal preference and individual circumstances.

Why to buy funds direct

Many reasons exist to buy funds directly from the company. Here are a few:

- **You’re thrifty.** And you can take that as a compliment. Being vigilant about your investing costs boosts your returns. By buying direct from no-load fund companies, you avoid the discount brokerage transaction costs.
- **You don’t have much money to invest.** If you’re investing less than $5,000 per fund, the minimum transaction fees of a discount broker will gobble up a large percentage of your investment. You don’t have to hassle with transaction fees when you buy direct from a no-load fund company.
- **You’re content investing through one of the bigger fund companies with a broad array of good funds.** For example, if you deal directly with one mutual fund company that excels in all types of funds, you can minimize your fees and maximize your investment returns. Given the breadth and depth of the bigger companies’ fund selections, you should feel content centralizing your fund investments through one of the better companies. However, if you sleep better at night investing through multiple fund companies’ funds, I won’t try to change your mind.

Given the fact that most of the major fund companies, such as Vanguard, Fidelity, and T. Rowe Price, have discount brokerage divisions offering mutual funds from companies other than their own, you could use one of these companies as your base and have the best of both worlds. Suppose, for example, that you want to invest a large portion but not all your money in Fidelity funds. By establishing a discount brokerage account at Fidelity, all your Fidelity fund purchases would be free of transaction fees; then through that same account, you could also buy other fund companies’ funds.

Why to buy through a discount broker

Here are the main reasons to go with a discount broker:

- **You want to invest in funds from many fund companies.** In general, different fund companies excel in different types of investments: You may want to build a portfolio that draws on the specific talents of various companies. Although you can buy directly through each individual fund company, the point eventually comes where the hassle and clutter just aren't worth it. The one-stop shopping of a discount broker may well be worth the occasional transaction fee.
- **You hate paperwork.** For those of you out there whose disdain of paperwork is so intense that it keeps you from doing things that you're supposed to do, a discount broker is for you.
- **You want easy access to your money.** Some discount brokerage accounts offer such bells and whistles as debit cards and unlimited check-writing privileges, making it simple for you to tap in to your money. (That can be a bad thing if this tempts you to spend your money!)
- **You want to buy into a high-minimum fund.** One unique feature available through some discount broker's fund services is the ability to purchase some funds that aren't normally available to smaller investors.
- **You want to buy funds on margin.** Another interesting but rarely used feature that comes with a brokerage account is that you can borrow *on margin* (take out a loan from the brokerage firm) against mutual funds and other securities (which are used as collateral) held in a nonretirement account. Borrowing against your funds is generally lower cost than your other loan options, and it's potentially tax deductible. That said, buying and holding funds on margin can be costly and risky, and you may be

forced to sell some funds or add cash to your account if the value of your investments declines too much.

You have a way (that involves hassle) to buy and sell your funds and use a discounter but reduce the total transaction fees: Purchase your funds initially from the mutual fund company and then transfer the shares at no charge into a discount brokerage account. Conversely, when you're ready to sell shares, you can transfer shares from the discounter to the mutual fund company before you're ready to sell. (See Chapter 16 for details about transfer forms.)

Debunking "No Transaction Fee" funds

After several years of distributing funds for all these different fund companies, discount brokers came up with another innovation. Discount brokers were doing a lot for mutual fund companies (for instance, handling the purchase and sale of funds, as well as the ongoing account recordkeeping and reporting), but they weren't being paid for all their work.

In 1992, Charles Schwab & Company negotiated to be paid an ongoing fee to service and handle customer accounts by some mutual fund companies. Today, through Schwab and other discount brokers who replicated this service, you can purchase hundreds of funds without paying any transaction fees (that is, you pay the same cost as if you'd bought the funds through the mutual fund company itself). These are called *No Transaction Fee (NTF) funds.*

On the surface, this idea certainly sounds like a great deal for you — the mutual fund investor wanting to buy funds from various companies through a discount brokerage account. You get access to many funds and one account statement without paying transaction fees.

The no-transaction fee fund is a case of something sounding much better than it really is. Although some discount brokers say or imply that NTF funds are free, they're hardly free. Discount brokers are able to waive the transaction costs only because the participating fund companies have agreed to foot the bill. In a typical arrangement, the participating fund company shares a portion of its operating expense ratio with the discount broker handling the account. But as you know if you read Chapter 7, annual operating expenses are drawn from the shareholders' investment dollars. So in the end, you're still the one paying the transaction costs.

As a group, NTF funds are inferior to the best no-load funds that you pay the discounters a transaction fee to purchase because NTF funds tend to

- Have higher operating expenses than non-NTF funds
- Be offered by smaller, less experienced fund companies who may be struggling to compete in the saturated mutual fund market

  You'll notice that big, well-established fund companies (including the ones discussed earlier in this chapter, such as Vanguard, Fidelity, and T. Rowe Price) don't participate in NTF programs. They don't have to; the demand for their funds is high even with transaction costs.

In their rush to sign up more NTF funds, some discounters have ignored the quality of the NTF funds they offer. Some financial publications encourage and effectively endorse this lack of quality control by giving higher ratings (in articles purporting to review and rate various discount brokers) to those discounters offering more "free" funds to customers. As with a restaurant meal, more isn't always better — quality counts as well!

Whenever you make a mutual fund investment decision through a discount broker, try not to be influenced by the prospect, or lack thereof, of a transaction fee. In your efforts to avoid paying a small fee today, you can end up buying a fund with high ongoing fees and subpar performance. If you're so concerned about paying additional fees, deal directly with mutual fund companies and bypass the discount brokers and their transaction fees.

Using the best discount brokers

Although I've spoken of mutual fund companies and discount brokers as separate entities, the line between them has greatly blurred in recent years. For example, Schwab started as a discount broker but later began selling its own mutual funds. Other companies started selling mutual funds but have now moved into the discount brokerage business. The most obvious example is Fidelity, which offers brokerage services through which you can trade individual securities or buy many non-Fidelity mutual funds.

Vanguard and T. Rowe Price have excellent discount brokerage divisions that offer an extensive array of funds from other leading fund companies and charge competitive transaction fees. Vanguard charges $35 per trade and $3 for regularly scheduled dollar-cost averaging trades (minimum of $100); T. Rowe Price charges $35 per trade.

The discount brokerage services of Fidelity, Vanguard, or T. Rowe Price make a lot of sense if you plan on doing the bulk of your fund investing through their respective funds. Remember, you only have to pay brokerage transaction fees on funds offered by other fund companies. You won't pay for buying a

Fidelity fund from Fidelity or a Vanguard fund from Vanguard or a T. Rowe Price fund from T. Rowe Price.

If you're already wondering how to get in touch with the companies that I recommend in this chapter, check out the Appendix, which includes the phone numbers, Web sites, and mailing addresses for all these companies. But before you put the cart before the horse, I strongly recommend that you at least read through Part IV of this book. That's where I recommend specific funds and discuss how to assemble a top-notch portfolio of funds.

Places to Pass By

BEWARE Don't base your investment decisions on your gut: Some mutual fund companies have plush offices and they charge relatively high fees for their funds (to pay for all their overhead costs) or sell poorly performing funds — or both. What types of places are likely to make you feel comfortable but lead you astray? Many people do their fund investing through a list of wrong places:

- **The First Faithful Community Bank:** Many people feel comfortable turning their money over to the friendly neighborhood banker. You've done it for years with your checking and savings accounts. The bank has an impressive-looking branch close to your home, complete with parking, security cameras, and a vault. And then there's that FDIC insurance that guarantees your deposits. So now that your bank offers mutual funds, you may feel comfortable taking advice from the "investment specialist" or "consultant" in the branch (and may erroneously believe that the funds it sells carry FDIC coverage).

  Well, the branch representative at your local bank is probably a broker who's earning commissions from the mutual funds he's selling you. Bank funds generally charge sales commissions and higher operating expenses and generally have less-than-stellar performance relative to the best no-load funds. And because banks are relatively new to the mutual fund game, the broker at your bank may have spent last year helping customers establish new checking accounts and may have little knowledge and experience with investments and mutual funds. Remember, if he's working on commission, he's a salesperson, not an adviser. And the funds he's selling are load funds. You can do better.

- **Plunder and Pillage Brokerage Firm:** Brokers work on commission, so they can and will sell load funds. They may even try to hoodwink you into believing that they can do financial planning for you. Don't believe it. As I discuss in Chapter 7, purchasing a load fund has no real benefit; you have better alternatives.

- **Fred, the Friendly Financial Planner:** You may have met Fred through a free seminar, adult education class, or a cold call that he made to you. Fred may not really be a financial planner at all; instead, he could be a salesperson/broker who sells load funds. (If you want to hire an objective planner or adviser for investing in funds, see the next section.)

- **Igor, Your Insurance Broker:** Igor isn't just selling insurance anymore. He now may sell mutual funds, as well, and may even call himself a financial consultant. (See the preceding remarks for brokers.)

- **The Lutheran-Turkish-Irish-Americans-Graduated-from-Cornell-and-Now-Working-in-the-Music-Business Fund:** Hoping to capitalize on the booming fund business, special interest groups everywhere have been jumping in to the fray with funds of their own. Don't be surprised if your church, your alma mater, or your ethnic group makes a passionate pitch to pool your money with that of like-minded individuals in the hands of a manager who truly understands your background.

Although something can possibly be said for group solidarity, I suggest leaving your nest egg alone. Such special-interest funds carry loads and high operating fees and, because they have relatively little money to manage, are usually managed by money managers with little experience.

Hiring an Adviser: The Good, Bad, and Ugly

Dealing directly with various fund companies or simply selecting funds from among the many offered through a discount brokerage service may seem overwhelming to you. But don't hire an adviser until you've explored the real reasons why you want to hire help. If you're like many people, you may hire an adviser for the wrong reason. Or you'll hire the wrong type of adviser, an incompetent one, or one with major conflicts of interest. Check out the following sections for the highlights of why you should and why you shouldn't hire an adviser for overall advice.

The wrong reason to hire an adviser

Don't hire an adviser because of what I call the *crystal ball phenomenon.* Although you know you're not a dummy, you may feel that you can't possibly make informed and intelligent investing decisions because you don't closely follow or even understand the financial markets and what makes them move. Don't believe any advisor who claims he saw particular events (for example, the early 2000s bear market, the late 2000s financial crisis) coming in advance and perfectly positioned his clients' investment portfolio.

REMEMBER No one who you hire has a crystal ball. No one can consistently predict future movements in the financial markets to know which types of investments will do well and which ones won't. Investing intelligently in mutual funds isn't that complicated. You bought this book, so read it, and you find out all you need to know to invest wisely in funds.

The right reasons to hire an adviser

Consider hiring an adviser if

- You're too busy to do your investing yourself.
- You always put off investing because you don't enjoy doing it.
- You're uncomfortable making investing decisions on your own.
- You want a second opinion.
- You need help establishing and prioritizing financial goals.

Beware of conflicts of interest

The field of investment and financial planning is booby-trapped with land mines awaiting the naive investor. A particularly dangerous one is the enormous conflict of interest that's created when "advisers" sell products that bring them commissions.

If a *financial planner* or *financial consultant* sells products and works on commission, he's a salesperson, not a planner — just as a person who makes money selling real estate is a real estate broker, not a housing consultant! There's nothing wrong with salespeople — you just don't want one spouting suggestions when you're looking for objective investment and financial-planning advice.

Here are some of the problems created by commission-based advice:

- **Investments that carry commissions can pit your interests against those of the broker selling them.** The bigger the commission on a particular investment product, the greater the incentive the broker/planner/adviser has to sell it to you.
- **Investments that carry commissions mean that you have fewer dollars working in the investments you buy.** Commissions are siphoned out of your investment dollars. When it comes to returns, non-commission investments have a head start over commission ones.
- **Investments that carry the highest commissions also tend to be among the costliest and riskiest financial products available.** They're inferior products; that's why they need high commissions to motivate salespeople to sell them.
- **Planners who work on commission have an incentive to *churn* your investments.** Commissions are paid out whenever you buy or sell an investment (every time you make a trade). So some commission-greedy brokers/planners encourage you to trade frequently, attributing the need to changes in the economy or the companies in which you've invested. Not only does heavy trading fatten the broker/adviser's wallet at your expense, but also it's a proven loser as an investment strategy. (See Chapter 10 for more about investment strategies and your portfolio.)
- **Planners who work on commission may not keep your overall financial needs in mind.** You may want to fund your employer-sponsored retirement plan or pay off your mortgage or credit card debt before you start investing. The commission-based and money-managing planner has no incentive to recommend such strategies for you; that would give you less money to invest through them.

- **Planners who work on commission may create dependency.** They may try to make it all so complicated that you believe you can't possibly manage your finances or make major financial decisions without them.

Your best options for help

You must do your homework *before* hiring any financial adviser. First, find out as much as you can about the topic you need help with. That way, if you do hire someone to help you make investment and other financial decisions, you're in a better position to evaluate his or her capabilities and expertise.

Realizing that you need to hire someone to help you make and implement financial decisions can be a valuable insight. Even if you have a modest income or modest assets, spending a few hours of your time and a few hundred dollars to hire a professional can be a good investment. The services that advisers and planners offer, their fees, and their competence, however, vary tremendously.

Financial advisers make money in one of three ways:

- From commissions based on sales of financial products
- From fees based on a percentage of your assets that they're investing
- From hourly consultation charges

If you read the preceding section, you already know why the first option is the least preferred choice. (If you really want to or are forced to work with an investment broker who works on commission, be sure to read the last section in this chapter — "If you seek a salesperson.")

A generally better choice than a commission-based broker is a planner who works on a fee basis. In other words, the planner is paid by fees from clients such as you, instead of from the investments and other financial products that he or she recommends that you buy. This compensation system removes the incentive to sell you products with high commissions and churn your investments through a lot of transactions to generate more commissions. However, this system still has potentially significant conflicts of interest.

Many of the leading discount brokerage and mutual fund companies now offer advisory services (either in-house or through referrals), which typically perform mutual fund management for a percentage of assets under their care. With their in-house asset management, you probably won't be able to get the hand-holding, handshakes, and eye-to-eye contact that you would by hiring a local financial-planning firm. However, if you're looking at hiring a financial adviser, I encourage you to consider and interview the advisory divisions of the firms discussed in this chapter. Just be sure to put them through the questions that I recommend in Chapter 24.

The most cost-effective method is to hire an adviser who charges an hourly fee and doesn't sell investment and other financial products. Because he doesn't sell any financial products, his objectivity should be greater. He doesn't perform money management, so he can help you get your financial house in order and make comprehensive financial decisions, including selecting good mutual funds.

Your primary concern in selecting a planner, hourly based or otherwise, is hiring one who's competent. You can address this by checking references and discovering the difference between good and bad financial advice. You have further risk if you and the adviser don't clearly define the work to be done and the approximate total cost before you begin. Don't forget to set your parameters upfront.

A drawback of an entirely different kind occurs when you don't follow through on your adviser's recommendations. You paid for this work but didn't act on it: The potential benefit is lost. If part of the reason that you're hiring an adviser in the first place is that you're too busy or not interested enough to make changes to your financial situation, then you should look for this support in the services you buy from the planner.

If you just need someone as a sounding board for ideas or to recommend some specific no-load mutual funds, hire an hourly based planner for one or two sessions of advice. You save money by doing the legwork and implementation on your own. Just make sure that the planner is willing to give you specific enough advice that you can implement it on your own. Some planners charge for developing a financial plan and then will withhold specific investing advice and recommendations to create the need for you to hire them to do more, perhaps even to manage your money.

If you have a lot of money that you want managed among a variety of mutual fund investments, you can hire a financial adviser who charges a percentage of your assets under management. Some also offer financial-planning services. Some just manage money in mutual funds and other investments.

In the chapters ahead, I give you enough information for you to make wise mutual fund investing decisions. You owe it to yourself to read the rest of the book *before* deciding whether to hire financial help. Also, be sure to pay extra close attention to Chapter 24, which covers the ten issues to consider and questions to ask when hiring an adviser to help with mutual fund investing.

If you seek a salesperson

Despite the additional (and hence, avoidable) sales charges that apply when you purchase a load fund instead of a no-load fund, you may be forced to, or actually want to, buy a load fund through a salesperson working on commission. Perhaps you work for an employer that set up a retirement plan with only load funds as the investment option. Or your Uncle Ernie, who's a stockbroker, will put you in the family doghouse if you transfer your money out of his firm and into no-load funds. Maybe you really trust your broker because of a long-standing and productive investment relationship (but ask yourself this: Is your success because of the broker or the financial markets?).

Protect yourself

If you're comfortable and willing to pay commissions from 4 percent up to as much as 8.5 percent to invest in mutual funds, you have a number of ways to protect your money and well-being when working with brokers:

- **Be aware that you're working with a broker.** Unlike the real estate profession in which an employee's title — real estate broker or agent — clearly conveys how she makes her money, many investment salespeople today have labels that obscure what they do and how they make money. Common misnomers include financial planner, financial consultant, or financial adviser as names for salespeople who used to be called stock, securities, or insurance brokers.
- **Make sure that you've already decided what money you want to invest and how it fits into your overall financial plans.** This point is one of the most important things for you to do first if you're going to invest through a commission-based investment salesperson. Guard against being pushed into dollar amounts and/or investments that aren't part of your financial plan.

Make sure you get the best funds

If you've optimized the structuring of your finances and you have a chunk of money that you're willing to pay as a sales charge to invest in load funds, make sure that you're getting the best funds for your investment dollars. The criteria to use in selecting those load funds are no different from those used to select no-load funds:

- Invest in funds managed by mutual fund companies and portfolio managers that have track records of expertise that take a level of risk that fits your needs, and that charge reasonable annual operating expenses.
- Pay attention to the annual operating expenses that both load and no-load funds charge. These fees are deducted from your funds' returns in much the same way that IRS taxes are deducted from your paycheck, with one critical difference: Your pay stub shows how much you pay in taxes, whereas your mutual fund account statement doesn't show the fund's operating expense charges. You need the prospectus for that, and even then it won't show you what you paid in dollars for that.
- Never invest in a mutual fund without knowing all the charges — sales charges, annual operating expenses, and any annual maintenance or account fees. You can find all these in a fund's prospectus (see Chapter 8 for the scoop on how to decipher a prospectus).

Chapter 11

Money Market Funds: Beating the Bank

In This Chapter

- Distinguishing money market funds from other mutual funds
- Choosing the right fund for you
- Getting a glimpse of the best money market funds around

Back in the days when Richard Nixon was President, folks had hundreds of alternatives for safely investing their spare cash — they could schlep around and shop among banks, banks, and still more banks. Although it may seem that safe-money investors had many alternatives, they really didn't. As a result, yields weren't all that great compared with what a large institutional investor with millions of dollars to invest could obtain by purchasing ultrasafe short-term securities.

Then in the early 1970s, money market mutual funds were born. The concept was fairly simple. The money market mutual fund invested in the same safe, higher-yielding financial instruments (which I discuss in the section "Grasping what money funds invest in," later in this chapter) that only those with big bucks could buy. The money market fund then sells shares to investors who don't have vast sums to invest. By pooling the money from thousands of investors, the fund offers investors a decent yield (after charging a reasonable fee to cover the operational expenses and make a profit). In their first years of operation, these "people's" money funds had little cash flowing in. By 1977, less than $4 billion were in money market funds. But then interest rates rose sharply as inflation took hold. Soon, bank depositors found that the rates of interest they could earn could rise no more, because banks were limited by federal regulations to paying 5 percent interest.

As interest rates skyrocketed in the late 1970s and investors found that they could earn higher yields by switching from bank accounts to money market funds, money flooded into those funds. Within just four years, money market fund assets mushroomed more than fiftyfold to $200 billion. (Today, more than $1 trillion resides in retail money market funds.)

Money Market Funds 101

Money market mutual funds are a large and unique part of the mutual fund industry's offering. *Money market funds are the only type of mutual fund whose share price doesn't fluctuate in value.* The share prices of stock and bond mutual funds fluctuate from day to day depending on how the stock and bond markets are doing. Money market funds, in stark contrast, are locked in at $1 per share. This section gives you the lowdown on these funds.

Comparing money funds with bank accounts

You make money with money market funds by earning dividends, similar to the interest you earn on bank savings accounts. However, the best money market mutual funds offer several significant benefits:

- **Higher yields:** What first attracted investors (including me as a young adult) to money market funds (back when interest rates zoomed up in the late 1970s and early 1980s) still holds true today. The best money market mutual funds pay a higher yield than equivalent bank accounts, despite the deregulation of the banking industry.
- **Multiple tax flavors:** Besides their lower rate of return, another problem with bank savings accounts is that they come in one tax flavor: taxable. There's no such thing as a bank savings account that pays you tax-free interest. Money market funds, however, come in a variety of tax-free versions, paying dividends free of federal or state tax or both. So, if

you're in a high federal or state (or both) income tax bracket, money funds offer you advantages that a bank savings account simply can't.

- **Check-writing privileges:** Money market mutual funds allow you to write checks, without charge, against your account. Most mutual fund companies require that the checks be written for larger amounts — typically at least $250 — and may limit the number that can be written per month. They don't want you using these accounts to pay all your small household bills because checks cost money to process.

- **Convenient access to other mutual funds:** After you've established a money market mutual fund at a particular fund company, investing in other funds offered by that company becomes a matter of placing a simple toll-free phone call or clicking your computer mouse. (And, as I discuss in Chapter 9, if your chosen fund company has a discount brokerage division, you may also be able to invest in mutual funds from other parent companies.) One centralized account eliminates the need to complete additional application forms every time and reduces the ongoing paperwork involved in tracking your funds. Paperwork nirvana!

How banks get away with paying less

How and why do banks continue to pay less interest than most money funds? Two reasons:

Banks have a lot of overhead due to all the branch offices they operate.

Banks know that they can get away with paying lower yields because many of their depositors, perhaps including you, believe that the FDIC insurance that comes with a bank account makes it safer than a money market mutual fund. I dispel this myth in the section "I won't have FDIC insurance," later in the chapter.

- **No lines and traffic jams:** Because you can invest and transact in mutual funds online, over the phone, and through the mail, you can save yourself considerable hassle. Even though most banks are becoming more technologically savvy, some bank transactions, including opening an account, require you to drive to a bank branch. When you deal with a fund, you've also eliminated the risk of being part of a crime scene, as numerous bank branches today still suffer from robberies and holdups.

  Sometimes, you get put on hold for a short time when you call a mutual fund company. The better companies (the ones I recommend in this book) generally won't leave you hanging for more than 15 to 30 seconds. If they do, please write me (you can drop me a note through my Web site at www.erictyson.com) and let me know so that together we can hassle them or delete them from the next edition!

Banks have developed money market deposit accounts (MMDAs) that are money fund wannabes. Banks set the interest rate on MMDAs, and it's generally lower than what you can get from one of the better money market mutual funds. Check writing on MMDAs, if it's available, is usually restricted to just a few checks monthly.

As latecomers to the mutual fund business, some banks now offer real money market mutual funds, including tax-free money funds. Again, the better money market mutual funds from mutual fund companies are generally superior (see my recommendations in the section "Finding the Recommended Funds," later in this chapter) to those offered by banks. The reason: Most bank money market funds have higher operating expenses and hence lower yields than the best money funds offered by mutual fund companies.

Finding uses for money funds

The best money market funds are the ideal substitute for a bank savings account — offering equivalent safety to a bank, but a much better yield. Money market funds are well suited for some of the following purposes:

- **Your emergency cash reserve:** Money market funds are a good place to keep your emergency cash reserve. Because you don't know what the future holds, you're wise to prepare for the unexpected — events such as job loss, unanticipated medical bills, or a leaky roof. Three to six months' worth of living expenses is a good emergency reserve target for most people (for example, if you spend $3,000 in an average month, keep $9,000 to $18,000 reserved).

  You may be able to get by with just three months' living expenses if you have other accounts, such as a 401(k) or family members and close friends that you could tap for a loan. Consider keeping up to one year's expenses handy if your income fluctuates wildly. If your profession involves a high risk of job loss, and if finding another job could take a long time, you also need a significant cash safety net.

- **Short-term savings goals:** If you're saving money for a big-ticket item that you hope to purchase within the next couple of years — whether it's a fishing boat or a down payment on a home — a money market fund is a terrific place to accumulate and grow the money. With such a short time horizon, you can't afford to expose your money to the gyrations of stocks or longer-term bonds. A money market fund offers not only a safe haven for your principal but also a yield that should keep you a step ahead of the inflation rate.

- **A parking spot for money awaiting investment:** Suppose that you have a chunk of money that you want to invest for longer-term purposes but you don't want to invest it all at once for fear that you may buy into stocks and bonds just before a big drop. A money market fund can be a friendly home to the money awaiting investment as you purchase into your chosen investment gradually over time. (This technique is known as *dollar-cost averaging,* which I explain in Chapter 10.)

- **Personal checking accounts:** You can use money market funds with no restrictions on check writing for household checking purposes. Some discount brokerage services that offer accounts with a check-writing option downplay the fact that an investor is allowed to write an unlimited number of checks (in any amounts) on his or her account. You can leave your bank altogether — some money funds even come with debit cards that you can use at bank ATMs for a nominal fee! Later in this chapter (in the section “Finding the Recommended Funds”), I point out specific funds that offer unlimited check-writing privileges.
- **Business accounts:** You can also open a money market fund for your business. You can use this account for depositing checks received from customers and holding excess funds, as well as for paying bills by means of the check-writing feature. Some money funds allow checks to be written for any amount, and such accounts can completely replace a bank checking account.

You can also establish direct deposit with most money market funds. You can have your paycheck, monthly Social Security benefit check, or most other regular payments you receive from larger organizations zapped electronically into your money market mutual fund account.

Refuting common concerns

Investors new to money market mutual funds sometimes worry about what they're getting themselves into. It's good to be concerned and educated *before* you move your money into securities you've never invested in. Most people don't worry about the money they keep in the bank. They should — at least a little. First of all, banks get burglarized and defrauded more than mutual funds! (A thief created a bogus ID and visited five branches of my bank, posing as me, and succeeded in withdrawing $400 from my checking account. The bank covered the loss, but I chose to take my business elsewhere.)

> The biggest risk of keeping extra money in a bank savings account is that inflation erodes your money's purchasing power because of the paltry interest you're getting. ***Remember:*** The FDIC insurance system is a government insurance system — not an ironclad, 100-percent safety guarantee. This section presents the concerns that I hear about money market funds, and the reasons I think that you shouldn't worry about them.

I won't have FDIC insurance

Some people are nervous about money market mutual funds because they aren't "insured." (One exception: Government insurance covered money funds by during the late 2000s financial crisis. See the sidebar: "The one year money market funds had insurance".) Bank accounts, on the other hand, come with insurance that protects up to $250,000 you have deposited (assuming that your bank participates in the FDIC system). So, if a bank with FDIC insurance fails because it lends too much money to people and companies that go bankrupt or abscond with the funds, you should get your money back, up to $250,000.

But consider this: Part of the reason that money market funds aren't insured is that they don't really need to be. Mutual fund companies can't fail because they have a dollar invested in securities for every dollar you deposit in their money funds. Banks, on the other hand, are required to have available just 12 cents for every dollar you hand over to them; that's why they need insurance.

The one year money market funds had insurance

During the height of the financial crisis in 2008, in early September 2008, the share price of a money market fund, the Reserve Primary Fund, fell below $1 per share, the normally fixed price for all money funds. This fund actually declined 3 percent to $0.97 per share. While 3 percent is a small decline, especially compared with declines in the stock market, investors in money market mutual funds have enjoyed and expect that the share price of their money funds would hold constant at $1 per share. (Reserve lost some money on Lehman commercial paper that it owned that plunged in value when Lehman filed for bankruptcy.)

To calm nervous investors, then U.S. Treasury Secretary Henry Paulson announced a new insurance plan, which covered money market fund asset balances investors had in money funds, on September 19, 2008. A specific date was chosen as regulators didn't want investors, especially large institutional investors, continuing to move money around trying to game the system. Some banks also complained that with insurance coverage instituted on money funds, bank depositors might move money from banks to the higher yielding money market funds. If banks and money funds both had insurance, why leave your money in a lower yielding bank account?

The new money market fund insurance program was not intended as a long-term or permanent change for the money market mutual fund business. The insurance ended on September 18, 2009, one year after its inception.

Historically, since their inception in 1972, money market funds have been extremely safe. Only one other fund broke the buck (by 6 percent) and that was a fund run by and invested in only by a modest number of institutional investors. Today, assets in all money funds (both retail and institutional) total more than $3 trillion. Hundreds of trillions of dollars have flowed into and out of money funds over the decades without any retail investors losing principal.

Rather than boosting yield by keeping their expenses low, some money funds venture into riskier debt to boost their fund's yields. That's one of several reasons why I recommend that when you invest in money market funds, you do so with a larger and conservatively managed investment company that keeps expenses low, which is the only safe way to boost a money fund's yield. These firms don't generally stretch for a little extra yield by taking silly risks, and in the highly unlikely event that they ever bought something problematic, they would surely make good on the $1 per share price.

In the late 2000s, a couple dozen money fund owners have infused modest amounts of capital into their money funds to keep them from possibly breaking the buck when they held a security that may have had to be listed at a reduced value on the fund's books. Taking such action requires U.S. Securities & Exchange Commission (SEC) approval. Such requests have happened before, but their pace increased dramatically during the 2008 financial crisis. Among fund companies having to take such action were Allianz, HSBC Holdings, Legg Mason, Northern Trust, Ridgewood Investments, SEI Investments, TD Ameritrade, and Wells Fargo.

According to law professor and industry observer Mercer Bullard (who also was the technical reviewer for this edition of this book), the law is unclear as to whether fund companies ever need to disclose to their shareholders that they sought relief for their money funds and were blessed to do so by the SEC.

It's possible that a money market fund's investments may decline slightly in value — thus reducing the share price of the money market fund below a dollar. In a few cases, money market funds have held some securities that ended up tanking. However, in each and every case (except for one, which I discuss next), the money market fund was *bailed out* — that is, cash was infused into the money fund by the mutual fund company, thus enabling the fund to maintain a price of $1 per share.

One money market fund, however, did break the buck. A newspaper article dramatically headlined, "Investors Stunned as a Money Fund Folds," went on to say, "The fund's collapse is the latest blunder to shake investors' confidence in the nation's mutual fund industry." Although such hype may help to fill readers with anxiety (and perhaps sell more newspapers), it obscures several important facts. This particular money fund didn't collapse; it was liquidated because its investors, who were all small banks, owned the fund, and they decided to disband it. The fund didn't hold money from retail investors like you and me. If it had, the fund company surely would've bailed it out, as other fund companies have done. You should also know that only 6 percent of the investing banks' money was lost. Hardly a collapse — and I doubt that anyone was stunned!

If you have more than $250,000 in one bank and that bank fails, you can lose the money over the $250,000 insurance limit. I've seen more than a few cases where people had more than the insured amount— in one case, a person who came to me for advice had nearly $2 million — sitting in a bank account! Now that's risk! Since 1980, more than 3,000 banks have failed. Because the government has taken a hard line on not going beyond the insurance limits in the 2000s, bank depositors have lost hundreds of millions of dollars.

Stick with larger mutual fund companies if you're worried about the lack of FDIC insurance. They have the financial wherewithal and the most incentive to save a floundering money fund. Fortunately, the larger fund companies have the best money funds anyway.

The check may get lost or stolen

No one can legally cash a check made payable to you. Don't mistakenly think that going to your local bank in person is safer —

you could slip on some dog droppings or get carjacked.

If you're really concerned about the mail, use a fund company or discount broker with branch offices. I don't recommend spending the extra money and time required to send your check by way of registered or certified mail. You know if your check got there when you get the statement from the fund company processing the deposit. (In those rare cases where a check does get lost, know that checks can be reissued.) And when you're depositing a check made payable to you, be sure to endorse the check with the notation "for deposit only" along with your account number under your signature.

When the bank or credit union may be better

Although I advocate use of the best money market funds, I realize that a bank or credit union savings account is sometimes the most practical place to keep your money. Your local bank, for example, may appeal to you if you like being able to do business face to face. Perhaps you operate a business where a lot of cash is processed; in this case, you can't beat the convenience and other services that a local bank offers. And, if you have only $1,000 or $2,000 to invest, a bank savings account may be your better option; the best money market funds generally require a higher minimum initial investment.

For investing short-term excess cash, you may first want to consider keeping it in your checking account. This option may make financial sense if the extra money helps you avoid monthly service charges because your balance occasionally dips below the minimum. In fact, keeping money in a separate savings account rather than in your checking account may *not* benefit you if service charges wipe out your interest earnings.

Don't forget to shop around for the best deals on your checking account because minimum balance requirements, service fees, and interest rates vary. Credit unions offer some of the best deals, although they usually don't offer extensive access to free ATMs. The largest banks with the most ATM machines — you know, the ones that spend gobs of money on advertising jingles and billboards — usually offer the worst terms on checking and savings accounts.

I may have trouble accessing my money

Although it may appear that you can't easily and quickly access your money market fund holdings, you can, in fact, efficiently tap your money market fund in a variety of ways (***Note:*** You can use these methods at most fund companies, particularly the larger ones):

- **Check writing:** The most efficient way to access your money market fund is to write a check. Suppose that you have an unexpectedly large expense that you can't afford to pay out of your bank checking account. Just write a check on your money market mutual fund.
- **Electronic transfers:** Another handy way to access your money (which may be useful if your money fund checkbook is hidden under a mountain of papers somewhere in the vicinity of your desk) is to call the fund company and ask it to have money sent electronically from your money market fund to your bank account or vice versa. (Such transactions can also be done on some fund companies' Web sites.) Or if you prefer, you can have the fund company mail you a check for your desired amount from your money fund.

  If you need money regularly sent from your money market fund to, say, your local bank checking account, you can set up an automatic withdrawal plan. On a designated day of the month, your money market fund electronically sends money to your checking account.
- **Wiring:** If you need cash in a flash, many money market funds offer the option of wiring money to and from your bank. Both the money market fund and the bank usually assess a small charge for this service. Most companies also

send you money via an overnight express carrier, such as Federal Express, if you provide them with an account number.

- **Debit cards:** Brokerage account money funds that offer debit cards allow access to your money through bank ATMs.

Chapter 16 explains how to establish these account features. Unlike when you visit a bank, you can't simply drop by the branch office of a mutual fund company and withdraw funds from your account. They don't keep money in branch offices because they're not banks. However, you can establish the preceding account features, if you didn't set them up when you originally set up your account, by mailing in a form or by visiting the fund's branch office.

Grasping what money funds invest in

Under the Securities and Exchange Commission (SEC) regulations, money market funds can invest only in the most credit-worthy securities, and their investments must have an average *maturity* (when the short-term bonds pay off) of less than 60 days per new rules released by the SEC in 2010. The short-term nature of these securities effectively eliminates the risk of money funds being sensitive to changes in (short-term) interest rates.

The securities that money market funds use are extremely safe. General-purpose money market funds invest in government-backed securities, bank certificates of deposits (CDs), and short-term corporate debt issued by the largest and most credit-worthy companies and the U.S. government (although that may not be much comfort to some of you). The following sections explain the major types of securities that money funds hold.

Commercial paper

Corporations, particularly large ones, often need to borrow money to help make their businesses grow and prosper. In the past, most companies needing a short-term loan had to borrow money from a bank. In recent decades, issuing short-term debt or IOUs — *commercial paper* — directly to interested investors has become easier. Money market funds buy high-quality commercial paper that matures typically within 60 to 90 days and is issued by large companies (such as Boeing, Exxon Mobil, Hewlett-Packard, Home Depot, Microsoft, and Wal-Mart), banks, and foreign governments.

If you had hundreds of thousands of dollars to invest, you could purchase commercial paper yourself instead of buying it indirectly through a money market fund. If you do have a lot of money to invest, I don't recommend this approach. You incur fees when you purchase commercial paper yourself, and you most likely lack the expertise to know how to evaluate credit risks and what a fair price to pay is. The best money funds charge a small fee to do all this analysis for you, plus they offer perks, such as check-writing privileges.

Certificates of deposit

You can go to your local bank and invest some money in a *certificate of deposit* (CD). A CD is nothing more than a specific-term loan that you make to your banker — ranging anywhere from a month to some number of years.

Money market funds can buy CDs as well. The only difference is that they invest a lot more money — usually millions — in bank CDs. Thus, they can command a higher interest rate than you can get on your own. Money funds buy CDs that mature within a few months. The money fund is only insured up to $250,000 per bank CD, just like the bank insurance that customers receive. As with other money fund investments, the money fund does research to determine the credit quality of banks and other institutions that it invests in. Remember that money funds' other investments aren't insured.

Money market funds may hold some other types of CDs. U.S. branches of foreign banks issue Yankee CDs. Foreign banks or the foreign branches of U.S. banks issue Eurodollar CDs.

Government debt

McDonald's has signs in many locations saying that billions and billions have been served. Well, the federal government also serves up trillions and trillions — of dollars in debt, that is — in the form of Treasury securities. A truckload of federal government debt is outstanding — about $12 trillion.

Most money market funds invest a small portion of their money in Treasuries soon to mature. Money funds also invest in short-term debt issued by government-affiliated agencies, such as the Federal Home Loan Bank, which provides funds to the nation's savings and loans.

Government agency debt, which money funds also invest in, unlike Treasuries, isn't backed by the "full faith and credit of the U.S. government." However, no federal agency has ever defaulted on its debt. The folks back in Washington are certain to avoid the loss of faith in government-issued debt that would surely follow should such a default be allowed to occur.

As I discuss in more detail later in the chapter, some money market funds specialize in certain types of government securities that distribute tax-free income to their investors. Treasury money market funds, for example, buy Treasuries and pay dividends that are state-tax-free, but federally taxable. State-specific municipal money market funds invest in debt issued by state and local governments in one state. The dividends on state money funds are federal-and state-tax-free (if you're a resident of that state).

Other types of securities

Other types of securities typically make up small portions of a money fund's holdings. These types include the following:

- *Repurchase agreements (repos)* are overnight investments that money funds send to *dealers* (banks and investment banks' securities divisions), and the money fund receives Treasury securities overnight as collateral.
- *Bankers' acceptances* are more complex: They're issued by banks guaranteeing corporation debt incurred from trade. For example, if Sony sends televisions from overseas to the United States by freight but doesn't want to wait for its money until the ship comes in and the stores pay for the televisions, Sony can get paid right away by borrowing from a bank based on the expected delivery of the televisions. The stores get the televisions and pay for them, and then Sony's loan gets repaid.

Choosing a Great Money Market Fund

A money market fund is probably the easiest type of mutual fund to select. To save you time and make you the most money, the following sections describe the major issues to consider when selecting money funds.

Why yield and expenses go hand in hand

Within a given category of money market fund (general, Treasury, or municipal), money fund managers are investing in the same basic securities. The market for these securities is pretty darned efficient, so superstar money fund managers may eke out an extra 0.1 percent of yield over their competitors but not much more.

However, money funds can differ significantly from one another in yield due to expenses. For money market funds more than for any other kind of fund, operating expenses are the single biggest determinant of return. All other conditions being equal (which they usually are with money market funds), lower operating expenses translate into higher yields for you.

For money market funds, you shouldn't tolerate annual operating expenses greater than 0.5 percent. Top quality funds charge 0.25 percent or less annually. Remember, lower expenses don't mean that a fund company is cutting corners or providing poor service. Lower expenses are possible in most cases because a fund company has been successful in attracting so much money to invest. As I discuss in Chapter 12, fund companies with consistently low expenses on their money funds also generally offer good bond funds.

Money funds 20 percent off!

Some money market mutual funds aren't above resorting to the marketing tricks that retailers use. Beware of money fund managers running specials or sales. They try to lure investors by temporarily waiving (also known as *absorbing*) operating expenses. These sales tricks create money fund yields that are a lot like muscles on steroids: artificially pumped up. When the fund managers start thirsting for profits — and with time they will, because these aren't charities — they simply reinstate operating expenses, and then you can watch the air go out of the yield balloon. Some bond mutual funds (see Chapter 12) engage in this deceptive practice as well.

Some fund companies run sales because they know that a major portion of the fund buyers lured in won't bother leaving (or knowing) when the operating expenses are jacked up. To get the highest long-term yield from money funds, you're best off sticking with funds that maintain everyday low prices for operating expenses. You can ensure that your fund isn't running a special by asking what the current operating expense ratio is and whether the fund is waiving some portion of the expenses. You may also discern this status by checking the annual operating expense ratio in the fund's prospectus (see Chapter 8).

If you want to move your money to companies having specials and then move it back out when the special is over, you may come out a little ahead in your yield. If you have a lot of money and don't mind paperwork, this strategy may be worth the bother. But don't forget the value of your time, lost interest when a check is in the mail, and the chance that you may not stay on top of the fund's expense changes.

Looking at your tax situation

TIP: You've perhaps heard the expression, "It's not what you make; it's what you keep." What you keep on your investment returns is what's left over after the federal and state governments take their cut of your investment profits. If you're investing money held outside of a retirement account and you're in a high tax bracket (particularly the federal 28 percent or higher bracket), you may come out ahead by investing in *tax-free* money market funds instead of taxable ones. If you're in a high-tax state, a state-specific money market fund (if a good one is available in your state) may be a sound move. (See "Finding the Recommended Funds" section for specific fund recommendations.)

REMEMBER: *Tax-free* refers to the taxability of the dividends paid by the fund. Don't confuse this term with the effective tax deductions you get on contributions to a retirement account, such as a 401(k).

Determining whether tax-free money market funds net you more

If you're in the highest federal tax brackets (see the federal tax rate chart in Chapter 10), you usually come out ahead in tax-free investments. The only way to know is to crunch the numbers.

In order to do the comparison properly, factor in federal as well as state taxes. Suppose, for example, that you call Vanguard, which tells you that its Prime Money Market fund currently yields 2.0 percent. The yield or dividend on this fund is fully taxable.

Suppose further that you're a resident of California and that Vanguard's California Money Market fund currently yields 1.4 percent. The California tax-free money market fund pays dividends that are free from federal *and* California state tax. Thus, you get to keep all 1.4 percent that you earn. The income you earn on the Prime Money Market, on the other hand, is taxed. So here's how you compare the two:

yield on tax-free fund ÷ yield on taxable fund

.014 (1.4 percent) ÷ .02 (2.0 percent) = 0.70

In other words, the tax-free fund pays a yield of 70 percent of that on the taxable fund. Thus, if you must pay more than 30 percent (1 – 0.70) in federal and California state tax, you net more in the tax-free fund. If you do this analysis comparing some funds today, be aware that yields bounce around. The difference in yields between tax-free and taxable funds widens and narrows a bit over time. Instead of simply comparing the current yield on a tax-free versus a taxable money fund, compare the two funds' yields over the past year.

One final and important point: Whenever a recession occurs, especially a severe one, some folks worry about the fiscal status of states that experience mushrooming deficits. California, for sure, was in the news a lot with its ballooning deficits due to the painful, late 2000s recession. Various commentators and talking heads referred to California as "bankrupt," which it most clearly was not. While I don't have a crystal ball for California or any other state, I can tell you that such fears have come and gone in the past. The conditions that lead to large budget deficits — declining tax revenue and rising state payments — inevitably reverse when the economy rebounds.

If you worry about being in a state-specific money market or bond fund due to the economic health of your state, then you probably should go with a nationally diversified fund to ease your fears. Either that, or tune out the fear-mongering talking heads (and visit my Web site at www.erictyson.com for an unbiased, level-headed view of recent news events).

Deciding where you want your home base

Convenience is another important factor in choosing where to establish a money market fund. For example, if you're planning on investing in stock and bond mutual funds at T. Rowe Price, that may be the best place for you to open up a money market fund as well. Although you may get a slightly higher money market yield from another fund company, opening up a separate account may not be worth the administrative hassle, especially if you don't plan on keeping much cash in the money fund.

If you don't mind the extra paperwork, you can go for the extra yield. Calculate (based on the yield difference) the costs of keeping a lower-yielding money fund. Every tenth (0.1) of a percent per $10,000 invested costs you $10 in lost dividends annually.

Keeping your investments close to home

Most mutual fund companies don't have local branch offices. Generally, maintaining few offices helps fund companies keep their expenses low and their yields higher. You may open and maintain your money market mutual fund through the fund's toll-free phone line, the mail, and the Internet.

Except for psychological security, selecting a fund company with an office in your area doesn't offer much benefit. But I don't want to downplay the importance of your emotional comfort level. Fund providers Fidelity, Schwab, TIAA-CREF, and TD Ameritrade have larger branch networks. Depending on where you live, you may be near one of the fund companies I recommend. (See the Appendix.)

Considering other issues

Most, but not all, money market funds offer other useful services, such as free check-writing privileges, fund exchange and redemption via telephone and the Internet, and automated, electronic exchange services with your bank account. The fund companies I recommend generally offer these features, so these shouldn't be deciding factors when debating among fund options. As I mention earlier in this chapter, most money funds require that you write checks for at least $250 or $500. Some funds don't have this restriction, which may be important if you want to pay smaller bills out of the account.

Another potentially important issue is the initial minimum investment required to open an account. Most funds require a minimum investment of $3,000 or so, although some require heftier amounts. If you drop below the minimum at most money market funds, it's no big deal, and no charge is assessed. Some money funds do, however, charge small fees for use of certain features. I discuss these fees in the next section.

Finding the Recommended Funds

In this section, I recommend the best money market funds, based on the criteria I discuss in the previous section,. Due to the financial crisis and severe recession in the late 2000s, short-term interest rates plummeted to near zero and continued that way into the new decade. As a result, the yield on many money market funds was near or even at zero. Many money funds had to absorb a portion of their fund's expenses so that the yield would not become negative. Some money funds closed to new investors because allowing new investors would have driven a fund's yield down even further because the fund manager would be forced to buy lower yielding bonds. Please see Chapter 12 for information on short-term bond funds as an alternative to low yielding money funds.

Taxable money market funds

Money market funds that pay taxable dividends are appropriate for retirement account funds awaiting investment as well as nonretirement account money when you're not in a high federal tax bracket *and* not in a high state tax bracket. Here are the best taxable money market funds to consider (call the fund companies for current yields):

- **Vanguard's Prime Money Market (VMMXX)** has an operating expense ratio of 0.25 percent per year. Like most Vanguard funds, it requires $3,000 to open. www.vanguard.com; 800-662-7447
- **TIAA-CREF Money Market (TIAXX)** has an annual expense ratio of 0.47 percent. Minimum to open an account is $2,500. www.tiaa-cref.org; 800-223-1200
- **Fidelity Cash Reserves (FDRXX)** has an operating expense ratio of 0.39 percent. $2,500 minimum initial investment. www.fidelity.com; 800-544-8888
- **T. Rowe Price Summit Cash Reserves** (TSCXX) has a minimum initial investment of $25,000 and an expense ratio of 0.47 percent per year. If you're doing the bulk of your investing through a fund company other than heavyweights Vanguard or Fidelity, it's your call whether you should do your money fund investing there as well. www.troweprice.com; 800-638-5660

U.S. Treasury money market funds

U.S. Treasury money market funds are appropriate if you're not in a high federal tax bracket but *are* in a high state tax bracket. Check out these funds:

- **Vanguard Admiral Treasury Money Market (VUSXX)** has a slim 0.12 percent annual expense ratio. Due to the very low yields on Treasury notes, this fund was closed to new investors in 2009. www.vanguard.com; 800-662-7447
- **USAA's Treasury Money Market (UATXX)** has a 0.44 percent operating cost and a $3,000 minimum initial investment. www.usaa.com; 800-531-8181
- **Fidelity's Government Money Market (SPAXX)** has an expense ratio of 0.45 percent. This fund's minimum initial investment is $25,000 for nonretirement accounts. This fund charges a $2 fee per check written (waived if your balance is greater than $50,000). www.fidelity.com; 800-544-8888

You can bypass Treasury money market funds and their operating fees by purchasing Treasury bills directly from your local Federal Reserve Bank for no fee. Buying Treasuries direct especially makes sense during periods of low interest rates like we had in the late 2000s and into the new decade. Although you save yourself expenses by going this route, you lose convenient access to your money. You have no check-writing privileges: If you need to tap the Treasuries before they mature, it's a bit of an administrative hassle and will cost you a brokerage fee. With Vanguard's expense ratios on their Treasury money funds, it costs you $12 per year with a $10,000 balance; $60 per year with a $50,000 balance.

Municipal tax-free money market funds

Municipal (also known as *muni*) money market funds invest in short-term debt issued by state and local governments. Dividends from municipal money funds are generally free of federal taxes. Those investors who limit their investing to just one state are generally free of state taxes as well (provided you live in that state).

You may be saying to yourself that state-specific muni funds are the way to go. Not so fast. You may not have to worry about shielding your dividends from state taxes if you live in a state that meets any of the following criteria:

- Doesn’t impose any income tax, such as Florida (you lucky dog)
- Charges a lower income tax (less than 5 percent), such as Michigan
- Has a higher income tax but no decent state-specific money market funds to invest in

Understanding discount brokerage money fund options

As I discuss in Chapter 9, some discount brokers offer all-in-one accounts that combine unlimited check writing with investing. These accounts can certainly reduce the paperwork in your life: Everything from your monthly bill payments to your mutual fund holdings is consolidated on one account statement.

Comprehensive brokerage accounts are usually built around some kind of hub, a temporary holding place for the money that’s waiting to be either spent or invested. This part is the portion of the account you can write checks against, funnel dividends into, and purchase investments with. You’re usually given an option on how you want to hold this hub money. Look at your options carefully, and don’t make the mistake of leaving your money in the default option.

With some all-in-one brokerage accounts, the hub may be called something like your *core account.* Your first option for the core account may be to keep it in cash. Although you do earn interest on it, that interest is fully taxable and offers a much lower yield than from a taxable money market fund.

Especially if you're in a higher tax bracket, the better choice may be to use a municipal money market fund that pays federally tax-free dividends. You also have the option to put your cash in a state-specific money market fund if you happen to live in a state in which the account provider offers such a fund: This strategy shields your dividends from state as well as federal taxes.

Of course, money funds outside of the core options don't give you features such as unlimited check writing, but you may be able to get a higher yield. You can always keep a small amount of money in one of the core options to cover any check-writing needs.

If you live in any of those states and if you're in a high federal tax bracket, you may be better off with a national money market fund, whose dividends are free of federal but not state tax. (Call the fund companies for current yields.) Check out these funds:

- **Vanguard Tax-Exempt Money Market (VMSXX)** has a 0.17 percent annual expense ratio and requires a $3,000 minimum initial investment to open. www.vanguard.com; 800-662-7447
- **T. Rowe Price Summit Municipal Money Market (TRSXX)** has a 0.47 percent annual expense ratio and requires a $25,000 minimum initial investment to open. www.troweprice.com; 800-638-5660
- **USAA Tax-Exempt Money Market (USEXX)** has a 0.51 percent annual expense ratio and requires a $3,000 minimum initial investment to open. www.usaa.com; 800-531-8181

State-specific money market funds, whose dividends are free of both federal and state taxes if you live in the specified state, are appropriate when you're in a high federal *and* state tax bracket. The major fund providers highlighted elsewhere in this chapter for having good money funds (Fidelity, USAA, Vanguard) offer competitive funds for states such as California, Florida, Massachusetts, Maine, New Jersey, New York, Ohio, Pennsylvania, and Virginia. If you can't find a good state-specific money fund for your state or you're only in a high federal tax bracket, you need to use one of the nationwide muni money markets just described.

Chapter 12

Bond Funds: When Boring Is Best

In This Chapter

- Defining bonds
- Knowing when and why to invest in bond funds
- Understanding how bond funds differ from one another
- Selecting short-, intermediate-, and long-term bond funds
- Considering CDs, GICs, and other alternatives to bond funds

Many investors, both novice and expert, think that the *b* in *bonds* is for *boring.* And they're partly correct. No one gets excited by bonds — unless she's an investment banker, money manager, or broker who deals in bonds and makes big bucks because of them.

But take the time in this chapter to get the whole scoop on bonds. They may seem boring, but they generally offer higher yields than bank and money market accounts with less volatility than stocks.

Understanding Bonds

So what the heck is a bond? Let me try to explain with an analogy. If a money market fund is like a savings account, then a bond is similar to a certificate of deposit (CD). With a five-year CD, for example, a bank agrees to pay you a predetermined annual rate of interest — say, 4.5 percent. If all goes according to plan, at the end of five years of earning the 4.5 percent interest, you get back the principal that you originally invested.

Bonds work about the same way, only instead of banks issuing them, corporations or governments issue them. For example, you can purchase a bond, scheduled to mature five years from now, from a company such as Walmart. A Walmart five-year bond may pay you, say, 6 percent. As long as Walmart doesn't have a financial catastrophe, after five years of receiving interest payments (also known as the *coupon rate*) on the bond, Walmart returns your original investment to you. (***Note:*** *Zero coupon* bonds pay no interest but are sold at a discounted price to make up for it.)

The worst thing that can happen to your bond investment is that if Walmart filed bankruptcy, then you may not get back *any* of your original investment, let alone the remaining interest.

You shouldn't let this unlikely but plausible scenario scare you away from bonds for these important reasons:

- **Bonds can be safer than you think.** Many companies need to borrow money (and thus issue bonds) and are good credit risks. If you own bonds in enough companies — say, in several hundred of them — and one or even a few of them unexpectedly take a fall, their *default* (failure to pay back interest or principal on time) affects only a sliver of your portfolio and wouldn't be a financial catastrophe. A bond mutual fund and its management team can provide you a diversified portfolio of many bonds.

- **You're rewarded with higher interest rates than comparable bank investments.** The financial markets and those who participate in them — people like you and me — aren't dumb. If you take extra risk and forsake FDIC insurance, you should receive a higher rate of interest investing in bonds. Guess what? Nervous Nellie savers who're comforted by the executive desks, the vault, the guard in the lobby, and the FDIC insurance logo at their local bank should remember that they're being paid less interest at the bank because of all those comforts.

If you like the government backing afforded by the FDIC program, you can replicate that protection in bond mutual funds that specialize in government-backed securities. (See the section "Eyeing Recommended Bond Funds," later in this chapter.) In the last section of this chapter, "Exploring Alternatives to Bond Funds," I discuss some potentially higher yield alternatives to investing in bond funds. There, you see that with those higher yields comes greater risk. After all, there's no free lunch in the investing world.

Sizing Up a Bond Fund's Personality

Bond funds aren't as complicated and unique as people, but they're certainly more complex than money market funds. And thanks to some shady marketing practices by particular mutual fund companies and salespeople who sell funds, you have your work cut out for you in getting a handle on what many bond funds really are investing in and how they differ from their peers. But don't worry: I explain these important details for the good funds that I recommend later in this chapter.

After you know four key facts about bond funds — maturity, credit rating, the different entities that issue bonds, and, therefore, the tax consequences on those bonds — you can put the four together to understand how mutual fund companies came up with so many different types of bond funds. For example, you can buy a *corporate intermediate-term high-yield (junk) bond fund* or a *long-term municipal bond fund.* In the following sections, you see the combinations are many.

Maturity: Counting the years until you get your principal back

In everyday conversation, *maturity* refers to that quiet, blessed state of grace and wisdom that you develop as you get older (ahem). But that's not the kind of maturity I'm talking about here. *Maturity,* as it applies to bonds, simply refers to when the bond pays you back — it could be next year, 5 years from now, 30 years from now, or longer. Maturity is the most important variable by which bonds, and therefore bond funds are differentiated and categorized.

You should care *plenty* about how long a bond takes to mature because a bond's maturity gives you a good (although far from perfect) sense of how volatile a bond will be if interest rates change (see Table 12-1). If interest rates fall, bond prices rise.

Table 12-1 Interest Rate Increases Depress Bond Prices

Bond Type	Price Change If Rates Suddenly Rise 1 Percent*
Short-term bond (2-year maturity)	–2 percent
Intermediate-term bond (7-year maturity)	–5 percent
Long-term bond (20-year maturity)	–10 percent

**Assumes that bonds are yielding approximately 7 percent. If bonds were assumed to be yielding more, then a 1 percent increase in interest rates would have less of an impact. For example, if interest rates are at 10 percent and rise to 11 percent, the price change of the 20-year bond is –8 percent.*

Bond funds are portfolios of dozens — and in some cases, hundreds — of individual bonds. You won't need to know the maturity of *every* bond in a bond mutual fund. A useful summarizing statistic to know for a bond fund is the *average maturity* of its bonds. In their marketing literature and prospectuses, bond funds typically say something like, "The Turbocharged Intermediate-Term Bond Fund invests in high-quality bonds with an average maturity of 7 to 12 years."

Bond funds usually place themselves into one of three maturity categories:

- **Short-term bond funds:** These funds concentrate their investments in bonds maturing in the next few years.
- **Intermediate-term bond funds:** This category generally holds bonds that come due within five to ten years.
- **Long-term bond funds:** These funds usually own bonds that mature in 15 to 20 years or so.

REMEMBER

These definitions aren't hard and fast. One long-term bond fund may have an average maturity of 14 years while another may have an average of 25 years.

You can run into problems when one intermediate-term fund starts bragging that its returns are better than another's. It's the old story of comparing apples to oranges. When you find out that the braggart fund has an average maturity of 12 years and the other fund has a maturity of 7, then you know that the 12-year fund is using the “intermediate-term” label to make misleading comparisons. The fact is, a fund with bonds maturing on average in 12 years *should* be generating higher returns than a fund with bonds maturing on average in 7 years. The 12-year fund is also more volatile when interest rates change.

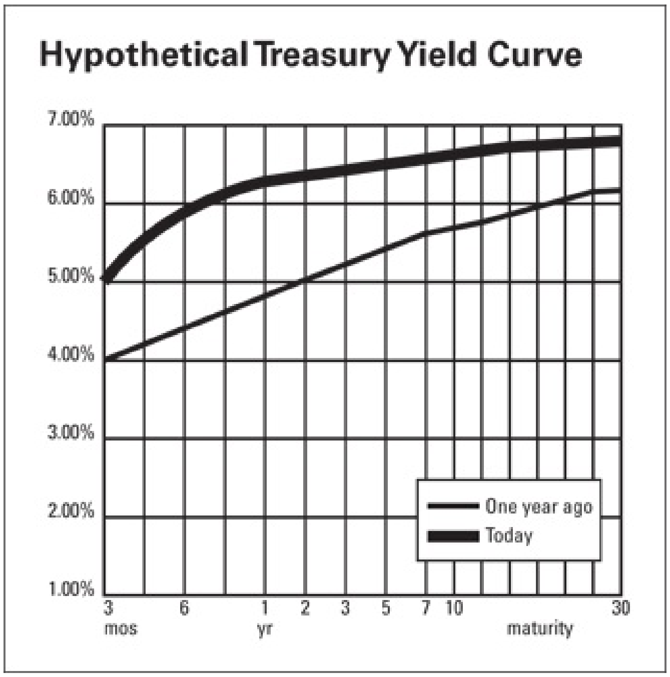
The greater risk associated with longer term bonds, which suffer price declines greater than do short-term bonds when interest rates rise, often comes with greater compensation in the form of higher yields.

Most of the time, longer term bonds pay higher yields than do short-term bonds. You can look at a chart of the current yield (“today”) of bonds of varying length maturities, which is known as a *yield curve.* Most of the time, this curve slopes upward (see Figure 12-1). Many leading financial publications and Web sites carry a current chart of the yield curve.

Duration: Measuring interest rate risk

If you’re trying to determine the sensitivity of bonds and bond funds to changes in interest rates, *duration* may be a more useful statistic than maturity. A bond fund with a duration of ten years means that if interest rates rise by 1 percent, then the value of the bond fund should drop by 10 percent. (Conversely, if rates fall 1 percent, the fund should rise 10 percent.) Trying to use average maturities to determine what impact a 1 percent rise or fall in interest rates will have on bond prices forces you to slog through all sorts of ugly calculations. Duration is no fuss, no muss — and it gives you one big advantage, too. Besides saving on number crunching, duration enables you to compare funds of differing maturities. If a long-term bond fund has a duration of, say, 12 years, and an intermediate fund has a duration of 6 years, the long-term fund should be about twice as volatile to changes in interest rates.

Figure 12-1: A yield curve chart.



Although duration is easier to work with *and* a better indicator than average maturity, you're more likely to hear about average maturity because a fund's duration isn't that easy to understand. Mathematically, it represents the point at which a bondholder receives half (50 percent) of the present value of her total expected payments (interest plus payoff of principal at maturity) from a bond. Present value adjusts future payments to reflect the fact that money received in the future has less value, primarily because of increases in the cost of living (inflation).

If you know a bond fund's duration, which you can obtain from the fund company behind the bond fund you're interested in, you know almost all you need to know about its sensitivity to interest rates. However, duration hasn't been a foolproof indicator: During particular periods when interest rates have risen, some funds have dropped more than the funds' durations predicted. But bear in mind that some heavy investing in unusual securities (such as derivatives) was required to make duration unreliable — so the duration values of the better funds, which I recommend in this chapter, usually work just fine as a guide. Also be aware that other factors — such as changes in the credit quality of the bonds in a fund — may affect the price changes of a bond fund over time.

Credit quality: Determining whether bonds will pay you back

Bond funds also differ from one another in terms of the creditworthiness of the bonds that they hold. That's just a fancy way of saying, "Hey, are they gonna stiff me or what?"

Every year, bondholders get left holding nothing but the bag for billions of dollars when their bonds default. You can avoid this fiasco by purchasing bonds that are unlikely to default, otherwise known as *high-credit-quality bonds.* Credit rating agencies — Moody's, Standard & Poor's, Duff & Phelps, and so on — rate bonds based on credit quality and likelihood of default.

The credit rating of a security depends on the company's (or the government entity's) ability to pay back its debt. Bond credit ratings are usually done on some sort of a letter-grade scale: For example, in one rating system, AAA is the highest rating, with ratings descending through AA and A, followed by BBB, BB, B, CCC, CC, C, and so on. Funds that mostly invest in ✓**AAA and AA rated bonds** are considered to be *high-grade* or *high-credit-quality* bond funds; bonds of this type have little chance of default. These bonds are considered to be *investment quality* bonds.

- ✓ **A and BBB rated bonds** are considered to be *general* bond funds (*moderate-credit-quality*). Like AAA and AA rated bonds, these bonds are known as investment quality bonds.

- **BB or lower rated bonds** are known as *junk bond* funds (or by their more marketable name, *high-yield* funds). These funds expect to suffer more defaults — perhaps as many as a couple of percent of the total value of the bonds per year or more. *Unrated* bonds have no credit rating because they haven't been analyzed or evaluated by a rating agency.

Lower quality bonds are able to attract bond investors by paying them a higher interest rate. The lower the credit quality of a fund's holdings, the higher the yield you can expect a fund to pay (to hopefully more than offset the effect of potential defaults).

Issuer: Knowing who you're lending to

Bond funds and the bonds that they hold also differ according to which type of entity is issuing them. Here are the major options:

- **Treasuries:** These are IOUs from the biggest debtor of them all — the U.S. federal government. Treasuries include Treasury bills (which mature within a year), Treasury notes (which mature between one and ten years), and Treasury bonds (which mature in more than ten years). All Treasuries pay interest that's state-tax-free but federally taxable.

- **Municipals:** *Munis* are state and local government bonds that pay federally tax-free and state-tax-free interest to those who reside in the state of issue. The governments that issue municipal bonds know that the investors who buy municipals don't have to pay most or any of the income tax that normally would be required on other bonds — which enables the issuing governments to attract buyers at a lower rate of interest. Later in this chapter (in the section "How to obtain tax-free income"), I explain how to determine if you're in a high enough tax bracket to benefit from muni bonds.

- **Corporates:** Issued by companies such as General Mills and Hewlett Packard, corporate bonds pay interest that's fully taxable.

- **Mortgages:** You can actually get back some of the interest you're paying on your mortgage by purchasing a bond fund that holds it! Some bond funds specialize in buying mortgages and collecting the interest payments. The repayment of principal on these bonds is usually guaranteed at the bond's maturity by a government-sanctioned organization such as the Government National Mortgage Association (GNMA, also known as Ginnie Mae) or the Federal National Mortgage Association (FNMA or Fannie Mae).
- **Convertibles:** These are hybrid securities — bonds that you can convert into a preset number of shares of stock in the company that issued the bond. Although these bonds do pay interest, their yield is lower than nonconvertible bonds because convertibles offer you the upside potential of being able to make more money if the underlying stock rises.
- **International bonds:** Bond funds (and individual investors) can buy most of the preceding types of bonds from foreign issuers as well. In fact, international corporate and government bonds are the primary bonds that foreign bond mutual funds may hold. International bonds are riskier because their interest payments can be offset by currency price changes and may be riskier due to political instability and insufficient information.

Management: Considering the passive or active type

Some bond funds are managed like an airplane on autopilot. They stick to investing in a particular type of bond (such as high-grade corporate), with a target maturity (for example, an average of ten years). *Index funds* that invest in a relatively fixed basket of bonds —

so as to track a market index of bond prices — are good examples of this passive approach. Exchange-traded funds (ETFs) of bonds are bond funds (generally index funds) that trade on a major stock exchange. See Chapter 5 for more on ETFs.

At the other end of the spectrum are aggressively managed funds. Managers of these funds have significant freedom to purchase bonds that they think will perform best in the future. For example, if a fund manager thinks that interest rates will rise, he'll buy shorter term bonds (remember that shorter term bonds are less sensitive to interest rate changes than longer term bonds) and keep more of a fund's assets in cash. The fund manager may be willing to invest more in lower credit-quality bonds if he thinks that the economy is going to improve and that more companies will prosper and improve their credit standing.

> Aggressively managed funds gamble. If interest rates fall instead of rise, the fund manager who moved into shorter term bonds and cash suffers worse performance. If interest rates fall because the economy sinks into recession, lower credit-quality bonds suffer from a higher default rate and depress the fund's performance even further.

Some people think that predicting which direction interest rates and the economy are heading is fairly easy. The truth is that economic predictions are *difficult*. In fact, over long periods of time (ten or more years), meaningful predictions are almost impossible.

> Investing some of your bond fund money in funds that try to be well positioned for changes in the economy and in interest rates may appear attractive. But remember that if these fund managers are wrong, you can lose more money. Over the long term, your best bet is efficiently managed funds that stick with a specific investment objective — such as holding intermediate-term, high-quality bonds — and don't try to time and predict

the bond market.

Trying to beat the market can lead to getting beaten. Some bond funds have fallen on their faces after risky investing strategies backfired (see Chapter 7). Interestingly, bond funds that charge sales commissions (*loads*) and higher ongoing operating fees are the ones more likely to have blowups. This may be because these fund managers are under more pressure to try and boost returns to make up for these higher fees.

Inflation-indexed Treasury bonds

In 1997, the U.S. federal government introduced a new type of Treasury bond that's inflation proof: inflation-indexed Treasuries. These new Treasury bonds were designed to better meet the needs of inflation-fearing investors.

An investor with, say, $10,000 to invest could recently have purchased a ten-year, regular Treasury bond that yielded 4 percent interest, or about $400, annually. Now, contrast this regular Treasury bond with its new inflation-indexed brethren. The ten-year inflation-indexed bonds issued at the same time yielded about 1.5 percent. Before you think that this low yield is a rip-off, know that this is a real (as in not affected or eroded by inflation) rate of return of 1.5 percent.

The other portion of your return with these inflation-indexed bonds comes from the inflation adjustment to the $10,000 principal you invested. The inflation portion of the return gets added back into principal. So if inflation runs at, say, 2.5 percent, after one year of holding your inflation-indexed bond, your $10,000 of principal would increase to $10,250.

So, no matter what happens with the rate of inflation, the investor who bought the inflation-indexed bond, in my example, always earns a 1.5 percent return above and beyond the rate of inflation. If inflation leaps to 10, 12, or 14 percent, or more, as it did in the early 1980s, the holders of inflation-indexed Treasuries won't have the purchasing power of their principal or interest eroded by inflation. Holders of regular Treasury bonds, however, won't be as fortunate because at a continued double-digit annual inflation rate, holders of these 4 percent yield bonds would have a negative real (after inflation) return.

Because inflation-indexed Treasuries protect the investor from the ravages of inflation, they represent a less risky security. In the investment world, lower risk usually translates into lower returns.

Of course, the rate of inflation can and will change in the future. For the ten-year bonds chosen in my example, inflation needs to exceed 2.5 percent per year for the holders of the inflation-indexed bonds to come out ahead of those holding the regular Treasury bonds. If inflation were running at, say, 3 percent per year, the total return of inflation-indexed bonds would be 4.5 percent, exceeding the 4 percent on the regular Treasury bonds.

Income-minded investors need to know that the inflation-indexed Treasuries only pay out the real return, which in the preceding example was just 1.5 percent. The rest of the return, which is for increases in the cost of living, is added to the bond's principal. Thus, relative to regular Treasury bonds, which pay out all their returns in interest, the inflation-indexed Treasuries pay significantly less interest. Therefore, they don't make sense for nonretirement account investors who seek maximum income to live on.

For recommended inflation-indexed Treasury funds, please see the "Eyeing Recommended Bond Funds" section, later in this chapter. (Also know that regular bond fund managers may invest some of their fund's assets in inflation-indexed Treasuries if they appear attractive relative to other bonds.) Investing in Bond Funds

It's time to get down to how and why you might use bonds. Bonds may be boring, but they can be more profitable for you than superboring bank savings accounts and money market funds. Bonds generally pay more than these investments because they involve more risk: You're purchasing an investment that's intended to be held for a longer period of time than savings accounts and money market funds.

That doesn't mean that you have to hold a bond until it matures, because an active market for them does exist. You can sell your bond to someone else in the bond market (which is exactly what a bond fund manager does if he wants out of a specific bond he holds in the bond fund). You may receive more — or less — for the bond than you paid for it depending on what has happened in the financial markets since then.

As I discuss earlier, in the section "Maturity: Counting the years until you get your principal back," bond funds are riskier than money market funds and savings accounts because their value can fall if interest rates rise. However, bonds tend to be more stable in value than stocks (see Chapter 1).

Why you might (and might not) want to invest in bond funds

Investing in bonds is a time-honored way to earn a better rate of return on money that you don't plan to use within at least the next couple of years. As with other mutual funds, bond funds are completely liquid on a day's notice, but I advise you to view them as longer term investments. Because their value fluctuates, you're more likely to lose money if you're forced to sell the bond fund sooner rather than later. In the short term, the bond market can bounce every which way; in the longer term, you're more likely to receive your money back with interest.

WARNING! Don't invest your emergency money in bond funds — use a money market fund instead (see Chapter 11). You could receive less money from a bond fund (and could even lose money) if you need it in an emergency.

Avoid using the check-writing option that comes with many bond funds. Every time you sell shares in a bond fund (which is what you're doing when you write a check), this transaction must be reported on your annual income tax return. When you write a check on a money market fund, by contrast, it isn't a so-called *taxable event* because a money fund has a fixed share price, so you're not considered to be adding to or subtracting from your taxable income when you sell these shares.

Aren't higher interest rates better if you need income?

In the early 2000s, after a multiyear drop, interest rates were at what seemed to be rock-bottom levels compared to those of earlier decades. Intermediate-term bonds were yielding around 4 percent — about one-third of what rates had been in the early 1980s.

Generally speaking, lower interest rates are great for the economy because they encourage consumers and businesses to borrow and spend more money. But if you were a retiree trying to live off the income being produced by your bonds, low interest rates seemed like the worst of all possible economic worlds.

For each $100,000 that a retiree invested in intermediate-term bonds, CDs, or whatever when interest rates were 12 percent, the retiree received $12,000 per year in interest or dividends. A retiree purchasing intermediate-term bonds in the early to mid 2000s after the fall in interest rates, however, received two-thirds less dividend income because rates on the same bonds and CDs were just 4 percent. So for every $100,000 invested, only $4,000 in dividend or interest income was paid.

If you're trying to live off the income being produced by your investments, a 67 percent reduction in that income may cramp your lifestyle. So higher interest rates are better if you're living off your investment income, right?

Wrong!

Never forget that the primary driver of interest rates is the expected future rate of inflation. Interest rates were much higher in the early 1980s because the United States had double-digit inflation. If the cost of living is increasing at the rate of 12 percent per year, why would you as an investor lend your money out (which is what you're doing when you purchase a bond or CD) at 4 percent? Of course, you *wouldn't* lend money at that rate — which is exactly why interest rates were so high in the early 1980s.

By the early 2000s, interest rates were low because the inflation dragon seemed to have been slain (and the economy was in a recession). So the rate of interest that investors could earn by lending their money dropped accordingly. Although low interest rates reduce the interest income, the corresponding low rate of inflation doesn't devour the purchasing power of your principal balance as quickly.

So what's an investor to do if she lives off the income from her investments but can't generate enough income because present interest rates are too low? A financially simple but psychologically difficult solution is to use up some of the principal to supplement the interest and dividend income. In effect, this situation is what happens anyway when inflation is higher — the purchasing power of the principal erodes more quickly. You also should educate yourself about the range of higher yielding (and quality) investment options available — this book helps you do just that.

You also shouldn't put too much of your longer term investment money in bond funds (for example, your retirement money if you're a young adult with many decades until you would retire). With the exception of those rare periods when interest rates drop significantly, bond funds won't produce the high returns that growth-oriented investments such as stocks, real estate, and your own business can.

Here are some common financial goals to which bond funds are well suited: ✔ **A major purchase:** But make sure that the purchase won't happen for at least two years, such as the purchase of a home. Short-term bond funds should offer a higher yield than money market funds. However, bond funds are a bit riskier, which is why you should have at least two years until you need the money to allow time for recovery from a dip in your bond fund account value.

- **Part of a long-term, diversified portfolio:** Because stocks and bonds don't move in tandem, bonds can be a great way to hedge against declines in the stock market. In fact, in a down economic environment, bonds may appreciate in value if inflation is declining. Different types of bond funds (high-quality bonds and junk bonds, for example) typically don't move in tandem with each other either, so they can provide an additional level of diversification. In Chapter 10, where I talk about asset allocation, I explain how to incorporate bonds into long-term portfolios for goals such as retirement.
- **Generating current income:** If you're retired or not working, bonds are better than most other investments for producing a current income stream.

How to pick a bond fund with an outcome you can enjoy

When comparing bond funds of a given type (for example, high-quality, short-term corporate bond funds), folks want to pick the one that's going to make the most money for them. But be careful; some mutual fund companies exploit your desire for high returns. These fund firms love to lure you into a bond fund by emphasizing high past performance and current yield, deflecting your attention away from the best predictor of bond fund performance: operating expenses.

Don't overemphasize past performance

A major mistake that novice bond fund investors make is to look at recent performance and assume that those are the returns they’re going to get in the future. Investing in bond funds based only on recent performance is tempting right after a period when interest rates have declined, because declines in interest rates pump up bond fund total returns. Remember that an equal but opposite force is waiting to counteract pumped-up bond returns — bond prices fall when interest rates rise, which they eventually will.

Don’t get me wrong: Past performance is an important issue to consider. But in order for performance numbers to be meaningful and useful, you must compare the same type of bond funds to each other (such as intermediate-term funds that invest exclusively in high-grade corporate bonds) and against the correct bond market index or benchmark (which I discuss in Chapter 17).

Be careful with yield quotes

A bond fund's *yield* measures how much the fund is currently paying in dividends; it's quoted as a percentage of the fund's share price — say, 5.2 percent. This statistic certainly seems like a valid one for comparing funds. Unfortunately, some fund companies have abused it.

Don't confuse a bond fund's yield with its return. Dividends are just one part of a fund's return, which also includes capital gain distributions and changes in the bond fund's share price. Over a given period of time, a bond fund could have a positive yield but a negative overall return, particularly if interest rates have increased or the credit quality of bonds in its portfolio has deteriorated.

Some unscrupulous fund companies try to obscure the difference between yield and return. For example, consider an advertisement sent by the Fundamental U.S. Government Strategic Income Fund. In huge type on the cover of this brochure, the fund boasted of its 11.66-percent yield, an impressive number because 30-year Treasury bonds were yielding less than 8 percent at the time. One can only assume that the designers of this promo piece hoped that you wouldn't check out the back cover, where the small print stated that the fund's total return for the previous year was –15.7 percent.

Mutual fund companies can play a few games to fatten a fund's yield. Such sleight of hand makes a fund's marketing department happy because higher yields make hawking the bond funds easier for salespeople. But remember that yield-enhancing shenanigans can leave you disappointed when a bond fund fails to perform well after you buy it based on the allure of a swollen yield. Here's what to watch out for:

- **Lower quality:** You may compare one short-term bond fund to another and discover, for example, that one pays 0.5 percent more and, therefore, looks better. But, if you look a little further, you see that the higher yielding fund invests 20 percent of its assets in *junk* bonds (a BB or less credit-quality rating), whereas the other fund is fully invested in *high-quality* bonds (AAA and AA rated). In other words, the junk bond fund isn't necessarily better; given the risk it's taking, it should be yielding more.

- **Lengthened maturities:** Bond funds can usually increase their yield just by increasing maturity a bit. (Insiders call this ploy *going further out on the yield curve.*) So when comparing yields on different bond funds, be sure that you're comparing them for funds of similar maturity. Even if they both call themselves "intermediate-term," if one bond fund invests in bonds maturing on average in seven years, while another fund is at ten years for its average maturity, comparing the two is a classic case of comparing apples to oranges. Because longer term bonds usually have higher yields (due to increased risk), the ten-year average maturity fund should yield more than the seven-year average maturity fund.
- **Giving your money back without your knowledge:** Some funds return a portion of your principal in the form of dividends. This move artificially pumps up a fund's yield but depresses its total return. Investors in this type of bond fund are rudely awakened when, after enjoying a healthy yield for a period of time, they examine the share price of their bond fund shares and find that they've declined in value.

TIP

When you compare bond funds to each other by using the information in the prospectuses (see Chapter 8), make sure that you compare their total return over time (in addition to making sure that the funds have comparable portfolios of bonds and similar durations).

- **Waiving of expenses:** Some bond funds, particularly newer ones, waive a portion or even all of their operating expenses to temporarily inflate the fund’s yield. Yes, you *can* invest in a fund that’s having a sale on its operating fees, but you also have the hassle of monitoring the fund to determine when the sale is over. Bond funds engaging in expense waiving often end such sales quietly when the bond market is doing well. Don’t forget that if you sell a bond fund (held outside of a retirement account) that has appreciated in value, you owe taxes on your profits.

Do focus on costs

Like money market funds, bond fund returns are extremely sensitive to costs. After you've identified a particular type of bond fund to invest in, expenses — sales commissions and annual operating fees — should be your number-one criterion for comparing funds.

For bond funds, you should generally shun funds with operating expenses higher than 0.5 percent.

The marketplace for bonds is fairly efficient. For any two bond managers investing in a particular bond type — say, long-term municipal bonds — picking bonds that outperform the other's over time is difficult. But if one of those bond funds charges lower fees than the other, that difference provides the low-fee fund with a big head start in the performance race.

How bond funds calculate their yields

When you ask a mutual fund company for a bond fund's yield, make sure you understand the time period that the yield covers. Fund companies are supposed to report the *Securities and Exchange Commission (SEC) yield,* which is a standard yield calculation that allows for fairer comparisons across bond funds. The SEC yield reflects the bond fund's so-called yield to maturity. This yield is the best to use when you compare funds because it captures the effective rate of interest an investor will receive going forward.

Funds also calculate a yield that only looks at the recently distributed dividends relative to the share price of the fund. Funds can pump up this number by purchasing particular types of bonds. For just that reason, yield based on recently distributed dividends isn't nearly as useful a yield number to look at (although some brokers who sell bond funds love to use it because they push funds that are pumping up their yields).

You can earn a higher return from a bond fund by investing in funds that

- Hold longer term bonds
- Hold lower credit-quality bonds
- Have lower operating expenses

Please note that the first two ways of earning a higher bond fund yield — using longer term and lower credit-quality bonds — increase the risk that you're exposed to. Stick with no-load funds that have low annual operating expenses as a risk-free way to boost your expected bond fund returns.

How to obtain tax-free income

Just as money market funds can produce taxable or tax-free dividends (see Chapter 11), so too can bond funds. In order to produce tax-free income, a bond fund invests in municipal bonds (also called *muni bonds* or *munis*) issued by state or local governments.

As long as you live in the United States, generally, municipal bond fund dividends are federally tax-free to you. Funds that specialize in muni bonds issued just in your state pay dividend income that's typically free of your state's taxes as well.

When you're investing in bonds inside retirement accounts, use taxable bonds. If you're investing in bonds outside retirement accounts, the choice between taxable versus tax-free depends on your tax bracket. If you're in a high tax bracket (28 percent or higher for federal) and you want to invest in bonds outside of tax-sheltered retirement accounts, you may do better in a muni fund than in a bond fund that pays taxable dividends (see Chapter 10 to determine your tax bracket).

Eyeing Recommended Bond Funds

If you've read through this chapter, you now know more about bond funds than you probably ever imagined possible, so now it's time to get down to brass tacks: selecting bond funds for a variety of investing needs.

Using the logic laid out earlier in this chapter, I present you with a menu of choices. Although thousands of bond funds are available — few are left to consider after you eliminate the high-cost ones (loads and ongoing fees), low-performance funds (which are often the just-mentioned high-cost funds), and funds managed by fund companies and managers with minimal experience investing in bonds.

I've done the winnowing for you, and the funds I present in the sections that follow are the best of the best for meeting specific needs. I've organized the funds by the average maturity and duration of the bonds that they invest in, as well as by the taxability of the dividends that they pay.

Use the following funds only if you have sufficient money in your emergency reserve (see Chapter 3). If you're investing money for longer term purposes, particularly retirement, come up with an overall plan for allocating your money among a variety of different funds, including stock and bond funds. For more on allocating your money, be sure to read Chapter 10.

Short-term bond funds

Short-term bond funds, if they live up to their name, invest in short-term bonds (which mature in a few years or less). Of all bond funds, these are the least sensitive to interest rate fluctuations. Their stability makes them the most appropriate bond funds for money on which you want to earn a better rate of return than a money market fund could produce for you. But with short-term bond funds, you also have to tolerate the risk of losing a few percent in principal value if overall interest rates rise.

Even lower fees: High-balance funds and exchange-traded funds

Throughout this chapter, I highlight the best bond funds. Among other positive attributes, those funds have low fees. That said, you may be able to lower your bond fund fees even further in two additional ways. Some mutual fund companies will offer a lower fee version of a given bond fund to investors who are able to invest a larger amount into the fund.

For example, many Vanguard bond funds now offer “Admiral” versions with even lower operating expenses (and thus higher yields) for big balance customers. For example, Vanguard’s Short-Term Investment-Grade Admiral shares (VFSUX), which sports a $100,000 minimum to invest, have an expense ratio of just 0.14 percent. The regular share class, which has a $3,000 minimum, has an expense ratio of 0.26 percent. You may qualify to convert your regular shares (also known as “Investor” shares) in Short-Term Investment-Grade into Admiral shares if you’ve been a longer term customer but lack $100,000. If you’ve held the Investor shares at least ten years, you need a balance of $50,000. Where relevant in this chapter, I note attractive options for high-balance investors.

Another potentially attractive and low-cost option is exchange-traded funds (ETFs). However, as I discuss in Chapter 5, don’t get blindly suckered into the pitch that ETFs are universally superior due to low costs. The vast majority of ETFs have higher costs than the best mutual funds recommended in this book. Interestingly and perhaps not surprisingly, the best bond ETFs come from Vanguard and where appropriate, I recommend some of their ETFs in this chapter.

Short-term bonds work well for investing money to afford major purchases that you expect to make in a few years, such as a home, a car, or a portion of your retirement account investments that you expect to tap in the near future.

Taxable short-term bond funds

Bond funds that pay taxable dividends are appropriate for nonretirement accounts if you're not in a high tax bracket (no more than 28 percent federal) and for investing inside retirement accounts. (Call the fund companies for current yields.)

Vanguard Short-Term Investment-Grade (VFSTX) invests the bulk of its portfolio in high-and moderate-quality, short-term corporate bonds. (The average credit rating is AA.) Typically, it keeps a small portion in U.S. Treasuries. It may even stray a bit overseas and invest several percent of the fund's assets in promising foreign bonds. This fund maintains an average maturity of two to three years, and duration currently is two years.

Robert Auwaerter has managed Vanguard's Short-Term Corporate fund since the early 1980s. Gregory Nassour, who had been an investment manager since 1994, was added as co-manager in 2008. All told, this fund invests in more than 1,000 bonds. (Imagine having to keep track of all of them on your own!) This fund's operating expense ratio is just 0.26 percent (0.14 percent for its Admiral share class discussed in the adjacent sidebar). It has a $3,000 minimum. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

Vanguard offers an ETF similar to this fund: **Short-Term Corporate Bond ETF (VCSH)**. It's expense ratio is just 0.15 percent.

U.S. Treasury short-term bond funds

U.S. Treasury bond funds are appropriate if you prefer a bond fund that invests in U.S. Treasuries (which have the safety of government backing) or if you're not in a high federal tax bracket (no more than 28 percent), but you *are* in a high state tax bracket (5 percent or higher). I don't recommend Treasuries for retirement accounts because they pay less interest than fully taxable bond funds. (Call the fund companies for current yields.) **Vanguard Short-Term Treasury (VFISX)** invests in U.S. Treasuries maturing within two to three years — you can't get much safer than that. Duration currently is two years. This fund has been managed by David Glocke since 2000, who has been an investment manager since 1991. Although the fund has that lean Vanguard expense ratio of 0.22 percent annually (0.12 percent for the Admiral share class), don't forget that you can buy Treasuries direct from your local Federal Reserve Bank if you don't need liquidity. The minimum initial investment is $3,000. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

Municipal tax-free short-term bond funds

Short-term bond funds that are free of both federal and state taxes are scarce. However, some good short-term funds are free of federal, but not state, taxes. These are generally appropriate if you're in a higher federal bracket (more than 28 percent) but in a low state bracket (less than 5 percent).

If you live in a state with high taxes, consider a state money market fund, which I cover in Chapter 11. (Call the fund companies for current yields.) **Vanguard Short-Term Tax-Exempt (VWSTX)** invests in the *crème de la crème* of the federally tax-free muni bonds issued by state and local governments around the country. (Its average credit rating is AA.) The fund's average maturity ranges from one to two years, and duration is about one year.

Vanguard Limited-Term Tax-Exempt (VMLTX) does just what the short-term fund does (and has the same manager), except that it does it a while longer. This fund's average muni bond matures in two to five years (with a duration of about three years), although its average credit rating is a respectable AA.

Both the short-term and limited-term funds have a miserly annual operating expense ratio of 0.20 percent and require a $3,000 minimum initial investment. Admiral shares, with a 0.12 percent expense ratio, are available for both these funds. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

Intermediate-term bond funds

Intermediate-term bond funds hold bonds that typically mature within a decade or so. They're more volatile than shorter term bonds but should be more rewarding. The longer you can own an intermediate-term bond fund, the more likely you are to earn a higher return on it than on a short-term fund, unless interest rates keep rising over many years.

You shouldn't purchase an intermediate-term fund unless you expect to hold it for a minimum of three to five years — or longer, if you can. Therefore, the money you put into this type of fund should be money that you don't expect to use during that period. (Call the fund companies for current yields.) Taxable intermediate-term bond funds

If you invest in these funds in a nonretirement account, be sure that you're not in a high tax bracket — more than 28 percent federal.

Dodge & Cox Income (DODIX) is run by a conservative management team at an old San Francisco investment firm that has been managing money for private accounts since 1930 and running mutual funds since 1931. This fund, which focuses on government securities and high-grade corporate debt, has an average bond credit rating of AA, an average maturity of five to ten years, and a duration of about four to five years. This fund is team managed with the managers having an average tenure of about 14 years. The operating expense ratio is a reasonable 0.43 percent: $2,500 is the minimum initial investment ($1,000 for retirement accounts). 800-621-3979.

Harbor Bond (HABDX) is a more aggressive intermediate-term bond fund. The fund invests mostly in corporate bonds, as well as in mortgage bonds with average maturities of up to ten years (duration is about five years), depending on fund manager William Gross's outlook for inflation and the economy.

Gross, who's managed this fund since 1987, has three plus decades of experience managing money in the bond market. He makes relatively wide swings in strategy and, during periods of rising interest rates, has bulked up the fund with money market securities to protect principal. At times, Gross has also ventured small portions of the fund into foreign bonds, junk bonds, and even a sprinkling of derivatives such as futures and options to slightly leverage returns. (The fund has an average credit rating of AA.) Despite its aggressiveness, the fund has had low volatility. Although this fund's expense ratio is a tad on the high side (0.57 percent), Gross has delivered high enough long-term returns to justify the slightly higher costs. The minimum initial investment is just $1,000. 800-422-1050.

Vanguard Total Bond Market Index (VBMFX) is an index fund that tracks the index of the entire bond market, the Lehman

Brothers Aggregate Bond Index. The fund is managed Kenneth Volpert, Gregory Davis, and a computer. It uses a sampling to mirror the index so it doesn't actually invest in every bond in the index. Investment-grade corporate bonds and mortgages make up the majority of the fund's investments; the rest are U.S. government and agency securities. The fund's average maturity is about seven years, with a duration of about five years. (Average bond credit rating is AA.) Annual operating expenses are a paltry 0.22 percent (0.14 percent for Admiral shares). (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) You need a $3,000 minimum initial investment to open. 800-662-7447.

Vanguard Total Bond Market ETF (BND) is an ETF similar to this fund. Its expense ratio is 0.14 percent.

Vanguard GNMA (VFIIX) invests in residential mortgages that people just like you take out when they purchase a home and borrow money from a bank. Like other GNMA funds, this one has very low credit risk. (Its average credit rating is AAA.) Why? Because the principal and interest on GNMAs is guaranteed by the U.S. government. All GNMA funds have prepayment risk. (If interest rates fall, mortgage holders refinance.) But this GNMA fund has less risk than most because it minimizes the purchase of mortgage bonds that were issued at higher interest rates — and are, therefore, more likely to be refinanced and paid back early.

This fund is managed by Thomas Pappas at Wellington Management, a private money management firm that Vanguard uses for some of its other funds. GNMA doesn't invest in some of the more exotic mortgage securities and derivatives that are abused by other firms' bond funds. Like all other bond funds, this one has interest rate risk, though it's comparable to other intermediate-term bond funds despite the longer maturity of most of this fund's holdings. Duration is generally around four years, and the fund's yearly operating expense ratio is 0.23 percent: $3,000 is the minimum initial investment. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

Vanguard Mortgage-Backed Securities ETF (VMBS) is an ETF similar to this fund. Its operating expense ratio is 0.15 percent.

Vanguard High Yield Corporate (VWEHX) invests in lower quality (junk) corporate bonds. These pay more and are for more aggressive investors stretching for greater yield. Intermediate-term junk bonds are volatile: They not only are interest rate sensitive, but also they're susceptible to changes in the economy. For example, this fund lost more than 10 percent of its principal value in 1989, 1990, and 1994 and more than 25 percent in 2008. (Dividends payments, of course, mitigated some of this principal erosion.) Unlike other high-yield funds, this fund invests little (if any) of its funds in lower rated junk bonds; it invests in the best of the junk (its average credit rating is BB). The average maturity of this fund is seven years, with a duration of five years. Michael Hong, who has been an investment manager since 1997, at Wellington Management has managed this fund since 2008. The fund has been around since 1978 — a degree of longevity that makes it one of the longest and best-performing junk bond funds. Yearly operating expenses are 0.32 percent: $3,000 is the minimum initial investment. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

U.S. Treasury intermediate-term bond funds

U.S. Treasury bond funds are appropriate if you prefer a bond fund that invests in U.S. Treasuries (which have the safety of government backing) and if you're not in a high federal tax bracket (no more than 28 percent), but you *are* in a high state tax bracket (5 percent or higher). I don't recommend Treasuries for retirement accounts because they pay less interest than fully taxable bond funds. (Call the fund company for current yields.) **Vanguard Intermediate-Term Treasury (VFITX)** invests in U.S. Treasuries maturing in five to ten years. (See the description for the short-term U.S. Treasury funds for minimum initial investment and expense ratio.) 800-662-7447.

Vanguard Inflation-Protected Securities (VIPSX) fund is a new breed of fund, which I cover in the "Inflation-indexed Treasury bonds" section in this chapter. With a low operating expense ratio of 0.25 percent (0.12 for the Admiral share class), this fund is a good one for inflation-skittish investors to consider. It has a $3,000 minimum initial investment. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

Municipal tax-free intermediate-term bond funds

Consider *federally* tax-free bond funds if you're in a high federal bracket (28 percent and up) but a relatively low state bracket (less than 5 percent). (Call the fund company for current yields.) If you're in the market for a state *and* federally tax-free bond fund, the problem is that the ones available (and there aren't all that many) have high expenses. High expenses are always a problem but are especially so in a low interest rate environment (like has been around for years) because little of a fund's yield will be left to pay out. So, if you're in high federal (28 percent and up) *and* high state (5 percent or higher) tax brackets, you're better off using the nationwide Vanguard municipal bond fund that I describe at the end of this section.

Fidelity Intermediate Municipal Income (FLTMX) invests in high-credit-quality (average rating is A) municipal bonds that generally mature within ten years. This fund's average maturity is usually around eight years, with a duration of about five to six years. The expense ratio is a competitive 0.38 percent, and the minimum initial investment is $10,000. 800-544-8888.

Vanguard Intermediate-Term Tax-Exempt (VWITX) does what Vanguard's short-term muni funds do, except that it invests in slightly longer term muni bonds. (Duration is generally about six years, and the average credit rating is AA.) The annual operating expense ratio is a mere 0.20 percent (0.12 for the Admiral share class); $3,000 is the minimum initial investment. Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee. 800-662-7447.

Long-term bond funds

Long-term bond funds are the most aggressive and volatile bond funds around. If interest rates on long-term bonds increase substantially, the principal value of your investment could decline 10 percent or more.

Long-term bond funds generally are used for retirement investing in one of two situations:

- For investors not expecting to tap their investment money — ideally — for a decade or more
- For investors wanting to maximize current dividend income and who are willing to tolerate volatility

Don't use these funds for investing money that you plan to use within the next five years, because a bond market drop could leave your portfolio with a bit of a hangover. (Use intermediate-term and short-term bond funds instead.) And don't use the taxable funds in a nonretirement account if you're in a high tax bracket — especially higher than 28 percent federal. (Call the fund companies for current yields.) Taxable long-term bond funds

Bond funds that pay taxable dividends are appropriate for nonretirement accounts if you're not in a high tax bracket (no more than 28 percent federal) and for investing inside retirement

accounts. (Call the fund companies for current yields.) **Vanguard Long-Term Investment-Grade (VWESX)** is comprised mostly of high-grade corporate bonds, but it sometimes holds around 10 percent in Treasuries and foreign and convertible bonds. (Average credit rating is A.) Long-term bonds such as these (the fund's average maturity is 20+ years, with a duration of 10+ years) can produce wide swings in volatility. For example, this fund lost more than 12 percent of its principal value in 1999, its worst year in a generation. The dividends of 6.3 percent paid that year brought the fund back to produce a total return of –6.2 percent. Wellington Management's Lucius Hill has managed the fund since 2008, and he has been an investment manager since 1993. Wellington itself has managed this fund since its inception in 1973. It has an annual operating expense ratio of 0.28 percent (0.16 percent for Admiral shares), with a $3,000 minimum initial investment. (Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee.) 800-662-7447.

An ETF version of this fund is available and is called **Vanguard Long-Term Corporate Bond ETF (VCLT)**. Its expense ratio is 0.15 percent.

U.S. Treasury long-term bond funds

U.S. Treasury bond funds are appropriate if you prefer a bond fund that invests in U.S. Treasuries (which have the safety of government backing) and if you're not in a high federal tax bracket (no more than 28 percent), but you *are* in a high state tax bracket (5 percent or higher). I don't recommend Treasuries for retirement accounts because they pay less interest than fully taxable bond funds. (Call the fund companies for current yields.) **Vanguard Long-Term Treasury (VUSTX)** invests in U.S. Treasuries with average maturities around 20 years. Duration is about 12 years. (See the description in the section "U.S. Treasury short-term bond funds" for minimum initial investment and expense ratio.) Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee. 800-662-7447.

Municipal tax-free long-term bond funds

Consider *federally* tax-free bond funds if you're in a high federal bracket (28 percent and up) but a relatively low state bracket (less than 5 percent). (Call the fund company for current yields.) **Vanguard Long-Term Tax-Exempt (VWLTX)** does what Vanguard's short-term muni funds do, except that it invests in long-term muni bonds. (The average credit rating is AA.) This fund has an operating expense ratio of 0.20 percent. This fund has a $3,000 minimum initial investment. Investors are advised to keep at least $10,000 in this fund or register their accounts at Vanguard's Web site for electronic delivery of statements and fund reports; otherwise, you pay a $20 annual fee. 800-662-7447.

State and federally tax-free bond funds may be appropriate if you're in high federal (28 percent and up) *and* high state (5 percent or higher) tax brackets. The fund providers Fidelity, T. Rowe Price, and Vanguard offer competitive funds for states such as California, Connecticut, Florida, Maine, Maryland, Michigan, Minnesota, New Jersey, New York, Ohio, and Pennsylvania. If you can't find a good state-specific bond fund for your state, or if you're only in a high federal tax bracket, use the nationwide Vanguard Municipal bond funds I describe in this section. (Call the fund companies for current yields.)

Exploring Alternatives to Bond Funds

Bond mutual funds are just one way to lend your money and get paid a decent yield. In the following sections, I discuss the advantages and disadvantages of other alternatives, some of which have acronyms that you can impress your friends and family with — or confirm that you're an investments geek. Regardless of which investment type(s) you end up purchasing, do your big-picture thinking first: What do you plan to use the money for down the road? How much risk are you willing and able to take? What's your tax situation?

Most of these bond fund alternatives have one thing in common: They offer psychological solace to those who can't stomach fluctuations in the value of their investments. After I tell you more about these alternatives (including information that you're not likely to hear in a marketing pitch from the company or person who's trying to sell you on them), low-cost bond funds may look more attractive.

Certificates of deposit

For many decades, bank certificates of deposit (CDs) have been the *safe* investment of choice for folks with some extra cash that they don't need in the near term. The attraction is that you get a higher rate of return on a CD than on a bank savings account or money market fund. And unlike a bond fund, a CD's principal value doesn't fluctuate. Of course, you also enjoy the peace of mind afforded by the government's FDIC insurance program.

All these advantages of CDs aren't nearly as attractive as they may seem on the surface. I start with the FDIC insurance issue. Bonds and bond mutual funds aren't FDIC-insured. The lack of this insurance, however, shouldn't trouble you on high-quality bonds because these bonds rarely default. Even if a fund held a bond that defaulted, it probably would be a tiny fraction (less than 1 percent) of the value of the fund, so it would have little overall impact.

You may believe that there's no chance you'll lose money on a CD — but banks have failed and will continue to fail. Although you're insured for $100,000 in a bank, if the bank crashes, you'll likely wait a while to get your money back — and you'll probably have to settle for less interest than you expected, too.

Here's another myth about CDs: The principal value of your CD doesn't fluctuate. Sure it does; you just don't see the fluctuations! Just as the market value of a bond drops when interest rates rise, so too does the "market value" of a CD — and for the same reasons. At higher interest rates, investors expect a discounted price on fixed-interest-rate CDs because they always have the alternative of purchasing a new CD at the higher prevailing rates. Some CDs are actually bought and sold among investors — on what's known as a *secondary market* — and they trade and behave just like bonds.

So a lot of those advantages CDs seem to have aren't as impressive as some may believe. In fact, compared to bonds, CDs have a number of drawbacks: **Early withdrawal penalties:** Money in a CD isn't accessible unless you pay a fairly big penalty — typically, six months' interest. With a no-load (commission-free) bond fund, if you need some or all of your money next month, next week, or even tomorrow, you can access it without penalty.

- **Restricted tax options:** Another seldom-noted drawback of CDs is that they come in only one tax flavor — taxable. Bonds, on the other hand, come both in tax-free (federal and/or state) and taxable flavors. So if you're a higher tax-bracket investor, bonds offer you tax-friendly options that CDs can't.

- **Lower yield:** For a comparable maturity, CDs yield less than a high-quality bond. Often, the yield difference is 1 percent or more. If you don't shop around — if you lazily purchase CDs from the bank that you use for your checking account, for example — you may be sacrificing 2 percent or more in yield.

  Don't forget about the unfriendly forces of inflation and taxes. They may gobble up all the yield that your CD is paying, thus leaving you no real growth on your investment. An extra percentage point or two from a bond can make a big difference in the long term.

You'll earn more over the years and have better access to your money in bond funds than in CDs. And bond funds make particular sense if you're in a higher tax bracket and would benefit from tax-free income on your investments. If you're not in a high tax bracket and you get gloomy whenever your bond fund's value dips, then consider CDs.

CDs may make the most sense if you know, for example, that you can invest your money for one year, after which you'll need the money for some purchase you expect to make. Just make sure that you shop around to get the best interest rate. If what attracts you to CDs is the U.S. government backing that comes with FDIC insurance, consider Treasuries, which are government-backed bonds. Treasuries often pay more interest than the better CDs available.

Individual bonds

Maybe you've had thoughts like these:

- Why buy a bond fund and pay all those ongoing management fees, year after year, when I can buy high-rated bonds that pay a higher yield than that fund I'm looking at?
- I can create my own portfolio of bonds and purchase bonds with different maturities. That way, I'm not gambling on where interest rates are headed, and I won't lose principal as I may in a bond fund.

Or more likely, you've listened to a broker — who was trying to sell individual bonds to you — make these sorts of remarks. Does the purchase of individual bonds make sense for you? Although the decision depends on several factors, I can safely say that most types of individual bonds probably are *not* for you. (Treasuries that you can buy directly from a local Federal Reserve Bank without charge are notable exceptions to my comments that follow.) Here are some solid reasons why a good bond mutual fund beats individual bonds:

- **Mutual funds allow for better diversification.** You don't want to put all your investment money into a small number of bonds of companies in the same industry or that mature at the same time. Building a diversified bond portfolio with individual issues is difficult unless you have a hefty chunk (at least several hundred thousand dollars) that you desire to invest in bonds.
- **You want to save on commissions.** If you purchase individual bonds through a broker, you're going to pay a commission. In most cases, it's hidden; the broker quotes you a bond price that includes the commission. Even if you go through a discount broker, transaction fees take a healthy bite out of your investment. The smaller the amount invested, the bigger the bite. On a $1,000 bond, the fee can

equal up to 5 percent.

- **Adjusting bond holdings as percentage of your portfolio is easy.** Good investment management includes monitoring and adjusting your overall bond/stock mix. Adding to or subtracting from your bond holdings by using individual bonds, however, can be inconvenient and costly.
- **Life's too short.** Do you really want to research bonds? You have better things to do with your time. Bonds and the companies that stand behind them aren't that simple to understand. For example, did you know that some bonds can be "called" before their maturity date? Companies often do this to save money if interest rates drop significantly. After you purchase a bond, you need to do the same things that a good bond fund manager would need to do, such as tracking the issuer's creditworthiness and monitoring other important financial developments.

In terms of costs, you can purchase terrific bond funds with yearly operating expense ratios of just 0.2 percent (or less). And remember, a bond mutual fund provides you tons of diversification and professional management so that you can spend your time doing activities you're good at and enjoy. You can increase your diversification by purchasing bond funds with different maturity objectives (short, intermediate, and long) or an index bond fund that covers the range.

If you already own individual bonds and they fit your financial objectives and tax situation, you can hold them until maturity because you've already incurred a commission (which some brokers instead call a *markup*) when they were purchased; selling them now would just create an additional fee. When the bond(s) mature(s), think about moving the proceeds into bond funds if you want to continue owning bonds.

Don't mistakenly think that your current individual bonds are paying the same yield as when they were originally issued. (That yield is the number listed on your brokerage account statement in the name of the bond.) As the market level of interest rates changes, the actual yield of your bonds fluctuates to rise and fall with the market level of rates. So if rates have fallen since you bought your bonds, the value of those bonds has increased — which in turn reduces the effective yield that you're currently earning.

Guaranteed-investment contracts

Guaranteed-investment contracts (GICs) are sold and backed by an insurance company. Typically, they quote you a rate of return projected one or a few years forward. So, like that of a CD, a GIC's return is always positive and certain. With a GIC, you experience none of the uncertainty that you normally face with a bond fund that fluctuates in value with changing interest rates and other economic upheavals.

The attraction of GICs is that your account value doesn't fluctuate (at least, not that you can see). For people who panic the moment a bond fund's value slips, GICs soothe the nerves. And they usually provide a higher yield than a money market or savings account.

As a rule, the insurance company invests GIC money mostly in bonds and usually a small portion in stocks. The difference between the amount these investments generate for the insurer and the amount they pay in interest is profit to the insurer. The yield is usually comparable to that of a bond fund. Typically, once a year, you'll receive a new statement showing that your GIC is worth more — thanks to the newly added interest.

Some employers offer GICs in their retirement savings plans as a butt-covering option or because an insurance company is involved in the company's retirement plan. More and more companies are eliminating GICs as investment options because of the greater awareness about GICs' drawbacks. First, insurance companies (like banks) have failed and will continue to fail. Although failed insurers almost always get bailed out — usually through a merger into a healthy company — you can take a haircut on the promised interest rate if your GIC is with a failed insurance company. Second, by having a return guaranteed in advance, you pay for the peace of mind in the form of lower long-term returns.

Mortgages

Another way that you can invest your money for greater dividend income is to lend your money via mortgages and second mortgages. Mortgage brokers often arrange these “deals.” They appeal to investors who don’t like the volatility of the stock and bond markets. With a mortgage, you don’t have to look up the value every day in the newspaper; a mortgage seems safer because you can’t watch your principal fluctuate in value.

What’s amazing is that people who invest in these types of mortgages don’t realize that they’re getting a relatively high interest rate *only because they are accepting relatively high risk.* The risk is that the borrower can default, which would leave you holding the bag. More specifically, you could get stuck with a property that you may need to foreclose on. And if you don’t hold the first mortgage, you’re not first in line with a claim on the property.

If a property buyer could obtain a mortgage through a conventional bank, he would. Banks offer the lowest interest rates. So if a mortgage broker is offering you a deal to lend your money at 12 percent when the going bank rate is, say, 8 percent, that means you’ll be lending money to people who the bank considers high risk. If a bank, with its vast assets on hand, isn’t willing to lend money to somebody, ask yourself whether you should. Mortgage investments also carry interest rate risk: If you need to “sell” the mortgage early, you’ll probably have to discount it, perhaps substantially if interest rates have increased since you purchased it.

If you’re willing to lend your money to borrowers who carry a relatively high risk of defaulting, check out high-yield bond funds, which I discuss earlier in the chapter (under “Taxable intermediate-term bond funds”). With such funds, you at least diversify your money across many borrowers, and you benefit from the professional review and due diligence of the fund management team. If the normal volatility of a bond fund’s principal value makes you queasy, then don’t follow your investments so closely!

When you’re selling some real estate and are willing to act as the bank and provide the financing to the buyer in the form of a first mortgage, consider that a viable investment. Be careful to check the borrower’s credit, employment, and income situation; get a large down payment (at least 20 percent); and try not to lend so much money that it represents more than, say, 10 percent of your total investments.

Exchange-traded bond funds

In 2007, Vanguard launched four different bond ETFs:

- Total bond market ETF
- Short-term bond ETF
- Intermediate-term bond ETF
- Long-term bond ETF

These funds track respective Lehman Brothers bond indexes. The expense ratio of these new ETFs is 0.11 percent. Check out Chapter 5 for more information on ETFs.

Chapter 13

Stock Funds: Meeting Your Longer Term Needs

In This Chapter

- Growing your money in the stock market
- Investing in stocks through mutual funds
- Getting some stock fund recommendations

Most stock market investors who don't manage money for a living and who make money do so not because they're pouring over daily market commentaries or are luckier or more clairvoyant than anyone else. They make money by simply being patient and using three simple investment methods:

- Invest in a diversified portfolio of stocks.
- Continue to save money and add to investments.
- Don't try to time the market.

A small number of extraordinary investors — Warren Buffett being a famous one who's frequently in the news — generate exceptional returns. Buffett and these other elite investors do the above three things *and* have a talent for identifying and investing in undervalued businesses before most others see that value. The good news for you is that you can earn handsome long-term stock market returns without having Buffett's talent. (And, you can some fun and make more money investing with the best fund managers who are able to post above-average, long-term returns.) People who get soaked in the stock market are those who make easily avoidable mistakes. An *investment mistake* is a bad decision that you could've or should've avoided, either because better options were available, or because the odds were heavily stacked against you making money. Investment mistakes result from the following:

- Not understanding risk and how to minimize it
- Ignoring taxes and how investments fit into overall financial plans
- Paying unnecessary and exorbitant commissions and fees
- Surrendering to a sales pitch (or salesperson)
- Trading in and out of the market

Give up the search for a secret code — there isn't one. Focus on avoiding major gaffes.

The stock market isn't the place to invest money that you need to tap in the near future (certainly not money you need to use within the next five years). If your stock holdings take a dive, you don't want to be forced to sell when your investments have lost value. So come along for the ride — but only if you can stay for a while!

The Stock Market Grows Your Money

Stocks represent a share of ownership in a company and its profits (see Chapter 1). As companies (and economies in general) grow and expand, stocks enable investors to share in that growth and success. Over the last two centuries, investors holding diversified stock portfolios earned a rate of return averaging about 9 to 10 percent per year, which ended up being about 6 to 7 percent higher than the rate of inflation. Earning such returns may not seem like much (especially in a world with gurus and brokers claiming returns of 20 percent, 50 percent, or more per year). But don't forget the power of compounding: At 9 to 10 percent per year, your invested dollars doubles about every seven to eight years. The purchasing power of your money growing 6 to 7 percent more per year than the rate of inflation doubles about every 10 to 12 years.

Contrast this return with bond and money market investments, which have historically returned just a percent or two per year over the rate of inflation. At these rates of return, the purchasing power of your invested money takes several decades or more to double.

Your investment's return relative to the rate of inflation determines the growth in purchasing power of your portfolio. What's called the *real growth rate* on your investments is the rate of return your investments earn per year *minus* the yearly rate of inflation. If the cost of living is increasing at 3 percent per year and your money is invested in a bank savings account paying you 3 percent per year, you're treading water — your *real* rate of return is zero. (When you invest money outside of a tax-sheltered retirement account, you end up paying taxes on your returns, which could lead to a *negative* real "growth" in your money's purchasing power!) Be patient

The 9 to 10 percent annual historic return in stocks (quoted in the preceding section) isn't guaranteed to be the same in the future. Consider some of the unexpected storms that hammered the stock market over the past 110 or so years (see Table 13-1).

Table 13-1 Great Plunges (20 Percent or More) in the Dow Jones Industrial Average Index of Large-Company Stocks

Years

Percent Decline*

Years

Percent Decline*			
1890–1896	47%	1961–1962	27%
1899–1900	32%	1966	25%
1901–1903	46%	1968–1970	36%
1906–1907	49%	1973–1974	45%
1909–1914	29%	1976–1978	27%
1916–1917	40%	1981–1982	24%
1919–1921	47%	1987	36%
1929–1932	89%	1998	20%
1937–1942	52%	2000–2003	40%
1946–1949	24%	2007–2009	55%

**The returns that stock market investors earned during these periods differ slightly from the above figures, which ignore dividends paid by stocks that mitigate some of the above declines. The returns also ignore changes in the cost of living, which normally increase over time and make these drops seem even worse. The Great Depression is the exception to that rule: The cost of living decreased then.*

As you see in Table 13-1, the stock market can sometimes take a beating. But before you let the chart convince you to avoid the stock market, look at the time periods during which those great plunges occurred — notice how relatively short most of them are. During the last century, major stock market declines have lasted less than two years on average. Some of the 20-percent-plus declines lasted less than one year. The longest declines (1890–1896, 1909–1914, 1929–1932, 1937–1942, 1946–1949, and 2000–2003) lasted from three to six years.

Also remember that these declines are from an absolute peak to an absolute bottom. While we all know folks who don't seem to be possess good luck, no investor invests all their money at a precise peak of the stock market — and then would be hapless enough to sell at the exact bottom!

Table 13-1 tells less than half the story. True, the stock market can suffer major losses. But over the long haul, stocks make more money than they lose. That’s how they end up with that 9 to 10 percent average annual long-term return I’ve been telling you about. Stock market crashes may be dramatic, but consider the powerful advances in Table 13-2 that have happened after big market declines.

Table 13-2 Great Surges in the Dow Jones Industrial Average

after Major Market Declines

Years

Percent Increase	
1896–1899	173%
1914–1916	114%
1932–1937	372%
1942–1946	129%
1949–1956	222%
1962–1966	86%
1970–1973	67%
1974–1976	76%
1987–1998	450%
2003–2007	98%
2009-2010*	71%

Increase may continue and add to the stated number

In each and every one of the cases, subsequent stock market increases more than made up for the previous declines. In other words, wait long enough, and time will bail you out! (Hence, why stocks are for long-term investors and long-term goals.) If you're going to invest in stocks, you must have the time on your side to wait out a major market decline. If you don't, you face the risk of selling your stocks for a loss. Don't keep your emergency money in stocks. Only invest money that you don't plan on using for at least five years — preferably ten or more.

Add regularly to your stock investments

Although the stock market may be able to double the purchasing power of your money on average every 10 to 12 years, the real key to creating wealth with stocks is investing in them regularly. Put $1,000 into stocks, and seven years later, you'll probably have $2,000. But if you put $1,000 into stocks *every year* for seven years, you end up with nearly $9,500 — that's nearly five times more. Remember the power of combining these two simple but powerful financial concepts: *Regular savings* and *investing in growth-oriented investments* lead to simply amazing long-term results.

Another advantage of buying in regular chunks (some call this *dollar-cost averaging,* a subject I cover in Chapter 10) is that it softens the blow of a major decline. Why? Because you can make some of your stock investments as the market is heading south; perhaps you may even buy at or near the bottom. After the market rebounds, you show a profit on some of those last purchases you made, which helps soothe the rest of your portfolio — as well as your bad feelings about the decline. If you used dollar-cost averaging during the worst decade for stock investors last century (1928–1938), you still averaged 7 percent per year in returns despite the Great Depression and a sagging stock market.

Using Mutual Funds to Invest in Stocks

The best stock funds offer you diversification and a low-cost way to hire a professional money manager. In Chapter 4, I discuss at length why purchasing individual stocks on your own doesn't make good financial sense. (If you haven't read Chapter 4 yet and you believe that buying individual stocks is the best route for you to take, please read it.) Reducing risk and increasing returns

When you invest in stocks, you expose yourself to risk. But that doesn't mean that you can't work to minimize unnecessary risk. One of the most effective risk-reduction techniques is *diversification* — owning numerous stocks in many industries to minimize the damage of any one stock’s decline. Diversification is one reason why mutual funds are a proven way to own stocks.

Unless you have a lot of money to invest, you can only cost-effectively afford to buy a handful of individual stocks. If you end up with a lemon in your portfolio, it can devastate the returns of your better-performing stocks. Companies go bankrupt. Even those that survive a rough period can see their stock prices plummet by huge amounts — 80 percent or more — and sometimes in a matter of weeks or months.

Even during the 1990s bull market (a *bull market* is one in which stock prices are rising; its opposite is a *bear market*), certain individual stocks took it on the chin. A good example is Iomega, a darling of Internet message boards in the mid-1990s. After zooming to more than $135 per share in 1996, it plunged and languished below $5 per share (adjusting for splits). It was finally acquired by EMC for just under $4 per share Of course, owning any stock in a company that goes bankrupt and stays that way means that you lose 100 percent of your investment. If this stock represents, say, 20 percent of your holdings, the rest of your stock selections must increase about 25 percent in value just to get your portfolio back to even.

Stock mutual funds reduce your risk by investing in many stocks, often 50 or more. If a fund holds 50 stocks and one drops to zero, you lose only 2 percent of the value of the fund if the stock was an average holding. If the fund holds 100 stocks, you lose 1 percent, and a 200-stock fund loses only 0.5 percent if one stock goes under. And don’t forget another advantage of stock mutual funds: A good fund manager is more likely to sidestep investment disasters than you are.

Another way that stock funds reduce risk (and thus their volatility) is by investing in different types of stocks across various industries.

Some funds also invest in both U.S. and international stocks.

Different types of stocks don't always move in tandem. So if smaller company stocks are being beaten up, large-company stocks may be faring better. If growth companies are sluggish, value companies may be in vogue. If U.S. stocks are in the tank, international ones may not be. (I discuss these different types of stock funds later in this chapter.) You can diversify into various types of stocks by purchasing several stock funds, each of which focuses on different types of stocks. This diversification has two potential advantages. First, not all your money is riding in one stock fund and with one fund manager. Second, each of the different fund managers can focus on and track particular stock investing opportunities.

Making money: How funds do it

When you invest in stock funds, you can make money in three — count 'em, three — ways:

- **Dividends:** Some stocks pay dividends. Many companies make profits and pay out some of these profits to shareholders in the form of dividends. Dividends are taxed at a far lower income tax rate than ordinary income. (Find the lowdown on fund investments and taxes in Chapter 18.) As a mutual fund investor, you can choose to receive your fund's dividends as cash or reinvest them by purchasing more shares in the mutual fund.

  Unless you need the income to live on (if, for example, you're retired), reinvest your dividends into buying more shares in the fund. If you do this outside of a retirement account, keep a record of those reinvestments because those additional purchases should be factored into the tax calculations you make when you sell the shares.

- **Capital gains distributions:** When a fund manager sells stocks for more than she paid for them, the resulting profits, known as *capital gains,* must be netted against losses and paid out to the fund's shareholders. As with dividends, your capital gains distributions can be reinvested back into the fund. Gains from stock held for more than one year are known as *long-term capital gains* and are taxed at a much lower rate than your regular income (see Chapter 18).

- **Appreciation:** The fund manager isn't going to sell all the stocks that have gone up in value. Thus, the price per share of the fund should increase (unless the fund manager made poor picks or the market as a whole is doing poorly) to reflect the gains in unsold stocks. For you, these profits are on paper until you sell the fund and lock them in. Of course, if a fund's stocks decline in value, the share price depreciates. Hold the fund for more than one year and you qualify for low long-term capital gains tax rates when you sell.

If you add together dividends, capital gains distributions, and appreciation, you arrive at the *total return* of a fund. Stocks (and the funds that invest in them) differ in the proportions that make up their total returns, particularly with respect to dividends.

Seeing your stock fund choices

Stock mutual funds, as their name implies, invest in stocks. These funds are often referred to as *equity funds. Equity* (not to be confused with equity in real estate) is another word for stocks.

Stock funds and the stocks that they invest in usually are classified into particular categories based on the types of stocks they focus on. Categorizing stock funds often is tidier in theory than in practice, though, because some funds invest in an eclectic mix of stocks. Funds and the stocks that they hold differ from one another in three major ways: ✔**Size of the company:** You can purchase stock in small, medium, and large companies. The size of a company is defined by the total market value (capitalization) of its outstanding stock. Small companies are generally defined as those that have total market capitalization of less than $2 billion. Medium-sized companies have market values between $2 billion and $10 billion. Large-capitalization companies have market values greater than $10 billion. These dollar amounts are somewhat arbitrary. (***Note:*** The term *capitalization* is routinely shortened to *cap,* as in small-cap company or large-cap stock.)

What do all those other names mean?

If small and large, value and growth, U.S. and international haven't created enough mind-numbing combinations of stock fund options, here are a few more names that you'll come across.

Start with all the variations on growth. *Aggressive growth* funds are, well, more aggressive than the other growth funds. Not only does an aggressive growth fund tend to invest in the most growth-oriented companies, but also the fund may engage in riskier investing practices, such as making major shifts in strategy and trading in and out of stocks frequently (turning over the fund's investments several times or more during the year).

Then consider *growth-and-income* funds and *equity-income* funds. Both of these fund types invest in stocks (equities) that pay decent dividends, thus offering the investor the potential for growth and income. Growth-and-income and equity-income are basically one and the same. The only real difference between them is trivial: Equity-income funds tend to pay slightly higher dividends (although some growth-and-income funds have higher dividends than equity-income funds!). They may pay higher dividends because they invest a small portion of their portfolios in higher-dividend securities, such as bonds and convertible bonds.

Income funds tend to invest a healthy portion (but by no means all) of their money in higher-yielding stocks. Bonds usually make up the other portion of income funds. As I explain later in this chapter, other fund names (such as *balanced* funds) designate those funds investing in both stocks and bonds. Income funds are really quite similar to some balanced funds.

The term *international* typically means that a fund can invest anywhere in the world except the U.S. The term *worldwide* or *global* generally implies that a fund can invest anywhere in the world, including the U.S. I generally recommend avoiding worldwide or global funds that have just one manager for three reasons: It's difficult for a fund manager to thoroughly follow the companies and financial markets across a truly global investment landscape. (It's hard enough to follow either solely U.S. or solely international markets.) Most of these funds charge high operating expenses — often well in excess of 1 percent per year — that drag down investors' returns.

The proportion of U.S. and foreign stocks within a global fund may vary a lot, which can make it difficult for you to have a set long-term allocation between foreign and domestic stocks.

Don't get bogged down in the names of funds. Remember that funds sometimes have misleading names and don't necessarily do what their names may imply. What matter are the fund's investment strategies and typical investments. I tell you what these strategies are for the funds I recommend in this book, and I show you how to combine great funds together into a portfolio in Chapter 15.

Why should you care what size companies a fund holds? Because smaller companies behave differently than larger companies do. Historically, smaller companies pay lower dividends (yields) or none at all, but may appreciate more. Their share prices, although more volatile, tend to produce greater total returns. Larger companies' stocks tend to pay greater dividends and on average are less volatile, but they produce slightly lower total returns than small-company stocks. Medium-sized companies, as you may suspect, fall between the two. Investing in companies of varying sizes can generally reduce a portfolio's risk and volatility.

- **Growth or value:** Stock fund managers and their funds are further categorized by whether investments are made in growth or value stocks.
  - *Growth* stocks are public companies that are experiencing rapidly expanding revenues and profits and whose stocks are relatively costly in relation to the assets and profits of the company. These firms tend to reinvest most of their earnings in the company to fuel future expansion; thus, these stocks pay low dividends.
  - *Value* stocks are public companies that are priced cheaply in relation to the company's assets and profits. Such a company could possibly be a growth company, but that's unlikely because growth company stocks tend to sell at a premium compared to what the company's assets are worth.
- **Geography:** Stocks and the companies that issue them are further categorized by the location of their main operations and headquarters. Is a company based in the United States or overseas? Funds that specialize in U.S. stocks are (surprise, surprise) called U.S. stock funds; those focusing internationally are typically called "international" or "overseas" funds.

By putting together two or three of these major classifications, you can start to appreciate all those silly and lengthy names that mutual fund companies give to their stock funds. You can have funds that focus on large-company value stocks or small-company growth stocks. These categories can be further subdivided into more fund types by adding in U.S., international, and worldwide funds. For example, you can have international stock funds focusing on small-company stocks or growth stocks.

The Best Stock Funds

Using the selection criteria outlined in Chapter 7, the following sections describe the best stock funds worthy of your consideration. The recommended funds differ from one another primarily in terms of the types of stocks they invest in. Keep in mind as you read through these funds that they also differ from each other in their tax friendliness (see Chapter 10). If you're investing inside a retirement account, you don't need to bother with this issue.

Because stock funds are used for longer-term purposes, the subject of stock funds usually raises another important issue: How do you divvy up your loot into the different types of investments for purposes of diversification and to make your money grow? Chapter 10 also answers that question.

Mixing it up: Recommended hybrid funds

Hybrid funds invest in a mixture of different types of securities. Most commonly, they invest in both bonds and stocks. These funds are usually less risky and less volatile than funds that invest exclusively in stocks; in an economic downturn, bonds usually hold up better in value than stocks do.

TIP

Hybrid funds make it easier for investors who're skittish about investing in stocks to hold stocks while they avoid the high volatility that normally comes with pure stock funds. You *could* place 60 percent of your investment moneys into a pure stock fund and the other 40 percent into a pure bond fund — but you can do just that by investing in one hybrid fund that has the same overall 60/40 mix. Because bonds and stocks often don't fluctuate in unison, movements of one can offset those of the other. Hybrid funds are excellent choices for retirement account investing, particularly when an investor doesn't have much money to start with.

Hybrid mutual funds come in two flavors:

- **Balanced funds:** Balanced funds try to maintain a fairly constant percentage of investment in stocks and bonds. For example, a balanced fund's objective may be to keep 60 percent of its investments in stocks and 40 percent in bonds. (Some balanced funds are exceptions to this rule and will, like asset allocation funds, adjust their mix over time.)
- **Asset allocation funds:** These funds adjust the mix of different investments according to the portfolio manager's economic expectations. Essentially, the fund manager keeps an eye on the big picture — watching both the stock and bond markets — and moves money between them in an *attempt* to get the best value. For example, if the manager thinks stocks are highly valued and bonds are not, he may move more money into bonds and out of stocks.

You should note, however, that most managers have been unable to beat the market averages by shifting money around instead of staying put in sensible investments. (See Chapter 10 for more on index funds.) One of the brighter spots on the mutual fund landscape is the best mutual funds that invest in a variety of different funds offered by their parent companies. They're known as *funds of funds,* and they're the ultimate couch-potato way to invest! Later in this section, I discuss specific best funds of funds.

Because hybrid funds hold taxable bonds and, therefore, pay decent dividends, they aren't appropriate for many investors who're purchasing funds outside tax-sheltered retirement accounts. If you're in a higher tax bracket (federal 28 percent and higher), bonds that you hold outside a retirement account should probably be tax-free. With the exception of the Vanguard Tax-Managed Balanced Fund (see the sidebar, "A tax-friendly hybrid"), you should avoid the hybrid funds if you're in this situation. Buy separate tax-friendly stock funds (which I cover later this chapter) and tax-free bond funds (see Chapter 12).

The following sections describe some terrific hybrid funds. They're loosely ordered from those that generally take less risk to those that take more. Higher risk hybrid funds tend to hold greater positions in stocks and/or make wider swings and changes in their investments and strategies over time.

Vanguard Wellesley Income

The Vanguard Wellesley Income is among the most conservative and income oriented of the hybrids. This fund typically has about 60 percent of its assets in high-quality bonds, with the remaining assets in high-yielding, large-company stocks. Since its inception in 1970, the majority of this fund's returns have come from dividends. Like many of the other conservative Vanguard funds, this one is managed by Wellington Management and the duo of John Keogh and Michael Reckmeyer, who have more than five decades of investment experience between them.

This fund is ideal for people who've either retired or are on the verge of retiring — or anyone else who wants a high rate of current income but also wants/has some potential for growth from their investments. Its stocks are value oriented and among the more stable of stocks. Its high-quality bonds, which tend to be intermediate term, also don't go through the gyrations that junk bonds do. Expense ratio is 0.31 percent (0.21 percent for the Admiral share class which requires a $100,000 minimum). Minimum initial investment is $3,000. The fund charges a $20 annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard's Web site for electronic delivery of statements and fund reports. 800-662-7447.

Vanguard's funds of funds

A *fund of funds* is simply a mutual fund that invests in other individual mutual funds. Although the concept isn't new, it's become increasingly attractive to investors who either are overwhelmed by the number of fund choices out there or who want to diversify. Vanguard offers some excellent funds of funds.

Begun in 1985 — and thus the oldest of the funds of funds — the **Vanguard Star** fund is diversified across 11 different Vanguard funds: 6 U.S. stocks, 2 foreign stocks, and 3 bonds. Its targeted asset allocation is about 65 percent in stocks and 35 percent in bonds. The Star fund's diversification comes cheap: The expense ratio of the underlying funds is 0.32 percent. (There's no additional charge for packaging them together.) The initial investment requirement is just $1,000.

A tax-friendly hybrid

Vanguard Tax-Managed Balanced is the one hybrid fund that's tax friendly enough to be considered for investments held outside tax-sheltered retirement accounts. Why? Because the bonds that it holds (typically half of this fund's investments) are federally tax-free municipal bonds. Be forewarned, though, that this fund has a steep initial minimum of $10,000 and is intended for investors who can hold the fund for at least five years. Otherwise, a 1 percent transaction fee is charged against your sale proceeds and paid into the fund. The fund's annual expense ratio is a mere 0.15 percent.

The bond portion of the portfolio is composed of high-quality and generally intermediate term municipal bonds. The stocks in this fund try to replicate the Russell 1000 index of the 1,000 largest company stocks in the United States, although the fund emphasizes stocks with lower dividends to reduce taxable distributions. Selling of stocks with capital gains is also minimized to reduce those taxable distributions as well.

Because this fund shuns dividend paying stocks, it's not a good choice for conservative, value-oriented investors seeking current investment income on which to live.

If you live in a high-tax state, instead of buying this Vanguard fund, you may be better off buying a state and federally tax-free municipal bond fund, if a good one's available for your state (see Chapter 12 to find out), and pairing it with a tax-friendly stock fund. Contact Vanguard investor and client information at (800) 662-7447.

Realizing that in the case of asset allocation, one size doesn't fit all, Vanguard introduced the LifeStrategy series of funds in 1994. Although each of the four LifeStrategy funds draws from numerous Vanguard stock and bond funds, they differentiate themselves by their target asset allocations. The **LifeStrategy Income** fund, the most conservative of the bunch, has 70 to 80 percent in bonds and 20 to 30 percent in stocks, whereas the **LifeStrategy Growth** portfolio, at the other end of the risk spectrum, invests 80 to 90 percent in stocks and 10 to 20 percent in bonds. The asset allocations of the **LifeStrategy Conservative Growth** and the **LifeStrategy Moderate Growth** funds fall somewhere in between. (If you want a fund that gradually scales back its risk as you get closer to retirement, take a look at Vanguard's Target Retirement fund series.) By relying more heavily on index funds than the Star fund does, the LifeStrategy funds come through with an even lower average expense ratio of 0.22 percent. Minimum initial investment is $3,000, and these funds charge a $20 annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard's Web site for electronic delivery of statements and fund reports. 800-662-7447.

The **Dodge & Cox Balanced** fund is one of the oldest and best-balanced funds, having started in 1931. Like Dodge & Cox itself, this fund is conservatively run, investing primarily in medium- and large-company U.S. value stocks and high-quality, intermediate-term bonds. Typically, it invests about 60 to as much as 70 percent in stocks and the rest in bonds.

This fund has always been managed by using a team approach, so if you like to be able to rattle off the name of a star fund manager who's investing your money, this fund isn't for you (although you can impress others by saying that the minimum account size that Dodge & Cox normally accepts is several million dollars). This fund has a low 0.53 percent expense ratio.

Vanguard Wellington

The **Vanguard Wellington** is the oldest hybrid fund: It dates back to the summer of 1929 (which means that it even survived the Great Depression!). This fund typically invests about 60 to 65 percent in larger company value-oriented stocks, with the remainder in high-quality, intermediate-to longer-term bonds. In recent years, approximately 10 to 15 percent of this fund’s stocks were overseas.

This fund is co-managed by Wellington Management’s Edward Bousa and John Keogh, who together have more than 55 years of investment management experience. The fund’s expense ratio is 0.35 percent (0.23 for Admiral shares that require a $100,000 minimum). Minimum initial investment is $10,000. The fund charges a $20, annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard’s Web site for electronic delivery of statements and fund reports. 800-662-7447.

Fidelity Puritan

One of the company's oldest funds (it began in 1947), the **Fidelity Puritan** fund is co-managed by Ramin Arani and George Fischer, who have a combined four decades with Fidelity in investment research and management. Puritan typically has about 60 percent in stocks that tend to be large company and value oriented. In recent years, the fund has been investing about 10 percent of its stock allocation overseas.

Most of the bonds are intermediate term, and a modest portion of them are junk bonds. The expense ratio is 0.67 percent. Minimum initial investment is $2,500. The fund charges a $12 annual low-balance fee for nonretirement account balances below $2,000. 800-544-8888.

Fidelity's Freedom funds of funds

Fidelity offers 12 Freedom funds of funds: Freedom Income, Freedom 2000, Freedom 2005, Freedom 2010, Freedom 2015, Freedom 2020, Freedom 2025, Freedom 2030, Freedom 2035, Freedom 2040, Freedom 2045, and Freedom 2050. The **Freedom Income** fund is the most conservative, targeting 40 percent of its assets to fixed income funds, 40 percent to money market funds, and 20 percent to equity funds. At the other end of the scale is the **Freedom 2050** fund, the most aggressive, with about 90 percent of its assets in equity funds and 10 percent in fixed-income funds. The asset allocations of the other funds fall between these extremes. (The higher the number in the fund title, which is theoretically the customer's approximate retirement date, the greater its percentage of stock funds.) All the Freedom Funds draw from a fixed pool of Fidelity funds, such as Capital & Income, Strategic Real Return, Investment Grade Bond, Blue Chip Growth, Disciplined Equity, Equity-Income, Growth Company, Large Cap Value, Diversified International, and Fidelity Overseas.

The combined operating expenses of the underlying funds within the Freedom Funds typically ranges from 0.7 to 0.8 percent. The Fidelity Freedom funds charge a $12 annual low-balance fee for nonretirement account balances below $2,000. 800-544-8888.

T. Rowe Price offerings

T. Rowe Price Balanced invests mainly in large-company stocks within the United States and has about one-quarter of its stocks overseas and 10 to 15 percent of its bonds in junk. The expense ratio is 0.69 percent. **T. Rowe Price Personal Strategy Balanced** is another fine hybrid fund, which typically holds 60 percent stocks of companies of varying sizes and has 20 to 25 percent of its stocks overseas. The expense ratio is 0.86 percent. Minimum initial investment for both of these funds is $2,500 ($1,000 for retirement accounts).

T. Rowe Price also has a series of target-date retirement funds, with names such as **T. Rowe Price Retirement** 2040, that are funds of funds. On the conservative end of the spectrum, it has T. Rowe Price Retirement Income and T. Rowe Price Retirement 2005, with expense ratios around 0.6 percent. At the most aggressive end of the spectrum, it has T. Rowe Price Retirement 2055, with an expense ratio of 0.79 percent. These funds gradually reduce their stock exposure and risk as you near the retirement date in the fund's name. 800-638-5660.

Letting computers do the heavy lifting: Recommended index funds Index funds are passively managed — that means an index fund's money is invested, using computer modeling, to simply track the performance

of a particular market index, such as the Standard & Poor's 500. When you buy into an index fund, you give up the possibility of outperforming the market, but you also guarantee that you won't much underperform the market either.

Beating the market is extremely difficult; most actively managed funds are unable to do it. The best index funds, however, have an advantage — the lowest operating expenses in the business. In Chapter 10, I further discuss the virtues of index funds and the role they should play in your portfolio.

Exchange-traded funds (ETFs) are index funds that are the newer kids on the block. ETFs trade on a stock exchange, and the best of them have low expense ratios like Vanguard's index funds. In fact, many of the best ETFs come from Vanguard. Where relevant, I have included recommended stock ETFs in this chapter. For more information about ETFs, including their pros and cons, please see Chapter 5.

Vanguard's index funds are generally the best stock index funds available. John C. Bogle, Vanguard's founder and former CEO, was the first person to take the idea of indexing to the mutual fund investing public; he's been a tireless crusader for index funds ever since. Today, Vanguard continues to be the index fund leader with the lowest operating expenses (which directly translates into higher index fund returns) and the biggest index fund selection around.

The flagship of Vanguard's index fleet, the **Vanguard Index 500** fund invests to replicate the performance of the popular stock market index — the Standard & Poor's 500 index — which tracks the stocks of 500 large companies in the United States. These 500 stocks typically account for about three-quarters of the total value of stocks outstanding in the U.S. market. I don’t enthusiastically recommend this fund because you miss out on medium-and smaller-sized companies. Also, because it’s weighted by the market value of the stocks in its index, you end up over-investing in sectors of the market (for example, technology stocks in the late 1990s and financial services stocks in the mid-2000s) that are bloated and due for a more substantial correction. The expense ratio on this fund is a razor-thin 0.18 percent, and if you invest $100,000 in the fund, you can use the Admiral share class with its ultra-low 0.09 percent expense ratio.

A more diversified and tax-friendlier fund than Vanguard’s Index 500 is the **Vanguard Total Stock Market Index,** which replicates the performance of the MSCI US Broad Market Index, comprising 99.5 percent or more of the total market capitalization of all of the U.S. common stocks regularly traded on the New York and American Stock Exchanges, and the NASDAQ over-the-counter market. This index comprises the entire U.S. market of large-, medium-, and small-company stocks. This fund, which holds more than 3,400 stocks, also has a wafer-thin expense ratio of 0.18 percent and also offers Admiral shares with a 0.09 percent expense ratio.

Value-oriented indexes generally are a little less volatile, produce more dividend income, and offer slightly higher long-term total returns. Among U.S. index funds and exchange-traded funds I like is **iShares Russell 1000 Value ETF**, which invests in large cap U.S. stocks. For smaller cap stocks, check out **iShares Russell 2000 Value ETF**, **Vanguard Small Cap Value Index** fund, and **Vanguard Small Cap Value ETF**.

Taxes on stock funds

For mutual funds held outside of retirement accounts, you have to pay income tax on dividends and capital gains that are distributed. Stock dividends and long-term capital gains are taxed at far lower income tax rates relative to ordinary income (see Chapter 10). If your circumstances lead you to have money that you want to invest in stock funds outside of retirement accounts, by all means do it. But pay close attention to the taxable distributions that funds make (especially short-term capital gains distributions that aren't eligible for the lower tax rates). (I've indicated in this chapter which funds are tax friendly.) In addition to the tax-friendly index and stock funds I note in the chapter, also check out the **Vanguard Tax-Managed Capital Appreciation** fund, which invests in the universe of the 1,000 largest company stocks in the U.S. stock market. (Vanguard actually selects and samples from among the 1,000 companies.) This fund seeks to minimize capital gains distributions by holding on to appreciating stock and, if it needs to sell some stocks at a profit, offsetting those sales by selling other stocks at a loss. Vanguard also offers a **Tax-Managed Growth and Income** fund, **Tax-Managed Small-Cap** fund, and a **Tax-Managed International** fund.

You shouldn't go into the Vanguard Tax-Managed funds unless you plan to hold your investment for five years because you'll get clipped with a transaction fee of 1 percent for such an early exit. The minimum initial investment is a hefty $10,000.

Vanguard Total International Stock Index seeks to replicate a combination of two international indexes: the Morgan Stanley Capital International Index (which is comprised of established economies) and the Select Emerging Markets Index. This fund is actually a fund of funds, as it includes Vanguard's index funds for Europe, the Pacific, and Emerging Markets. At 0.34 percent, this fund's expense ratio is a bargain for an international fund.

Vanguard FTSE All-World ex-US ETF is also a solid core international fund worth considering.

For nonretirement accounts, the minimum initial purchase for Vanguard index funds is $3,000. Vanguard's index funds charge a $20 annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard's Web site for electronic delivery of statements and fund reports. 800-662-7447.

Keeping it local: Recommended U.S.-focused stock funds

This section focuses on the better actively managed funds that invest primarily in the U.S. stock market. I say *primarily* because some "U.S." funds venture into overseas investments. The only way to know for sure where a fund is currently invested (or where the fund may invest in the future) is to ask. You can start by calling the toll-free number of the mutual fund company that you're interested in. You can also read the fund's annual report (which I explain how to do in Chapter 8). A prospectus, unfortunately, won't give you anything beyond the general parameters that guide the range of investments: It won't tell you what the fund

is currently investing in or has invested in.

Of all the different types of funds offered, U.S. stock funds are the largest category. To see the forest amidst the trees, remember the classifications I cover earlier in the chapter. Stock funds differ mainly in terms of the size of the companies they focus on and whether those companies are considered “growth” or “value” companies.

I highly recommend another of the fine but few funds offered by Dodge & Cox, the **Dodge & Cox Stock** fund, which focuses on large-and medium-company value stocks, including about 10 to 20 percent in foreign shares.

Unlike most U.S. stock funds today, this fund does little trading, often less than 15 percent of its portfolio annually. Like the Dodge & Cox Balanced Fund, this fund is managed by a team and doesn’t try to time the markets. Its annual expense ratio is a low 0.52 percent.

Fairholme Fund

You may think that a fund that was started in late 1999, right before the peak of a long bull market and just before U.S. stocks in general suffered their worst decade was destined for trouble. But, you'd be wrong in the case of the **Fairholme Fund.** Fund managers Bruce Berkowitz and Charles Fernandez scour the world stock markets for undervalued stocks, primarily in medium-and larger size companies. This firm started out in the private money management business — Fairholme Capital Management — in 1997, which required a $1 million initial investment. The Fairholme fund's expense ratio is 1 percent. Initial minimum investment is $2,500; $1,000 for retirement accounts. 866-202-2263.

Fidelity Low-Priced Stock

The **Fidelity Low-Priced Stock** fund specializes in investing in small-and medium-company value stocks. As of this writing, about one-third of its stocks are overseas. As you may guess from its name, it buys stocks that have low share prices. Lower priced stocks tend to coincide with smaller companies, but not always: The price per share of a stock may bear little resemblance to the size of the issuing company because companies can "split" their stock and issue more shares, which cuts the price per share. This fund has been managed since its inception in 1989 by Joel Tillinghast, an amazing run given the turnover of managers at many funds, especially at Fidelity. Annual operating expenses are 1 percent. The minimum initial investment requirement is $2,500 for all accounts. 800-544-8888.

Sequoia

A conservatively managed fund with a long history (dating back to 1970) of success, **Sequoia** got a boost from Warren Buffett who closed an investment fund in 1969 and recommended that investors invest with the newly formed Sequoia, which was managed by Bill Ruane.

The fund generally focuses on larger company stocks. This fund is co-managed by Robert Goldfarb and David Poppe. Its expense ratio is 1 percent. Minimum initial investment is $5,000, $2,500 for retirement accounts. 800-686-6884.

Vanguard Primecap

Vanguard Primecap is one of the few growth-oriented stock funds that doesn’t trade its portfolios heavily, trading typically less than 20 percent of its fund per year. It invests in companies of all sizes and even invests a small portion overseas. This fund has been managed since its inception by Howard Schow and Theo Kolokotrones of Primecap Management, a Southern California investment management company. Joel Fried was added as a co-manager in 1993; several additional co-managers were added in recent years. The expense ratio for this reasonably tax-friendly fund is a competitive 0.49 percent. (***Note:*** This fund is currently closed to new investors.) Although this fund is closed, you can, however, still tap in to the investment expertise of Primecap Management through the **Primecap Odyssey Growth** fund ($2,000 minimum, 0.73 percent expense ratio). 800-662-7447 for Vanguard; 800-729-2307 for Odyssey.

Vanguard Selected Value

James Barrow and Mike Giambrone, who have nearly six decades of investment management experience between them, are principals in the money management firm of Barrow, Hanley, Mewhinney, & Strauss, which have managed most of this fund since 1999. A portion of this fund has also managed by Donald Smith & Company since 2005. **Vanguard Selected Value** focuses on mid-size value stocks and invests a small portion overseas. The fund's expense ratio is a low 0.45 percent. Unfortunately, Vanguard raised the minimum investment amount on this excellent fund to $25,000, so those with smaller balances to invest will need to look elsewhere. 800-662-7447.

Vanguard Strategic Equity

Using models honed by Gus Sauter and Joel Dickson of Vanguard's Quantitative Equity Group, this fund has invested in small-and medium-sized U.S. companies since 1995. This fund, too, has a higher minimum: $10,000. Expenses are a low 0.30 percent. 800-662-7447.

Being worldly: Recommended international funds

As I discuss in Part I, for diversification and growth potential, funds that invest overseas should be part of an investor's stock fund holdings. Normally, you can tell you're looking at a fund that focuses its investments overseas if its name contains words such as *international, global, worldwide,* or *world.*

Generally, you should avoid foreign funds that invest in just one country. As with investing in a sector fund that specializes in a particular industry, this lack of diversification defeats the whole purpose of investing in funds. Funds that focus on specific regions, such as Southeast Asia, are better but are generally problematic because of poor diversification and higher expenses than other, more-diversified international funds.

In addition to the risks normally inherent in stock fund investing, international securities and funds are also influenced by changes in the value of foreign currencies relative to the U.S. dollar. If the dollar declines in value, the value of foreign stock funds goes up. Some foreign stock funds hedge against currency changes. Although hedging helps to reduce volatility a bit, it costs money to do, so I wouldn't worry about it if I were you. Remember, you're investing in stock funds for the long haul. And in the long haul, your international stock funds' performance will largely be driven by the returns generated on foreign stock exchanges, not currency price changes.

The following sections offer my picks for diversified international funds that may meet your needs. Compared to U.S. funds, fewer established international funds exist, and they tend to have higher annual expense ratios. So I've listed fewer options for you. (Don't forget the **Vanguard Total International Stock Index** fund and the **Vanguard Tax-Managed International** fund, which I discuss earlier in this chapter.) Vanguard International Growth

The **Vanguard International Growth** fund invests primarily in large companies with growth potential, mainly in established countries. It also invests a modest 15 to 20 percent in emerging markets.

International Growth is primarily managed by London-headquartered Schroder Capital Management, which has research offices around the world focused on specific countries and has managed this fund since its inception in 1981. In 2003, James Anderson of Baillie Gifford was added to manage a portion of this large fund. This fund has an expense ratio of 0.53 percent and has been reasonably tax friendly. Initial minimum investment is $3,000 (Admiral shares of this fund have a $100,000 minimum and levy 0.34 percent in annual expenses). The fund charges a $20 annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard's Web site for electronic delivery of statements and fund reports. 800-662-7447.

Dodge & Cox International

This excellent private money management firm also offers a handful of excellent mutual funds and manages the **Dodge & Cox**

International fund, a foreign stock offering, which focuses on larger company, value-oriented stocks. The fund is managed by a team of investment managers, most of whom have been with the firm for 20+ years. Expenses are a low 0.64 percent. Minimum initial investment is $1,000 for retirement accounts; $2,500 for other accounts. 800-621-3979.

Masters' Select International Equity

Like a fund of funds, **Masters' Select International Equity** has some of the best fund managers each managing a portion of fund. Some of these top fund managers manage funds that are closed to new investors. Although each manager has a somewhat different investment orientation, collectively this fund invests in foreign companies of all sizes, including those in emerging markets.

Masters' Select International's expenses are 1.07 percent. (Unfortunately this fund is closed to new investors.) If you sell shares in this fund within six months of purchase, you must pay a 2 percent redemption fee. Minimum initial investment is $10,000 ($1,000 for retirement accounts). 800-960-0188.

Expanding your horizon: Recommended global stock funds A select number of stock funds invest globally (overseas as well as in the United States) and do so well and cost-effectively; I detail those funds in this section.

Oakmark Global

The **Oakmark Global** fund invests in an eclectic mix of companies worldwide. Oakmark is one of a very short list of fund firms that has successfully managed a global stock mutual fund. While the fund commenced operations in 1999, fund manager Clyde McGregor has been with the Oakmark Funds parent company (Harris Associates) since 1981 and co-manager Robert Taylor has been with Harris since 1994. Together, McGregor and Taylor have five decades of experience in money management. While expenses are a little high at 1.23 percent. Minimum initial investment for all account types is $1,000. 800-625-6275.

T. Rowe Price Spectrum Growth

T. Rowe Price offers a number of good stock funds, both U.S. and international, and the **Spectrum Growth** fund of funds offers a simplified way to invest in them. The U.S. stock funds in this fund cover the entire range of company sizes. Spectrum Growth also invests about 25 percent of its assets overseas.

This fund of funds is managed by regular meetings of a committee made up of fund managers within the company. Slight changes in allocations among the different funds are made based on expectations of how particular types of stocks (for example, growth versus value, larger versus smaller company) will fare in the future. The expense ratio of the funds in this fund come to about 0.82 percent, and the company doesn't charge an additional fee for the fund's packaging. Minimum initial investment is $2,500 ($1,000 for retirement accounts). 800-638-5660.

Tweedy Browne Global Value

Tweedy Browne Global Value invests in value stocks of companies of all sizes worldwide, primarily in established countries. Although it can invest in the United States, its U.S. holdings are generally 10 to 15 percent of the fund. The parent company has an excellent reputation, managing money privately since the 1920s; this fund itself has been in existence since 1993 and has done well. Operating expenses, consistently lowering as the fund grows in size, are still a bit on the high side at 1.4 percent. Initial minimum investment is $2,500 ($500 for retirement accounts). 800-432-4789.

Vanguard Global Equity

This excellent fund is co-managed by three leading private money management firms: Marathon Asset Management, Acadian Asset Management, and AllianceBernstein. U.S. stocks currently comprise about 40 percent of the fund. The expense ratio of 0.47 is low for a global fund. Minimum initial investment is $3,000. The fund charges a $20 annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard’s Web site for electronic delivery of statements and fund reports. 800-662-7447.

Chapter 14

Specialty Funds: One of a Kind In This Chapter

► Looking into real estate investment trust (REIT) funds ►Getting the scoop on precious metals and commodities funds ►Reviewing utility funds ►Doing good with socially responsible and market neutral funds In the other chapters in this part of the book, I explain the three major types of funds: money market, bond, and stock. Specialty funds, which tend to be stock funds, are often known as *sector* funds because they tend to invest in securities in specific industries. But, as you see in this chapter, some specialty funds hold securities in a variety of industries but engage in unusual strategies that separate them from their peers.

In addition to real estate and precious metals funds, other types of sector-focused funds I discuss in this chapter are commodity funds, and utility funds, which are popular with some investors who want more conservative stock investments. In addition, I cover specialty funds that engage in unusual strategies and invest in a wide range of industries — socially responsible funds and market neutral funds.

Sector Funds: Should You or Shouldn't You Invest in Them?

WARNING!

In most cases, you should avoid specialty or sector funds. Investing in stocks of a single industry defeats a major purpose of investing in mutual funds — you give up the benefits of diversification. Also, just because the fund may from time to time be dedicated to a *hot* sector (a sector fund or two is often at the top of short-term performance charts), you can’t assume that the fund will pick the right stocks within that sector.

Another good reason to avoid sector funds is that they tend to carry much higher fees than other mutual funds do. Many sector funds also tend to have high rates of trading or turnover of their investment holdings. Investors holding these funds outside of retirement accounts may have to turn over a tidy portion of their returns to the IRS.

The only types of specialty funds that may make sense for a small portion (10 percent or less) of your investment portfolio are funds that invest in real estate or precious metals. These types of funds can help diversify your portfolio because they can do better during times of higher inflation — which often depresses general bond and stock prices. Don’t feel obligated to invest in these sector funds, however, because diversified stock funds tend to hold some of these specialty investments.

Landlording Made Easy: Real Estate Investment Trust (REIT) Funds Do you want to invest in real estate without the hassle of being a landlord? Invest in *real estate investment trusts (REITs),* which are

stocks of companies that invest in real estate. These funds typically invest in properties, such as apartment buildings, shopping centers, and other rental properties. Of course, evaluating REIT stocks is a hassle, but you can always (you guessed it) invest in a mutual fund of REITs!

REITs are small-company stocks and usually pay decent dividends. Sorry, but these dividends aren’t eligible for the lower dividend tax rates for other stock funds. As such, REITs aren’t appropriate for higher-tax-bracket investors investing money outside of retirement accounts. Most of the larger, diversified U.S. stock funds that I recommend in Chapter 13 have a small portion of their fund’s assets invested in REITs, so you’ll have some exposure to this sector without investing in a REIT-focused fund.

Here are some solid REIT funds from which to choose: ✓**Cohen & Steers Realty Shares** has been managed by Martin Cohen and Robert Steers since the fund began in 1991. (Two additional comanagers have recently been added.) The minimum initial investment is steep at $10,000. Discounters also may offer it without transaction charges. Annual operating expenses are 1.00 percent. 800-437-9912.

- **Fidelity Real Estate Investment,** the oldest REIT mutual fund, is managed by Steven Buller, who's been with Fidelity since 1992 and managed this fund since 1998. This fund has expenses of 0.92 percent per year. Initial minimum investment is $2,500 ($500 for retirement accounts). 800-544-8888.
- **T. Rowe Price Real Estate** has been managed since its inception by portfolio manager David Lee. 0.75 percent, $2,500 minimum ($1,000 for retirement accounts). 800-638-5660.
- **Vanguard REIT Index,** yet another of Vanguard's long line of index funds, has minimal expenses of just 0.21 percent. Although this fund will never be a star in its category, its low expenses should ensure its long-term success. Minimum investment amount is $3,000. The fund charges a $20, annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard's Web site for electronic delivery of statements and fund reports. 800-662-7447.

Profiting from What Everyone Needs: Utility Funds Utility funds tend to attract older folks who want to earn good dividends and not have the risk of most stock investments. And that's what utility funds are good for. But this once-staid industry

has been shaken up by increased competition.

In a sense, utility funds are superfluous. Most diversified stock funds contain some utilities, and those investors who want income can focus on better income-producing funds, such as Wellesley Income in the hybrid group and the value-oriented stock funds that I discuss in Chapter 13.

Arming for Armageddon: Precious Metals Funds Gold and silver have been used by many civilizations as mediums of exchange because these metals have unique physical properties and rarity. These precious metals are used not only in jewelry but also in less frivolous applications, such as manufacturing.

With a paper-based currency, such as the U.S. dollar, the government can always print more currency to pay off its debts. This process of casually printing more and more currency can lead to a currency's devaluation — and to inflation.

Holdings of gold and silver can provide a so-called hedge against inflation. In the United States during the late 1970s and early 1980s, inflation rose dramatically. This rise depressed stocks and bonds. Gold and silver, however, soared in value, rising more than 500 percent (even after adjusting for inflation) from 1972 to 1981.

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

Don't purchase precious metals futures contracts. *Futures* aren't investments; they're short-term gambles on which way prices of an underlying investment (in this case, gold or silver) may head over a short period of time (see Chapter 1). You also should stay away from firms and shops that sell coins and *bullion* (not the soup, but bars of gold or silver). Even if you can find a legitimate firm (which isn't an easy task), storing and insuring gold and silver are costly. You don't get good value for your money.

Gold and silver can help to diversify a portfolio, but if you want to invest in precious metals, you're wise to do so through mutual funds. For more information about determining how these types of funds may fit with the rest of your investments and how to buy them, be sure to read Chapter 12.

Vanguard Precious Metals and Mining fund, like most gold and precious metals funds, invests in mining companies' stocks worldwide because many are outside the United States in countries such as South Africa and Australia. This fund, which also invests in other metals such as platinum and nickel, has one of the best track records among precious metals funds and has been around since 1984. Annual operating expenses for this tax-friendly fund are 0.40 percent. At the time this book went to press, this fund was closed but will likely reopen, probably when this market sector isn't overheated as it has been recently. Minimum initial investment is $3,000. The fund charges a $20, annual low-balance fee for account balances below $10,000 unless you register your account on Vanguard's Web site for electronic delivery of statements and fund reports. 800-662-7447.

If you expect high inflation or if you just want an inflation hedge in case you expect the end of civilization, you could invest in a gold and precious metals fund. But these funds have wild swings and aren't for the faint of heart or for the majority of your portfolio. To illustrate why, consider this: In 1993, the Vanguard Precious Metals and Mining fund rocketed up 93 percent, whereas in 1997, it lost almost 39 percent. From 2000 through 2007, it increased in value more than 600 percent! But, then in 2008, this fund lost a whopping 56 percent. In 2009, it jumped 76.5 percent. For an alternative, less volatile (and lower return) inflation hedge, consider investing in inflation-protected Treasury bonds (which I discuss in Chapter 12).

Commodity Funds

Precious metals are but one type of commodity. The major commodities that trade include energy commodities (such as oil, gasoline, and natural gas), grains and other agriculture commodities, industrial metals (such as titanium, aluminum, stainless steel, nickel, and copper), and livestock.

A number of mutual funds invest so as to track or beat various broadly diversified commodity indexes. Here are the notable attributes of commodities as an investment class: ✓**Modest returns:** Long-term commodity returns are comparable to those on bonds but certainly less than stocks.

- ✓ **High volatility:** Commodities tend to be at least as volatile as stock prices without offering as high long-term returns.
- ✓ **Diversification value:** Historically, commodities have posted their best returns when stocks and bonds have done poorly. For example, this situation happened during a portion of the 1970s, when commodities did well during times of increasing inflation. Thus, commodities add some diversification to a portfolio.

Plenty of poor commodity funds, including exchange-traded funds, are out there. In addition to high fees, funds in this space are often plagued by poor long-term returns due to excessive risk taking that doesn't pan out.

Commodity funds should never be used for more than a small portion (say, 10 percent) of your portfolio, you should primarily use them for their diversification value. Because of their volatility, commodity funds are best used over several or more years, as you would use a stock fund.

Here's a short list of some of the better commodity funds available: ✓Credit Suisse Commodity Real Return Strategy ✓Fidelity Global Commodities ✓Harbor Commodity Real Return Strategy ✓PIMCO Commodity Real Return Strategy Hedging: Market Neutral (Long-Short) Funds In Chapter 6, I discuss hedge funds. As I have in prior editions of this book, I warn investors about the many dangers of such funds, which lure investors with the promise of expected high returns and the possibility of doing well even when the stock market is doing poorly. Many hedge funds sell stocks short — a strategy that makes money when stock prices fall, but that typically leads to losing money.

Often overlooked are the high fees, big risks, and relatively poor to mediocre long-term performance of most hedge funds.

The mutual fund industry developed *market neutral funds,* also known as *long-short funds,* as yet another answer to investor fears about falling stock market prices. A typical market neutral fund invests in stocks, which its fund manager believes will rise in value, but also shorts some stocks that the fund manager thinks will fall in value. (When you *sell short,* you borrow a security from a broker, sell it, and then hope to buy it back later at a lower price.) Supposedly, such funds shine during a volatile market because plenty of stocks should be rising and falling, and a smart manager, so the theory goes, should be able to invest in those that will rise and short those that will fall.

Well, this category of funds has generally failed to deliver for investors, which is why I haven't recommended these funds in prior editions of this book. Consider the following issues with market neutral funds: **High expenses:** The average expense ratio is a whopping 2.07 percent. One reason is the high costs involved in short selling. Paying more than 2 percent per year in fees is a major drag on your potential long-term returns.

- **Lack of track records:** Of the 235 funds engaging in this strategy, only 65 have a five-year track record, only 19 have 10-year track records, and only 8 have 15-year track records.
- **Mediocre returns:** In the five-year period ending April 7, 2010, which includes a fairly volatile period of rising and falling markets, the average market neutral fund posted an annual average return of just 1.9 percent. Over this same period, diversified funds generally returned double to triple that amount.

REMEMBER

If you're skittish about investing in stocks, then you need to develop an overall investment plan which includes holding a diversified portfolio. Ultimately, if you're uncomfortable putting any money in stocks, then don't do so. Investing in funds that short stocks is even more dangerous and risky.

Matching Morals to Investments: Socially Responsible Funds *Socially responsible* mutual funds appeal to investors who want to marry their investments to their social principles and avoid supporting causes that they feel are harmful. These funds attempt to look at more than a company's bottom line before deciding to commit their investors' capital. Many of these funds consider such factors as environmental protection, equal employment opportunity, the manner in which a company's employees are treated, and the level of honesty that

a company displays in its advertising.

I can certainly understand the desire to put your money where your mouth is; unfortunately, socially responsible funds fail to bridge the gap between theory and practice. If you blindly plunk down your money on such a fund, you may be disappointed with what you're actually getting. Bear with me as I explain.

Evil is in the eye of the beholder The biggest problem is that the term *socially responsible* **has different meanings for different people. Sure, most socially conscious investors can agree on some industries as being "bad." The tobacco industry, associated with hundreds of thousands of deaths and billions of dollars of healthcare costs, is an obvious example, and socially responsible funds avoid them. But most industries aren't so easy to agree on.**

For example, McDonald's is the world's largest fast-food (hamburger) company, as well as a stock that some socially responsible funds hold. McDonald's is deemed socially responsible because of its support for children's charities, participation in recycling programs, hiring and promotion of women and minorities, and purchase of hundreds of millions of dollars in goods and services from woman-and minority-owned businesses.

But how socially responsible is a company whose business depends on beef? It’s certainly not the best for people’s health, and raising cattle is tremendously land and water intensive. Moreover, some may also question the screening and awarding of contracts based on gender and ethnicity. Others may blame McDonald’s for running small local restaurants out of business and contributing to the sterile strip-mall culture of our communities.

Or consider Toys “R” Us, the giant toy retailer and another stock that’s widely held by socially responsible funds for many of the same reasons that McDonald’s is. But this company sells widely criticized violent video games that keep kids away from homework. Thus, some investors might consider Toys “R” Us a socially *ir*responsible company — and that’s before you consider the heaps of plastic (made from petroleum) and the drive toward overconsumption that the toy industry generates.

Pick any company, put it under a magnifying glass, and you can find practices that are objectionable to somebody’s (perhaps your) moral consciousness. Of course, that’s a poor argument for throwing in the towel. I’m simply warning you that you may be hard-pressed to find a fund manager whose definition of social responsibility is closely enough aligned to yours. A mutual fund, by its very nature, is trying to please thousands of individual investors. That’s a tall order when you throw moral consciousness into the picture.

Even if you can agree on what’s socially irresponsible (such as selling tobacco products), funds aren’t always as clean as you’d think or hope. We live in a global economy where it’s increasingly difficult to define a company’s sphere of influence. Although a socially responsible fund may choose to avoid tobacco manufacturers, it may invest in retailers that sell tobacco products, or the paper supplier to the tobacco manufacturer, or the advertising agency that helps pitch tobacco to consumers.

Ways to express your social concerns Some funds that aren’t labeled “socially responsible” still meet many investors’ definitions of socially responsible. These other funds usually carry lower fees and produce better returns. For example, GNMA bond funds invest in mortgages that allow people to purchase their own homes. Municipal bond funds buy bonds issued by local governments to fund projects that most would consider good — such as building public transportation, libraries, and schools. See Chapter 10 for my specific bond fund recommendations.

If you consider investing in socially responsible funds, look well beyond a fund’s marketing materials. When you find a socially responsible fund that interests you, call the fund company and ask it to send you a recent report that lists the specific investments that the fund owns. Otherwise, you may be blissfully ignorant, but not as socially responsible as you may like to believe.

You can always consider alternative methods of effecting social change, such as through volunteer work and donations to causes that you support. You can also exercise a means of change that people the world over are dying for, a means that is guaranteed to all U.S. citizens by the Constitution and is exercised today by only a minority of American adults — the right to voice your opinion and vote.

Chapter 16

Applications, Transfers, and Other Useful Forms

In This Chapter

- Explaining application basics
- Understanding nonretirement and retirement account forms
- Establishing an automatic investment program
- Asking for help

When you invest money, completing forms is unfortunately a requirement. But don't despair. If you truly detest paperwork and mailing things, you'll be happy to know that you can now complete many application forms online. In this chapter, I explain how to fill out fund application and transfer forms.

Although the subject of this chapter may seem mundane, I explain some extra-nifty things that perhaps you didn't know you could do with fund investing. And, unlike dealing with IRS tax forms year after year, fund paperwork isn't unpleasant to deal with. You won't have much (if any) ongoing paperwork to do, except for filing the taxes owed on mutual fund distributions held outside of retirement accounts (the subject of Chapter 18).

Taking the Nonretirement Account Route

As I discuss in Chapter 9, you can purchase most of the excellent mutual funds that I recommend in this book either directly from the mutual fund company responsible for them or through a discount brokerage firm. Though you see many similarities between mutual fund company and discount broker applications, you also see that brokerage account applications are a different type of animal than mutual fund company applications. I show you how to handle both in this chapter.

Filling in the blanks: Application basics

In years past, prospective customers called the fund company on its toll-free number and said, “Please send me your account application materials for your (fill-in-the blank) fund.” Several days later, a packet arrived in the mailbox with enough density and heft to make a great flyswatter! Most of the content was marketing propaganda to convince people to send gobs of money. You had to hunt around for the document that said something like *Account Registration Form* or *New Account Application* or *Application.*

Thanks to the Internet, now you can open fund accounts online. In the past, although various fund companies allowed you to access and download account application forms on their Web sites, you still had to print the application, sign it, and drop it in the mail. But today, electronic signatures exist. *E-signatures,* as they’re commonly referred to, are now legally equal to traditional pen-and-ink signatures on paper forms. You don’t literally sign a form using your computer; you’re simply assigned a code that serves as your very own e-signature. Fund companies ensure your account’s security by requiring your Web browser to use sophisticated encryption technology and by mailing another code to the address that you provide in your application.

Here are the potential benefits of completing an account application online:

- You can get your new account open much faster, which may come in handy when you face a deadline for opening a particular type of account (such as a retirement account).
- You can save time completing forms through the same company. Most of the better fund-company Web sites remember your information when you've completed one form, which allows them to precomplete common portions of new forms when you come back to open more new accounts.

The following sections explain and show you how to complete the important portions of a typical new account application for a nonretirement account (I discuss the nuances of retirement account applications later in the chapter).

Account registration

In the *account registration* section (which usually comes first on an account application), you're asked to choose the appropriate box and enter the name of the individual or organization that's registering the account. Here are the common types of account registrations:

- **Individual or Joint Account:** Choose this option if you're opening the account for yourself or jointly for yourself and someone else. *Joint tenants with rights of survivorship* is generally the default classification for jointly registered accounts and establishes the following conditions:
  - The person you've jointly registered the account with can do everything that you can do on the account, such as calling and inquiring about account balances, performing transactions, and writing checks. Neither party needs the other's permission (although it's possible to establish the account so that both signatures are required for check writing).
  - Each account holder has an equal interest in the account.
  - If you should die, the entire account balance goes to the other person registered on the account without the hassles and expense of going through probate.

  A rarely used option is to register the account as tenants in common. To arrange a *tenancy in common,* you can have a legal document drawn up specifying that each tenant owns a certain percentage of the account. Unlike shares of ownership for joint tenants with rights of survivorship, the shares for tenants in common need not be equal. If you die, the account is restricted; your share of the account is distributed to the person whom you designated to receive it, and the surviving account holder is required to set up a new account for his share.

If you go to the trouble of setting up the account registration as tenants in common, just write in the margin in this section of the form that you want the account set up this way or attach a short letter that presents the same request. The fund company doesn't want or need to see the legal document (which you should keep with your will) or other important personal financial documents.

- **Gift or Transfer to Minor:** Use this section if you want to open (register) an account in your child's name. As the parent, you're the *custodian,* your child the *minor.* Your state's name is requested in this section because two different sets of laws govern custodial accounts: the Uniform Gift to Minors Act (UGMA) and the Uniform Transfer to Minors Act (UTMA). States allow one or the other. Your child is legally entitled to the money in the account when she reaches the so-called age of majority (which is, depending on the state, between 18 and 21). Read Chapter 3 before putting money into an account in your child's name because there are drawbacks.

- **Trust:** Generally, you know if you have a trust because you're either the one who sets it up or you're the recipient of assets that are part of a trust. There are many types of trusts. For example, some folks, by the time they get older, have set up a *living trust* that allows their assets to pass directly to heirs without going through probate. If you have a trust agreement, provide the pertinent details at this point in the form.

- **Corporation, Partnership, or Other Entity:** If you want to open a mutual fund account for your corporation or local Rotary Club, use this section. You need a taxpayer ID number. If your organization doesn't have one, call the IRS at 800-829-3676 (800-TAX-FORM) and request Form SS-4, or visit its Web site at www.irs.gov.

Your personal information

This part’s easy. You may be wondering why some fund companies ask for your phone numbers, the name of your employer, and your occupation. The company wants your phone numbers so it can call you regarding account issues. The rest of this information is partly required by fund regulators and partly just desired by the fund company for its own market research; it wants to know about the people who invest in each of its specific types of funds. If you want to maintain your privacy, you can skip the employment stuff, and the fund company will still happily open your account.

Your investment

The investment section is where you tell 'em which fund you want. But be careful in this section. Most account applications offer a menu of fund choices, so you need to double-check that you've selected the fund that you have your heart set on.

To ensure that the money is deposited into the correct fund, check the account statement that you receive when you open your account. Although it doesn't happen often, fund companies (and you!) occasionally make mistakes.

Your method of payment

After you open an account, you’re faced with the task of getting money into your new account in order to buy some mutual funds. You can put money into your account by mailing the fund company a check, having funds electronically transferred from an existing bank account, or transferring funds from an account you previously opened at the fund company.

Generally, you need to send a check to open a mutual fund account. If this is the case, make the check payable to the fund (if the company numbers its funds, include the fund number next to the fund company name). Don’t worry about someone stealing the check or a mail thief cashing it (remember that you make the check payable to the fund).

After you open a money market fund account, you can do exchanges into other accounts by telephone. Exchanges save you the hassle of filling out more application forms every time you open new funds at the same company (although different account types, such as IRAs, do require separate account applications). Make sure that you have another source of cash during the time it takes for the fund company to open your money fund and send your first check. Sometimes people send in almost all their money and then, in a few days, they wish that they’d kept some back.

Dividend and capital gains payment options

Most mutual funds make dividend and capital gains payments. If you’re not living off this income, it’s usually best to reinvest these payments by purchasing more shares in the fund. To reinvest, just check the box indicating that you want to have the fund’s dividend and capital gains reinvested. This strategy eliminates the hassle of receiving and cashing checks often and then figuring out where to invest the money (but it doesn't change the taxability of a fund's distributions).

On the other hand, if you're retired, for example, you may want the distributions on your fund sent to you so that you can spend it on early-bird restaurant specials. Most fund companies offer you the option of having the money from distributions sent to you as a check through the mail. Or, even better, the fund can electronically transfer the money to your bank account. This method gets you the money quicker and requires less mail to open and fewer checks to sign and schlep to the bank.

Wiring and automatic investment options

You're not required to have wiring and automatic investment options on an account. *Wire redemption* allows you to request that money be wired to your bank account. Use this feature if you might unexpectedly need money fast. Your mutual fund and your bank may charge for wiring services, though, so don't use wiring as your regular way to move money to and from your bank.

If you want to make regular deposits into one of your fund accounts, you can select an *automatic investment* plan, which authorizes the fund to instruct your bank to send a fixed amount on a particular day of the month (or some other time period). You can do the same in reverse by withdrawing money on a regular schedule, too. The minimum amount should be stated on the form.

Special purchases and redemptions is an electronic funds transfer — it's like a paperless, electronic check that allows you to move money back and forth between your bank and mutual fund accounts. This process usually takes a full two days to complete because, like a check, the transaction is cleared through the Automated Clearing House (wiring can typically be done the same day or next day). The fund and the bank shouldn't charge for the service because it's just like a check (which means that it costs less than wiring).

To establish these additional services, remember to attach a preprinted deposit slip or blank check (write "VOID" in large letters across the front of the check so that no one else can use it).

Check-writing option

Check writing is a useful feature to sign up for on a money market fund. But most money funds limit check writing to amounts of $250 or more.

I don’t recommend establishing check writing for bond funds because each time you write a check on a bond fund, you must report the transaction on your annual tax return (because the price of the bond fund fluctuates, you’ll be selling at different prices than you bought). Keep enough cash in your money fund and write your checks from there.

Opening multiple fund accounts quickly

Some of the larger fund companies have a number of good funds, so you may want to invest in multiple funds at one company. Through a comprehensive account application form, *most* fund companies let you invest in multiple funds without having to complete a mountain of paperwork. However, not all fund companies offer these comprehensive account application forms. You're supposed to fill out a separate application for each fund you plan to invest in, but you don't need to. Avoid this paperwork nightmare in several ways:

Establish a money market fund first. Then you may do exchanges by phone into any other funds you want. When you call to order the money fund materials, ask for the prospectuses for the other funds that you're interested in. When you do telephone exchanges, fund companies are required by the SEC to ask if you've received the prospectus before they'll allow an exchange.

Attach a separate piece of paper to one application with instructions to the fund company to open "identically registered accounts in the following funds" (but first make sure the company allows this shortcut). Next to each fund name, list the amount you want to invest. Don't forget to sign the page and attach your check.

Open a discount brokerage account through a firm that allows telephone exchanges (see the "Buying in to discount brokerage accounts" section).

Buying in to discount brokerage accounts

As I discuss in Chapter 9, discount brokerage firms and the discount brokerage divisions of fund companies offer you the opportunity, through a single account, to invest in hundreds of funds from many fund companies. Brokerage firms are different from mutual fund companies. The first difference is that brokerage accounts allow you to hold and trade individual securities, such as stocks and bonds. This feature is handy if you hold individual securities and want them in the same account as your mutual fund.

Another difference is that, in addition to offering mutual funds, brokerage accounts allow you to invest in riskier types of securities and engage in riskier investing strategies. Many brokerage firms, for example, allow investing in options (see Chapter 1), which are volatile, short-term, gambling-type instruments. Keep your distance.

Most of the sections on a typical brokerage application are the same as those on a mutual fund application, which I describe in the "Filling in the blanks: Application basics" section, earlier in the chapter. The following sections explain the main differences that may give you cause for pause.

Borrowing money so you can invest: Margin accounts

Brokers offer (and sometimes encourage) *margin trading.* Just as you can purchase a home and borrow some money to finance the purchase when you can't afford to pay all cash, you can do the same with your investments. When you buy a home, most banks require that you make a 10 to 20 percent down payment on the purchase price. When you invest in a brokerage account, you need to make a 50 percent down payment.

Buying investments on margin isn't something I recommend because

- You pay interest. Although the rate is competitive — nothing approaching the worst credit cards — it still isn't cheap. Typically, the rate is a bit more than you'd pay on a fixed-rate mortgage on your home.
- If your investments fall significantly in value (25 to 30 percent), you get a *margin call,* which means that you need to add more cash to your account. If you can't or don't add more money to your account, you must sell some

investments to raise the cash. Of course, if your securities' prices increase in value, you earn money not only on the down payment you invested but also on the borrowed money invested. (That's called *leverage.*)

- You can't invest on margin in retirement accounts, which is where you should be doing most of your investing (because of the tax benefits).

Borrowing on margin can be useful as a short-term source of money. Suppose you need more short-term cash than you have in a money fund. Instead of selling your investments, just borrow against them with a margin loan. This move makes sense especially if you'd have to pay a lot of tax on profits were you to sell appreciated investments.

Getting personal

Brokerage applications ask for financial information that most people consider to be confidential, such as your driver's license number, income, and net worth. "Why," you may rightfully ask, "are they being so nosy? Do they really need to know this stuff?"

All brokerage firms ask for this kind of information (although different firms ask different questions) because of the so-called know-your-customer rule imposed by regulators. Because brokerage accounts allow you to do some risky stuff, regulators believe that brokerage firms should make at least a modest effort to determine whether their clients know enough and have a sufficient financial cushion to make riskier financial investments.

Make your paperwork go faster and your investing less dangerous and skip this! If you're not signing up for the risky account features, such as margin and options trading, the brokerage firm doesn't need to know this info.

Accessing your cash: Checks and debit cards

Some brokerage accounts offer additional features, such as check writing and a debit card, that allow more convenient ways for you to access the money in your account. The only challenge is that you may have to request a different application for the special type of account that offers these features.

Debit cards look just like credit cards and are accepted by retailers the same way as credit cards. But, when you use your debit card, the money is generally sucked out of your account within a day or two. Using debit cards instead of credit cards may simplify your financial life by saving you from writing a check every month to pay your credit card bill. However, you give up the *float* — the free use, until the credit card bill is due, of the money that you owe — because debit cards quickly deduct the money owed from your account. You may also use your debit card to obtain cash from ATMs.

As with a money market mutual fund account, you may obtain checks to write against the money market fund balance in your brokerage account. Don't forget to complete the signature card for check writing.

Some brokerage accounts come with even more features that make organizing your finances easier, such as unlimited check writing and a bill payment service. These services cost more money, and you may have to put more money into your account, pay a monthly service fee, and/or pay an annual account fee if you don't place a specified minimum number of trades per year.

Transferring your dough into a new brokerage account

You may have cash, securities, and most mutual funds transferred into a new brokerage account that you establish. (If you haven't opened an account yet, you also need to complete an account application form.) All you need is an account transfer form for the brokerage firm into which you're transferring the assets. Using one of these forms saves you the hassle of contacting brokerage firms, banks, and other mutual fund companies from which you want to move your money. Using this form also saves you the bother and risk of taking possession of these assets. The following sections contain the info you need to know to complete a typical brokerage account transfer form.

Information about your (new) brokerage account

Your new brokerage firm needs to know into which account you want your assets transferred, so in this section you fill in your name as you have it on your account application or as it's currently listed on your account, if it's already open. If you're sending your account application with this transfer form, you won’t have an account number yet, so just write *NEW* in the space for your account number.

Information about the account you’re transferring

Here, you write the name of the brokerage, bank, or fund company that holds the assets you want to transfer and enter the account number of your account there. You may see the phrase *Title of account;* this simply means your name as it appears on the account you’re transferring.

Brokerage account transfers

In this section, you indicate whether you want to transfer your entire brokerage account — which makes your administrative life easier by eliminating an account — or only a part of it. (Another advantage of closing accounts at firms such as Prudential, Merrill Lynch, and so on is that they generally charge an annual account fee.)

If you're doing a partial transfer, you generally just list the assets that you want to transfer — for example, IBM stock — and the number of shares, such as "50" or "All." With partial transfers that include the transfer of mutual funds, you may have to go through the hassle of completing a transfer form for each company whose funds you're moving. You may have to list these funds in a separate section.

You generally won't be able to transfer (into your new brokerage account) mutual funds that are unique (or *proprietary*) to the brokerage firm you're leaving. Funds that can't be transferred typically include funds such as Prudential, Merrill Lynch, and so on. If there are no adverse tax consequences, you're better off selling these funds and transferring the cash proceeds. Check out Chapter 17, which walks you through the issues to consider if you're debating whether to hold or sell a fund.

If you bought some of those awful limited partnerships, check with the discount brokerage firm to which you're transferring your account to see if it'll be able to hold them. Discounters will likely charge you a fee ($25 to $50) to hold LPs, but many of the lousy firms that sold them to you in the first place also charge you for the privilege of keeping your account open with them. If the costs are about the same, I'd move the LPs to your new account to cut down on account clutter. Another alternative is to speak with the branch manager of the firm that sold them to you and ask that it waives the annual account fee for continuing to hold your LPs there.

Mutual fund transfer forms

As I explain in the last section, you can only transfer certain companies' funds into a brokerage account. For each fund you're transferring, you typically list the fund name, your account number, and the amount of shares you want transferred or sold.

If you're transferring the fund as is instead of selling it, tell the new firm whether you want the fund's dividends and capital gains distributions reinvested. Unless you need this money to live on, I'd reinvest it.

Bank, savings and loan, or credit union transfers

A potential complication occurs when you're transferring money from a certificate of deposit. In that case, send in this form several weeks before the CD is set to mature.

If you're like most people and do things at the last minute, you may not think about transferring a CD until the bank notifies you by mail days before it's due to mature. Here's a simple way around your inability to get the transfer paperwork in on time: Instruct your bank to place the proceeds from the CD into a money market or savings account when the CD matures. Then you can have the proceeds from the CD transferred whenever you like.

Attach your account statement!

Don't forget to attach a copy of a recent statement of the account you're transferring as well as your account application if you haven't previously opened an account. At this point . . . you're done! Mail the completed application in the company's postage-paid envelope, and the transfer should go smoothly. If you have problems, see Chapter 19 for solutions.

Preparing for Leisure: Retirement Accounts

The applications for retirement accounts pose new challenges. But, remember that it will be worth the effort: Otherwise, how will you pay for dentures and your annual AARP membership? The first part of these applications is just like a nonretirement account application, except that it’s easier to fill out. Retirement accounts are only registered in one person’s name: You can’t have jointly registered retirement accounts. Because mutual fund company retirement account forms are so similar to brokerage account retirement forms, I cover only the differences here.

Retirement account applications

Individual Retirement Accounts (IRAs) are among the most common accounts you may use at a mutual fund company. This section explains what you need to know to complete an IRA application. I also discuss the unique features of the other common retirement accounts — SEP-IRAs and Keoghs, which are used for the self-employed and small business owners. (For a detailed explanation of the various types of retirement accounts, see Chapter 3.)

If you plan to transfer money from a retirement account held elsewhere into the one you're opening, before you start, pay attention to two details:

- Make sure that the retirement account type you're opening (such as a SEP-IRA) matches the type you're transferring from (unless you're moving money from a 401(k) plan, in which case you'd be sending that money into an IRA because you can't open a 401(k) as an individual).
- If you want to transfer individual securities from a brokerage account, you need a *brokerage* account application for the type of retirement account you're opening, not a mutual fund account application.

Register for an account

Account registration is an easy section to fill out — but make sure that, if you're transferring IRA money from another firm into your mutual fund IRA, you list your name exactly as it appears on the account you're transferring. Otherwise, the firm that has your IRA may make a fuss, causing delays and making you complete yet more forms. ***Note:*** Some applications ask for your employer info. You don't have to provide this if you don't want to.

Choose your investment method

With an IRA, you can fund your account through three methods:

- **Annual contribution:** Select this option if you're opening up a new IRA with money previously held outside any kind of retirement account. You must specify which kind of fund(s) you want to buy, how much you'll be contributing (in 2010, up to $5,000; $6,000 if you're age 50 and older), which kind of IRA you want to open (traditional or Roth), and which tax year you're making your contributions. You have until the time you file your tax return (the deadline is April 15) to make a contribution for the previous year.
- 

Transfer from an existing IRA: If you want to move an IRA from another investment firm or bank into your new mutual fund IRA, select this option. You also need to complete an IRA transfer form (which I explain in the "What to do before transferring accounts" section). This option is the best way to move an existing IRA because it presents the least hassle and the fewest possibilities of a tax screw-up.
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Rollovers: Withdrawing the money from another IRA and sending it yourself to the new account isn't a good way to transfer your IRA. The big danger is that if you don't get the funds back into the new account within 60 days, you'll owe megataxes (income tax plus penalties).

Retirement plan applications for the self-employed and small business: SEP-IRAs and Keoghs

If you're self-employed or a small business owner, consider opening a SEP-IRA or Keogh plan. Most self-employed people can generally make larger tax-deductible contributions into these accounts than they can into a regular IRA. (I discuss the pros, cons, and contribution limitations of SEP-IRAs and Keoghs in Chapter 3.)

SEP-IRA applications are virtually identical to IRA applications, so just follow the instructions for the IRA applications in the section "Retirement account applications" (in fact, some firms use the same application form). At those firms that use SEP-IRA applications that differ from IRA applications, you may see references to "Employer Contribution" as the main difference. If you're the business owner, you, as the self-employed person, are your own employer. If you have other employees, they may be eligible for SEP-IRA contributions under your plan (the maximum waiting period is three years of service — a *year of service* is a year in which an employee earns $550). When employees become eligible for contributions, you set up accounts for them (with their names on them) — they don't establish accounts on their own.

Keogh account applications are more complicated. You must complete more paperwork, particularly if you set up the combined profit-sharing and money purchase pension plans that I explain in Chapter 4.

A few items appear on a Keogh application that you won't find on an IRA application. First, you must supply an *employer tax identification number.* If your business has obtained a tax identification number from the IRS, plug that in. Otherwise, most small business owners use their Social Security numbers. You also need the name(s) of the *plan administrator,* the person(s) responsible for determining which employees are eligible in the plan, making contributions into the accounts, and other tasks. If you're a sole proprietor, you're the administrator. In larger businesses, the administrator is the business owner(s).

The Keogh plan documents also ask whether your company operates, for tax purposes, on a calendar year (which ends on December 31) or a fiscal year (which has some other end date for the year). Employees are eligible to participate after they've completed two years of service. Different plans define a year of service differently, but most use 500 or 1,000 hours as the threshold.

If you're rolling over money from an employer-sponsored plan, such as a 401(k), you can select the option that’s labeled something like *Traditional Rollover IRA.* Tax advisers usually recommend that money coming from your employer’s plan should go into a rollover account. This choice allows you to someday transfer the money back into another employer’s plan. Of course, you can choose investments in your IRA, so this may sound like a silly reason to use a rollover IRA. An advantage to establishing a contributory IRA, instead, is that you can add to it with future IRA contributions. You can also merge it with other IRAs.

Don’t request that your employer issue you a check because your employer must withhold 20 percent for taxes. If you want to roll the full amount over — a wise move — you must come up with the missing 20 percent when you deposit the money into your IRA. Otherwise, you owe tax and penalties on it. Establish your IRA and then instruct your employer to send your money directly to that account.

Select your account service options

Most companies allow you to pick and choose from various service options that come with your IRA. Some of them, such as telephone/computer exchange, are automatically available with your account unless you specify otherwise. You can usually also set up an automatic investment plan; contributions to your IRA can be regularly deducted from either your bank checking account or your paycheck itself. Such plans generally have lower minimum initial investment requirements.

Designate your beneficiaries

In the beneficiaries section, you specify who gets all this retirement money if you work yourself into an early grave or haven't spent all of it by the time you go. In most cases, people name their spouses, kids, parents, or siblings. You may also list organizations such as charities that you want to receive some of your money; providing their tax identification number and address is a good idea (just include this info on a separate piece of paper).

If your children are under 18, they don't have access to the money. A guardian who you identify through your will controls the money. If you die without a will, the courts will assign a guardian. Your *primary beneficiaries* are first in line for the money, but if they've all crossed the finish line by the time you do, your *contingent beneficiaries* receive the money.

What to do before transferring accounts

If you have money in a retirement account in a bank, brokerage firm, other mutual fund company, or in a previous employer's retirement plan, you can transfer it to the mutual fund(s) of your choice. Here's a list of steps for transferring a retirement account. ***Note:*** If you're doing a rollover from an employer plan, please heed the differences indicated:

1. **Decide where you want to move the account.**

   See Chapter 9 for help with this decision.

2. **Obtain an account application and asset transfer form.**

   Call the toll-free number of the firm you're transferring the money to (or visit its Web site) and ask for an *account application and asset transfer form* for the type of account you're transferring to — for example, an IRA, SEP-IRA, Keogh, or 403(b).

   You can tell which account type you currently have by looking at a recent account statement; the account type is given near the top of the form or in the section with your name and address. If you can't figure it out on a cryptic statement, call the firm that currently holds the account and ask a representative which type of account you have (just be sure to have your account number handy when you call).

3. Figure out which securities you want to transfer and which you need to liquidate.

Transferring existing investments in your account to a new investment firm can cause glitches because not all securities may be transferable. If you're transferring cash (money market assets) or securities that trade on any of the major stock exchanges, transferring isn't a problem.

If you own publicly traded securities, it's often better to transfer them *as is* to your new investment firm, especially if the new firm offers discount brokerage services. (The alternative is to sell them through the firm you're leaving, which may cost you more.)

If you own mutual funds unique to the institution you're leaving, check with your new firm to see whether it can accept them. If not, you need to contact the firm that currently holds them to sell them.

4. (Optional) Let the firm from which you're transferring the money know that you're doing so.

(You don't need to worry about this step if you're rolling money out of an employer plan.) If the place you're transferring from doesn't assign a specific person to your account, you definitely should skip this step. If you're moving your investments from a brokerage firm where you've dealt with a particular broker, though, the decision is more difficult. Most people feel obligated to let their rep know about the transfer.

In my experience, calling your representative with the bad news is usually a mistake. Brokers or others who have a direct financial stake in your decision to move your money will try to sell you on staying. Some may try to make you feel guilty, and badger you. The more that you feel personally obligated to continue doing business with a broker, the more likely it is that your personal relationship is getting in the way of your financial goals. Instead, write a letter if you want to let them know you're moving your account. It may seem the coward's way out, but writing usually makes your departure easier on both sides. With a letter, you can polish your explanation, and you don't run as much risk of putting the broker on the defensive. Just say that you've chosen to self-direct your investments.

But then again, telling an investment firm that its charges are too high or that it sold you a bunch of lousy investments that it misrepresented to you may help the firm to improve in the future. Don't fret this decision too much. Do what's best for you and what you're comfortable with.

Establishing retirement accounts quickly

Okay, so you procrastinate — you're human. Perhaps it's April 14 or 15, and you want to establish an IRA, but you need to do it, like, now. You don't have time to call a toll-free number, wait for days to get the application in the mail, and then wait even more days until the fund company receives your check. All isn't lost; get yourself out of your pickle in several proven ways:

Visit a branch office. Companies such as Fidelity and TD Ameritrade have numerous branch offices. Call them to find the location of the one nearest you. You may also be near other companies' main offices. Check the Appendix of this book for contact information. And believe it or not, some branch offices are kept open late on tax day. (Some larger firms even keep some of their branches open until midnight.)

Visit a Web site. Most fund companies provide downloadable account applications on the Internet — and increasing numbers of fund providers allow you to complete these applications online using e-signatures (which I discuss in the section "Filling in the blanks: Application basics"). Most likely, however, you'll have to print and mail a form. And to get your money into your newly opened account, you need to wire or electronically transfer funds (or employ one of the other strategies that I discuss in this sidebar).

Use an express mail service. Although not a low-cost option, if you have a chunk of money at stake, an overnight express mail service may be worth the cost and save you the time of going to a branch office.

Go to your local bank. Establish your retirement account in a savings or money market type of account at the bank. Later, when the dust settles and you have breathing room, call your favorite fund company for its application and transfer forms to move the money.

Bank employees will more than likely try to talk you into a CD or one of the mutual funds that they sell. Skip the CD, because you're looking for a short-term and flexible parking place for your retirement contribution. Bank mutual funds tend to be commission-based (load) funds and aren't among the best choices.

File for a tax extension. If you're opening a non-IRA retirement account, such as an SEP-IRA or a Keogh, consider buying yourself more time by filing for an extension. Although you must still pay any outstanding tax owed by the April 15 deadline, filing for an extension by using IRS Form 4868 gets you six more months (until October 15) to file your Form 1040 and establish and fund your retirement accounts. (***Note:*** This extension doesn't apply to normal IRAs; for those, April 15 is the absolute deadline.)

If you're self-employed, be aware that you need to file the paperwork for a Keogh retirement account by December 31 — no extensions are allowed (although, as with other retirement accounts, you do have until the time you file your tax forms to fund the Keogh). You can use the strategies I discuss in this sidebar to get the job done by year's end.

Filling out transfer forms

Transferring retirement accounts generally isn't too difficult. In most cases, all you need to do is complete a transfer form. You can use a mutual fund transfer form to move money that's in a bank account, in another mutual fund, or in a brokerage account. You may only use this form to move investment money that you want liquidated and converted to cash prior to transfer.

You'll probably need to use one of these retirement account transfer forms for each investment company or bank you're transferring IRA money out of. If you're transferring individual securities (for example, stocks or bonds) or want brokerage account features, you need a brokerage account transfer form (and brokerage application forms). The following sections detail the unique features that you should know about when completing a transfer form.

Account ownership and address

Be sure to list your name and address as it appears on the account you're transferring (look at a recent statement for that account). A discrepancy between the two accounts often leads to an incomplete transfer.

If you're transferring an IRA, look at a statement for the account you're transferring and see which type of IRA you have. If you can't figure it out, either call that company and ask which of the three types you have or just leave it blank, send it to the mutual fund, and let it figure it out from the statement for the account that you're transferring!

Where the retirement account funds will be invested

On most applications, you simply list the funds that you want the transferred money invested in and the percentage of the money that is to go into each (the percentages must total 100 percent). If you want to divvy up the money into more funds than the form allows space for, list the additional funds on a separate piece of paper and attach that sheet to the form.

Account being transferred

In this section of the transfer form, you tell the fund company where the account you want to transfer is currently held. If it's in another fund, list the name of the fund (if you're transferring more than one fund from the same company, just squeeze those names into the space provided). If it's money in a CD that you're moving, try to send your transfer form several weeks before the CD is scheduled to mature.

If you don't get around to sending the form until right before your CD matures, buy yourself more time by directing your bank to place the CD proceeds into a money market or savings type account from which you then can do the transfer.

List the firm where your account is currently being held. You may see the term *custodian,* which is simply the term for the company holding your IRA — for example, First Low Interest Bank & Trust or Prune Your Assets Brokerage. Some transfer forms ask for a specific department or person who handles account transfers at your old firm. You probably won't have a clue as to which person or department has this responsibility. If you don't, you can call the company and try to find out. My advice: Don't bother. Most funds don't burden you with having to find this information out — the funds should already know from other transfers that they've done with that firm. If they don't, let them do the work to find out.

List the mailing address and phone number of the company where your account is currently held, and also list your account number there. Attach a copy of the statement for the account that you want to move. If you don't know the phone number, don't worry — it isn't critical.

Authorization to transfer your account

It’s a pain, but some firms that you’re transferring out of may require that you burn a chunk of your day to go get your signature guaranteed at your local bank (a notary doesn’t do this). Fortunately, most companies don’t require this effort — but the only way to know for certain is to call and ask.

Investing on Autopilot

You may have noticed if you were reading earlier in this chapter that I mention that some mutual fund applications include sections that allow you to establish an automatic investment program. This program allows the fund to electronically transfer money from your bank account at predetermined times. You'll probably need to complete a separate form to establish this service if your fund company doesn't have this option listed on its original application, you didn't fill out that part when you opened the account, or you're investing through a discount brokerage firm. (See the explanation in "Filling in the blanks: Application basics" earlier in this chapter.)

If you have a pile of money sitting in a money market fund and you want to ease it (dollar-cost averaging) into mutual funds, you can use the services most fund companies and discount brokers offer for this purpose. They may have separate forms to fill out or, even better, some companies allow you to establish this service by phone after your money fund account is open. (See Chapter 10 for a discussion of the pros and cons of dollar-cost averaging.)

> If you're investing outside a retirement account into fund(s) at different points in time, here's a hint: For tax recordkeeping purposes, save your statements that detail all the purchases in your accounts. (Most mutual fund companies also provide year-end summary statements that show all the transactions you made throughout the year.)

If you don't save your statements, it won't be the end of the world — as long as you're investing through most of the larger and better fund companies, which are able to tell you your average cost per share when you need to sell. Average cost isn't the only or even necessarily the most advantageous method for you to use in determining your cost basis (see Chapter 18).

Finding Help for a Overwhelmed Brain

If you get stuck or can't deal with filling out forms — not even with the comfort and solace you get from this book — you have two safety nets:

- **Call the fund company or discount broker and ask for help.** (The number is usually listed at the top of the first page of the application.) Providing assistance is one of the many tasks those phone reps are paid to do. If you get someone who's impatient or incompetent, simply call back, and you'll get someone else. (Should this happen with the companies recommended in this book, please let me know!)

  If you're dealing with a problem that can't be solved during the first phone call and you're working with a representative on it, jot down the person's name and extension number. And don't forget to ask which office location he's in. Some of the larger fund companies route their toll-free calls to various offices, so you may not know where your call has ended up unless you ask.

- **Visit a branch office.** Accessibility is one of the reasons that branch offices exist. Some companies have them; others don't (see Chapter 9).

Chapter 17

Evaluating Your Funds and Adjusting Your Portfolio In This Chapter

▶ Understanding the finer points of fund statements ▶Translating discount brokerage firm statements ▶Figuring your funds' performance ▶Deciding whether to sell, hold, or buy more of a fund ▶Fine-tuning your portfolio as you get older After you've explored different funds, filled out the application forms, and mailed your money, the hard part is over. Congratulations! You've accomplished what millions of people are still thinking about but haven't gotten off their blessed behinds to do (probably because they haven't read this book yet).

Now that you've started investing in funds (or even if you've been doing so for years), of course, you want to know how your funds are doing — specifically, you want to know how much return your funds are generating. You may also be interested in evaluating funds you already owned before you and I met, wondering if your prior holdings are greyhounds or basset hounds.

In this chapter, I explain how to evaluate the performance of your funds and decide what to do with them over time. I also explain why most of the statements you get from fund companies make your head spin and leave you clueless as to how you're doing.

Deciphering Your Fund Statement Every mutual fund company has its own statement design. But they all

report the same types of information, usually in columns. The following sections present the type of entries you find on typical fund company statements, along with my short explanations of what they all mean.

Trade date or date of transaction The *trade date* **(or date of transaction) is the date that the mutual fund company processed your transaction. For example, if you mailed a check as an initial deposit with your account application, you can see which date the company actually received and processed your check. If the fund company receives your deposit by 4 p.m. EST, it will generally purchase shares that same day in the bond and/or stock funds that you intended the check for.**

Money market funds work a little differently than bond and stock funds. Money market fund deposits don’t start earning interest until the day after the company receives your money. The delay is due to the fact that the fund company must convert your money into federal funds.

Transaction description In the *transaction description* column, you find a brief blurb about what was actually done or transacted. In this column, you’re likely to see a few things:

- **Annual maintenance fee charge: You may see this entry, although not necessarily. (Try to pay these fees outside the account so that more of your money continues compounding inside the retirement account.)**
- **Asset transfer: This term refers to a transfer of money into your retirement account from another investment company or bank.**
- **Capital gains reinvest:** Funds may pay capital gains, and you can choose to reinvest those into purchasing more shares in the fund. In order to satisfy the IRS, capital gains are specified, for example, as short-term capital gains or long-term capital gains, for which different tax rates apply. (See Chapter 18 for the reasons the IRS cares, and the

consequences for your tax return. And check out the "Capital gains distributions" section later in this chapter for more on the subject.) ✓**Check-writing redemption:** On the statement for a money market fund, you may see such entries to show the deduction of a check that has cleared your account (should you use the option of writing checks that draw from the fund — like a checking account).

✓ **Contribution:** Often, new purchases for retirement accounts are referred to as a contribution (such as *2010 IRA contribution*).

✓ **Dividend reinvestment:** This term simply means that the fund paid a dividend that you reinvested by purchasing more shares of that same fund in your account. (See details in the section "Dividends" later in the chapter if you're not sure what a dividend is.) ✓**Income dividend cash:** If you so desire, you may receive your dividends as cash — the fund company can send a check to you, or it can electronically deposit the money into your bank checking account.

✓ **Phone exchange from so-and-so fund:** For example, if you moved money into a fund from your U.S. Treasury money market fund by phone, this item may read *phone exchange from U.S.T. money fund.*

✓ **Purchase or purchase by check:** If you mailed a deposit, you may see this notation.

Dollar amount

The *dollar amount* column simply shows the actual dollar value of the transaction. If you sent a $5,000 deposit, look to make sure that the correct amount was credited to your account. Fund companies calculate and credit the appropriate amount of dividends and capital gains to your account. There's really no need to check these distributions. At any rate, I'm not aware of a fund company making a mistake with these, other than possibly a delay (a few days beyond the promised deadline) in crediting shareholder accounts.

Share price or price per share The *share price* **(or** *price per share***) column shows the price per share that the transaction was conducted at. When you’re dealing with a** *no-load* **(commission-free) fund, such as those that I recommend in this book, you get the same price that everyone else who bought or sold shares that day received. Money market funds maintain a level price of $1 per share.**

If you’re concerned that a load was charged, check with the company to see the buy (bid) price and sell (asked) price on the day you did a purchase transaction. If a load wasn’t charged, these two prices should be identical. If a load was charged, the buy price is higher than the sell price, and the purchase on your statement was done at the buy price.

Share amount or shares transacted The *share amount* **(or** *shares transacted***) column simply shows the number of shares purchased or sold in the particular**

transaction. The number of shares is arrived at by default: The fund company takes the dollar amount of the transaction and divides it by the price per share on the date of the transaction.

For example, a $5,000 investment in a bond fund at $20 per share gets you 250 shares. You detail-oriented types will be happy to know that fund companies usually go out to three decimal places in figuring shares.

Shares owned or share balance If money was added to or subtracted from your account, the share balance changes by the amount of shares purchased or redeemed and listed in the prior section, "Share amount or shares transacted."

In one unusual instance, the number of shares in an account changes even though no transactions have occurred: when a fund *splits.* If it splits 2 for 1, for example, you receive two shares for every one that you own. This split doesn't increase the worth of the investments you own; the price per share in a 2-for-1 split is cut by 50 percent.

Why do funds split? It's a gimmick. In the world of individual securities, stock splits are often associated with successful, growing companies; likewise, mutual fund splits are usually trying to cash in on positive connotations. The fund company wants potential buyers to think that the fund has done *so* well that the company has split its shares in order to reduce the price; that way, new investors won't think that they're paying a high price. But the high price doesn't matter because fund minimum investment requirements, not the share price, determine whether you can afford to invest in a fund. (*Reverse splits* can be done as well to boost a laggard fund's price per share.) Some exchange-traded funds (ETFs) have split, which may make some sense. The reason is that ETFs trade on a stock exchange, so if an ETF's share price has risen too high, it may actually keep buyers with small amounts to invest from being able to buy some shares. (See Chapter 5 for details on ETFs.) Account value

Typically, on a different part of the account statement separate from the line-by-line listing of your transactions, fund companies show the total *account value* or market value of your fund shares as of a particular day — usually at the end of a given month. This value results from multiplying the price per share by the total number of shares that you own.

Four out of five fund investors care about total account value more than the other totals (at least, according to my scientific surveys of fund investors that I work with!). So you'd think that the fund companies would list on your statement how this value has changed over time. Well, many don't, and that's one of the reasons why examining your account statement is a lousy way to track your fund's performance over time.

Some fund companies show how your current account value compares to the value when your last statement was issued. This comparison sheds some useful light on your account's performance, but it still doesn't tell you how you've done over longer time periods (since you originally invested, for example). See the later section, "Assessing Your Funds' Returns," for how to determine your funds' performance.

Interpreting Discount Brokerage Firm Statements Discount brokerage statements may look a bit different from those that mutual fund companies produce. In a discount brokerage statement, the *portfolio overview* (summary of the value of each fund holding) and the transaction details are usually listed in separate sections. This section breaks down a typical brokerage firm statement.

Portfolio overview A *portfolio overview* **section on a brokerage account statement lists funds from your various fund companies. As on a mutual fund statement,**

the *number of shares* (quantity), *price per share* (latest price), and *market value* of the funds held as of the statement date are listed.

Brokerage statements may use terms like *long,* which simply means that you bought shares and you're holding those shares. (You may — although I don't recommend it — actually *short* shares held in nonretirement brokerage accounts. Shorting shares simply means that you sell the shares first, hope that they decline in value, and then buy them back.) You may also see the term *cash* or the letter *C* associated with your fund holdings. These items mean that this fund is a cash holding (as opposed to one purchased with borrowed money).

Account transaction details An *account transaction details* section, which summarizes any transactions occurring on your fund holdings since the last statement, often confuses people because transactions seem to be repeated. The apparent repetition occurs because of the silly accounting system of debits and credits that brokerage firms use.

For example, you might see a line item for one of your funds that shows that 5.953 shares of the fund were purchased at $9.80 per share for a total purchase of $58.34. Where did this odd amount of money come from for the purchase? The next line on the statement tells you the fund paid a dividend of $58.34. It'd be logical and more understandable if these two lines were reversed, wouldn't it? First the money comes in, and then it's reinvested into purchasing more shares!

Assessing Your Funds' Returns

Probably the single most important issue that fund investors care about — how much or little they're making on their investments — isn't easy to figure from those blasted statements that fund companies send you. That is, it isn't easy to figure unless you know the tricks regarding what to look for and what to ignore.

If you've just started investing in funds — or even if you've held funds a long time — you need to realize that what happens to the value of your stock and bond funds in the short term is largely a matter of luck. Don't get depressed if your fund or funds drop in value the day after you buy them or even over the first three or six months. When you invest in bond and stock funds, you should focus on returns produced over longer periods — periods of at least one year and preferably longer.

Getting a panoramic view: Total return The *total return* of a fund is the percentage change in the overall value of your investment over a specified period. For example, a fund may tell you that its total return during the year that just ended December 31 was 15 percent. Therefore, if you invested $10,000 in the fund on the last day of December of the prior year, your investment is worth $11,500 after the year just ended.

This section explains the three components that make up the total return on a fund: dividends, capital gains distributions, and share price changes. These are the three ways you can make money in a mutual fund.

Dividends

Dividends are income paid by investments. Both bonds and stocks can pay dividends. As I explain in Chapter 12, bond fund dividends (which come from the interest paid by bonds) tend to be higher than stock fund dividends. When a dividend distribution is made, you can receive it as cash (which is good if you need money to live on) or reinvest it into more shares in the fund. In either case, the share price of the fund drops by an amount that exactly offsets the payout. So if you’re hoping to strike it rich by buying into funds just before their dividends are paid, don’t bother. All you may accomplish is increasing your income tax bill!

If you hold your mutual fund outside a retirement account, the dividend distributions are taxable income (unless they come from a tax-free municipal bond fund). When you’re ready to buy into a fund outside a retirement account that pays a decent dividend, you may want to check to see when the fund is next scheduled to pay it out. For funds that pay quarterly taxable dividends (such as balanced or hybrid funds), you may want to avoid buying in the weeks just prior to a distribution (which is usually late in each calendar quarter).

Capital gains distributions When a stock or bond mutual fund manager sells a security in the fund, any gain realized from that sale (the difference between the sale price and the purchase price) must be distributed to fund shareholders as a *capital gain.* **(Gains offset by losses — so called** *net gains* **— are what actually get distributed.) Typically, funds make one annual capital gains distribution in December. Some funds make two per year, typically making the other one mid-year.**

As with a dividend distribution, you can receive your capital gains distribution as cash or use it to buy more shares in the fund. In either case, the share price of the fund drops by an amount to exactly offset the distribution.

For funds held outside retirement accounts, all capital gains distributions are taxable. As with dividends, capital gains are taxable whether or not you reinvest them into additional shares in the fund.

Before you invest in bond and stock funds outside retirement accounts, determine when capital gains are distributed if you want to avoid investing in a fund that's about to make a capital gains distribution. (Stock funds that appreciated greatly during the year and that do significant trading are most likely to make larger capital gains distributions. Money funds don't ever make these distributions.) Investing in a fund that will make a distribution soon increases your current-year tax liability for investments made outside retirement accounts. About a month before the distribution, fund companies should be able to estimate the size of the distribution.

Share price changes

You also make money with a mutual fund when the share price increases. This occurrence is just like investing in a stock or piece of real estate. If your fund is worth more today than when you bought it, you have made a profit (on paper, at least). To realize — or lock in — this profit, you need to sell your shares in the fund. A fund's share price increases if the securities that the fund has invested in have appreciated in value.

Tallying the total return

After you've seen all the different components of total return, you're ready to add them all up. For each of the major types of funds that I discuss in this book, Table 17-1 presents a simple summary of where you can expect most of your returns to come from over the long term. The funds are ordered in the table from those with the lowest expected total returns and share price volatility to those with the highest.

Table 17-1 Components of a Fund's Returns

Funds	Dividends	+ Capital Gains	+ Share Price	= Total Return

			Changes	
Money market funds	All returns come from dividends	None	None	Lowest expected returns but principal risk is nil
Shorter term bond funds	Moderate	Low	Low	Expect better than money funds but more volatility
Longer term bond funds	High	Low to moderate	Low to moderate	Expect better than short-term bonds but with greater volatility
Stock funds	None to moderate depending on stock types	Low to high depending on trading patterns of fund manager	Low to high	Highest expected returns but most volatile

Focusing on the misleading share price You probably know someone who’s always glued to his computer screen or favorite wireless mobile device to check on the share prices of individual stocks and how much they’ve gone up or down.

Unfortunately, mutual fund share prices are also reported on various financial Web sites and through other media outlets. I say “unfortunately” because all too many fund investors, perhaps taking a cue from individual-stock owners, look to daily or other short-term-oriented sources of fund pricing information.

If you follow the price changes in your fund(s) every day, week, month, or other time period, you won’t know how your fund is doing. Referring to Table 17-1, you can see that share price is but one of the three components that make up your total return. And to make matters worse for the share-price hawks, another one of the three components — dividends — directly affects share price. When a fund makes a distribution to you, you get more shares of the fund. But distributions create an accounting problem because they reduce the share price of a fund by the exact amount of the distribution. Therefore, over time, following just the share price of your fund doesn't tell you how much money you've made or lost.

The only way to figure out exactly how much you've made or lost on your investment is to compare the *total value* of your fund holdings today to the total dollar amount you originally invested. If you've invested chunks of money at various points in time, this exercise becomes much more complicated. (Some of the investment software I recommend in Chapter 21 can help if you want your computer to crunch the numbers. Frankly, though, you have easier, less time-consuming ways to get a sense of how you're doing.)

How often should I check on my funds?

I recommend that you *don't* track the share prices of your funds every day. It's time consuming and nerve-racking and can make you lose sight of the long term. Worse, you'll be more likely to panic when times get tough. A weekly, monthly, or even quarterly checkin is more than frequent enough to follow your funds. I know many successful investors who check on their funds' performance twice or even just once a year.

If you do check your funds more often, one day, usually soon after you talk with a friend and mention how pleased you are with your fund's returns, you'll receive a rude awakening. "It dropped $1.21 per share!" That's what one of my clients said to me after noticing the price of one of her international stock funds in December. Guess what? The fund made a distribution that reduced the price per share but increased the number of shares. So she wasn't losing money after all.

If you follow your funds through the daily newspaper and you see such a large price drop, look again to see if any special letters are printed after the fund's name, such as *x,* which indicates that a fund paid its dividend, and *e* for payment of a capital gains distribution.

Figuring total return As I mention in the “Account value” section earlier in the chapter, fund companies make determining your total return in the fund from the information they provide on their statements almost impossible for you.

Regardless of the time period over which you’re trying to determine your funds’ total return, here are the simplest ways to figure total return without getting a headache: ✓**Call the fund company’s toll-free number or visit its Web site.** The telephone representatives can provide you with the total return for your funds for various lengths of time (such as for the last three months, the last six months, the last year, the last three years, and so on). Most fund companies post similar information on their Web sites as well.

- ✓ **Examine the fund’s annual and semiannual reports.** These reports provide total return numbers.
- ✓ **Keep a file folder with your investment statements.** That way, you can look up the amount you originally invested in a fund and compare it to updated market values on new statements you receive. You can make a handwritten table or enter the figures in the software I describe in Chapter 21.
- ✓ **Check fund information services and periodicals.** Fund information services and financial magazines and newspapers carry total return data at particular times during the year. Some, such as *The Wall Street Journal,* carry this information daily. See my favorite Web sites in Chapter 21.

If you’ve made numerous purchases in a fund, you may want to know your effective rate of return when you also factor in the timing and size of each purchase. The only way to make this calculation is with software. However, you don't need to know the exact rate of return for your overall purchases in order to successfully evaluate your fund investments. Comparing your funds' performance over various time periods to relevant *performance benchmarks* is sufficient. (I explain how to do just that in the next section.)

Examining online charts of mutual fund prices over time on financial Web sites provides an inaccurate picture of a fund's total return. The reason is that most online charting services fail to correct for the effect of fund distributions (for example, capital gains and dividends). Take a simple example of a fund that begins the year at $20 per share and in late December is at $22 per share. Thus, it has increased 10 percent. However, further suppose it makes a distribution of $2 per share and thus ends the year at $20 per share. With an online chart, it would appear that the fund dropped sharply at year-end and provided no return for the year when in fact shareholders were rewarded with a 10 percent return. (Charts on fund company sites that show the change in value of an investment in a particular fund correct for this problem and do accurately show the returns of a fund over time.)

Which total return figures are best for the long term?

Fund companies typically report fund total returns in one of two ways. The *absolute return* measures the total percentage increase from the beginning to the end of the time period being looked at. The *annualized return* measures the average increase *per year* during the specified time period. Over a five-year period, for example, the absolute return of the Blue Chip Stock fund may be 98 percent, which translates to an annualized return of about 14.6 percent.

Don't be fooled by a more impressive-sounding absolute return. Remember, both numbers are measuring the same real return. Beware of fund companies that exploit the eye-catching qualities of absolute return numbers to make themselves look good in their marketing literature: 200 percent, 300 percent! Sounds spectacular, but it doesn't mean anything unless the time period and the performance of comparable funds and benchmarks are taken into account. If the time period is long enough, just about any fund's absolute return figure, especially if it's for a stock fund, is impressive looking, even if it's actually below average.

Annualized return numbers are much more useful for comparative purposes. Because a time factor — per year — is built in to the number, a glance at the annualized return gives you a much better idea of how a fund has performed and a much easier time comparing that performance to similar funds for similar time periods.

Assessing your funds' performance

Whenever you examine your funds' returns, compare those returns to appropriate *benchmark indexes.* **Although many stock market investors may have been happy to earn about 10 percent a year with their investments during the 1980s and 1990s, they really shouldn't have been because the market averages or benchmark indexes were generating about 15 percent per year.**

REMEMBER

You should compare each mutual fund to the most appropriate benchmark given the types of securities that a fund invests in. For the bond and stock funds that I recommend in Chapters 12, 13, and 14, I provide descriptions of the types of securities that each fund invests in. The following sections offer a brief rundown of the benchmark indexes you'll find useful. (I present benchmarks for the types of funds most people use for longer term purposes, such as retirement account investing.) Don't get too focused on performance comparisons. Indexes don't incur expenses that an actual mutual fund does although, as you may know, expenses among funds vary tremendously. Remember all the other criteria — such as the fees and expenses and the fund company's and manager's expertise — that you should evaluate when you consider a fund's chances for generating healthy returns in the years ahead (see Chapter 7).

Bond benchmarks

A number of bond indexes exist (see Table 17-2) that differ from one another mainly in the maturity of the bonds that they invest in; for example, short-term, intermediate-term, and long-term indexes.

Table 17-2 Bond Indexes

Year	Barclays Short-Term Bond Index	Barclays Intermediate-Term Bond Index	Barclays Long-Term Bond Index	Barclays U.S. GNMA Index	Barclays High Yield (Junk Bond) Index
2000	8.9%	12.4%	16.2%	11.1%	–5.9%
2001	9.0%	8.8%	7.3%	8.2%	5.3%
2002	8.1%	13.0%	14.8%	8.7%	–1.4%
2003	3.4%	6.0%	5.9%	2.9%	29.0%
2004	1.9%	5.3%	8.6%	4.4%	11.1%
2005	1.4%	1.8%	5.3%	3.2%	2.7%
2006	4.2%	3.8%	2.7%	4.6%	11.9%
2007	6.1%	5.0%	3.6%	7.0%	1.9%
2008	–1.1%	–4.7%	–3.9%	7.9%	–26.2%
2009	13.5%	19.0%	16.8%	5.4%	58.2%
5-year annualized average	4.8%	4.7%	4.5%	6.0%	7.8%

10-year annualized average	5.9%	7.0%	7.5%	6.3%	7.4%

Many more specialized indexes exist than those listed in Table 17-2; for example, indexes for municipal bonds, treasury bonds, and so on. So if you're looking at these different types of funds, take a look in the fund's annual report to see which index it compares the fund's performance to. But don't assume that it's using the most comparable index.

U.S. stock benchmarks

The major U.S. stock indexes (see Table 17-3) are distinguished by the size of the companies (large, small, all sizes, and so on) whose stock they're tracking. The Standard & Poor's 500 index tracks the stock prices of 500 large-company stocks on the U.S. stock exchanges. These 500 stocks account for more than 70 percent of the total market value of all stocks traded in the United States. The MSCI 1750 index tracks 1,750 smaller company U.S. stocks. The MSCI Broad Market index tracks all stocks of all sizes on the major U.S. stock exchanges.

Table 17-3 U.S. Stock Indexes

Year	Standard & Poor's 500 Index	MSCI U.S. Small Cap 1750 Index	MSCI Broad Market Index
2000	–9.1%		
2001	–11.9%		
2002	–22.1%		
2003	28.7%		
2004	10.9%		
2005	4.9%	7.5%	6.4%
2006	15.8%	15.8%	15.7%
2007	5.5%	1.2%	5.6%
2008	–37.0%	–36.2%	–37.0%

2009	26.5%	36.1%	28.8%
5-year annualized average	0.4%	1.8%	1.0%
10-year annualized average	-0.9%	n/a	n/a

If you're evaluating the performance of a fund that invests solely in U.S. stocks, make sure to choose the index that comes closest to representing the types of stocks that the fund invests in. Also, remember to examine a stock fund's international holdings. Suppose, for example, that a particular stock fund typically invests 80 percent in U.S. stocks of all sizes and 20 percent in the larger, established countries overseas. You can create your own benchmark index by multiplying the returns of the MSCI Broad Market index by 80 percent and the Morgan Stanley EAFE international index (which I discuss in the next section) by 20 percent, and then adding them together.

International stock benchmarks When you invest in funds that invest overseas, you should use a comparative index that tracks the performance of international stock markets. The *Morgan Stanley EAFE* **(which stands for Europe, Australia, and Far East) index tracks the performance of the more established countries' stock markets. Morgan Stanley also has an index that tracks the performance of the emerging markets in Southeast Asia and Latin America (see Table 17-4).**

Table 17-4 International Stock Indexes

Year	Morgan Stanley EAFE	Emerging Markets
2000	–14.2%	–31.8%
2001	–21.4%	–4.9%
2002	–15.9%	–8.0%
2003	38.6%	51.6%
2004	20.3%	26.7%

2005	13.5%	32.8%
2006	26.3%	29.7%
2007	11.2%	39.4%
2008	–43.4%	–53.3%
2009	31.8%	78.5%
5-year average	4.0%	15.9%
10-year average	1.6%	10.1%

You should know that emerging markets are volatile and risky. As I discuss in Chapter 13, diversified international funds that invest in both established and emerging markets offer a smoother ride for investors who want some exposure to emerging markets. More-diversified funds also aren't as constraining on a fund manager who believes, for example, that emerging markets are overpriced.

If you do invest in the more diversified international funds that place some of their assets in emerging markets, remember that it's not fair to compare the performance of those funds solely to the EAFE index. So how do you fairly compare the performance of this type of fund? Well, if an international fund typically invests about 20 percent in emerging markets, then multiply the EAFE return in the table by 80 percent and add to that 20 percent of the *Emerging Markets* index return. For 2009, for example: 0.318(0.8) + 0.785(0.2) = 0.411, or 41.1 percent. With this computation formula, you can see how any international fund that invested in emerging markets in 2009 couldn't help but look good in comparison to the EAFE index. (The numbers in Table 17-4 also suggest why you shouldn't be too impressed with an emerging markets fund that boasted of a 60 percent return in 2009 — if it did, it was well below average!)

The hard part is finding out the percentage of assets a fund typically has invested in emerging markets. Some international funds don't report the total of their investments in emerging markets. For the international funds I recommend in Chapter 13, I provide some general idea of the portion they've invested in emerging markets.

Also, you can peek at a fund’s recent annual or semiannual report, in which the fund managers detail investments held for each country.

Deciding Whether to Sell, Hold, or Buy More

Investors often ask me, “How do I know when I should sell a fund?” The answer is relatively simple: *Sell only if a fund is no longer meeting the common-sense criteria* **(which I outline in Chapter 7)** *for picking a good fund in the first place.* **Stick by your fund like a loyal friend as long as it is**

- **Generating decent returns relative to appropriate benchmarks and the competition (Even one or two years of slight underperformance are okay if the fund’s five-and ten-year numbers are**

still comparatively good.) ✓Not raising the fees that it charges and not charging more than the best of the competition ✓Still managed by a competent fund manager The only other reason to sell a fund is if your circumstances change. For example, suppose that you're 50 years old, and you inherit a big pot of money. You hadn't been planning to retire early, but with oodles of money suddenly at your disposal, maybe now you're thinking that early retirement isn't such a bad idea after all. This change in circumstances may cause you to tweak your portfolio so that you have more income-producing investments and fewer growth investments.

This section deals with two special situations that require further thought and reflection: down markets and the acquisition of your funds by another company.

Handling bear markets

No one enjoys losing money. Most people find it unpleasant and at times stressful. If you follow my advice in the rest of this book, you know that I advocate building a diversified portfolio of funds and investing for the long term, not tomorrow. Eventually, you'll suffer a down period. Anyone who was investing in the early 2000s and late 2000s understands firsthand that stocks and stock mutual funds can drop significantly. So for handling such *bear* (down) markets in your funds, here is my advice:

- **Don't watch your funds too closely.** Tracking your fund's prices daily or even weekly is sure to make you a nervous wreck if you're doing so because you fear a market slide. Don't dwell on

daily news reports of the latest stock market gyrations. Remember that you're investing for future years, not next week and next month.

- **See the glass as half full, not half empty.** When certain types of funds that you own decline in value, don't get depressed. If you're still feeding new money into purchases (or perhaps reinvesting distributions), remind yourself that your next purchases will be at lower prices. If you're retired and not making more purchases, you surely have the wisdom that good days and periods follow difficult ones. Be patient for improvement.
- **Look at your portfolio's performance, not individual funds.** The whole point of diversifying is so that some of your funds may go up while others are down. So, when some of your funds do decline, remember to assess the performance of your entire portfolio, and you may be pleasantly surprised that things aren't as bad as you may have thought.
- **Buy value (and different assets) if you dislike volatility.** Stock funds that focus on value-oriented stocks (please see Chapter 13) tend to be less volatile. You can also dampen the gyrations in your portfolio by investing in different types of assets (bonds, real estate, and so on).

Dealing with fund company consolidations The fund industry is increasingly competitive, and some fund companies (usually those of the larger variety) swallow other (usually smaller) fund companies.

Such mergers can lead to problems, but you can steer clear of them:

- **Financial firms, including fund companies, have been known to put deposits into the wrong account or to lose track of certain accounts altogether. During the transition period, be vigilant about ensuring that your account information, including recent transactions and current balances, is correct.**
- The new parent company in a merger may jack up fees or make other unfavorable changes to your fund. Use the straightforward criteria that I outline earlier in this section to determine what you should do post-merger.

Tweaking and Rebalancing Your Portfolio

Over longer periods of time, you may need to occasionally adjust your portfolio to keep your investment mix in line with your desires. Unless you experience a major change in your circumstances,

I advocate adjusting your investment mix every three to five years (see Chapter 10). Suppose that at the age of 40, you invest about 80 percent of your retirement money in stock funds with the balance in bonds. By the age of 45, you find that the stock funds now comprise an even larger percentage (maybe 85 percent) of your investments because they've appreciated more than the bond funds have. *You* are also appreciating (in age, that is) and should in fact be reducing your stock allocation as you get older.

Using the asset allocation guidelines in Chapter 10, you decide that at the age of 45, you now want to have about 75 percent of your money in stock funds. The solution is simple: Sell enough of your stock funds to reduce your stock holdings to 75 percent of the total and invest the proceeds in the bond funds. Don't forget to factor in the tax consequences when you contemplate the sale of funds held outside retirement accounts (see Chapter 18).

Trying to time and trade the markets to buy at lows and sell at highs rarely works in the short term and never works in the long term. If you do a decent job *upfront* of picking good fund companies and funds to invest in, you should have fewer changes to make over the long haul.

If you have a good set of funds, keep feeding money into them as your savings allows. As your portfolio value grows, add a new fund or two to broaden your overall mix. Holding a couple (or several) of each different type of fund makes a lot of sense. (I cover the common sense of fund diversification in much depth in Chapter 10.) Don’t end up with 50 funds though — you won’t keep up with what they’re doing and reviewing their reports.

Chapter 18

The Taxing Side of Mutual Funds

In This Chapter

- Checking out Form 1099-DIV and distributions from mutual funds
- Understanding the issues of selling funds
- Browsing Form 1099-R and retirement fund withdrawals

You invest in mutual funds to make money. But guess who starts licking his chops when he hears about money being made? That's right: good ol' Uncle Sam. And state governments, too. (In Chapter 17, I explain the different ways that mutual funds can make you money: either through distributions (capital gains and dividends) or through appreciation. If the fund that made the money is being held outside a tax-sheltered retirement account, federal and state governments will demand a portion of your fund's distributions and of your profits when you sell shares in a fund for more than you paid for them.)

Once each year, the mutual fund companies or brokerage firms where you're holding funds send you one or more tax forms that tell you how much taxable money you made on your mutual funds held outside of retirement accounts. (Remember, you don't need to file anything with funds held inside retirement accounts.) Come April (or whenever you get around to completing your tax returns), you must transfer the information on these fund-provided tax forms to your income tax return, where you calculate how much tax you actually owe on the money you made from your mutual funds.

If you cringed when you read the words *tax forms,* you've obviously battled these ugly beasts. I sometimes wonder if the people who write tax forms come from another planet — that would perhaps explain their use of what appears to be a nonhuman form of communication. But don't despair. I devote this entire chapter to helping you interpret the hieroglyphics on these sometimes intimidating documents.

Just for toughing out this chapter, you get a few rewards. I show you how to use a fund's tax forms to help you discover whether your mutual fund money is being invested in the most tax-friendly way. I also give you some tips on reducing your tax bill if you have to sell some mutual funds.

Mutual Fund Distributions Form: 1099-DIV

If you're an employee of a company, you're probably familiar with IRS Form W-2, that little piece of paper that comes in late January or early February and sums up the amount of money your employer paid you over the previous year. You're required to report this income on your income tax return.

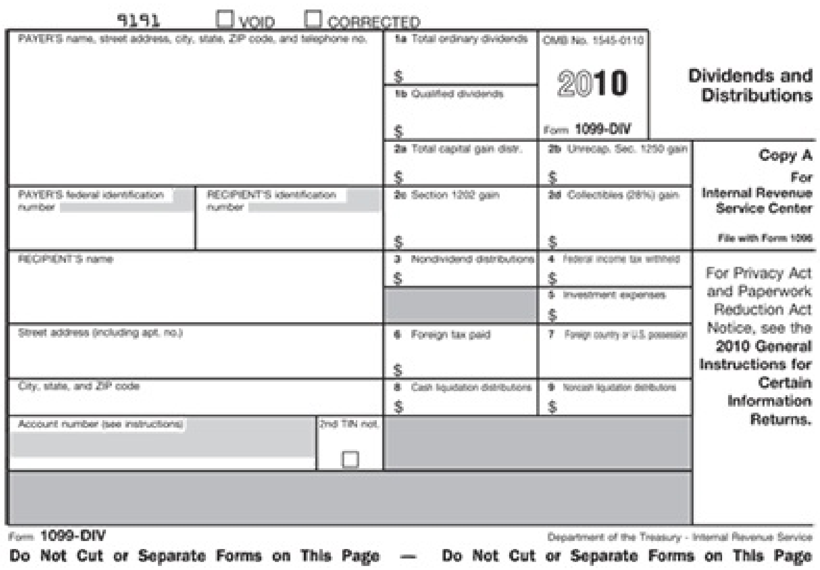
Form 1099-DIV is similar to a W-2, but instead of reporting income from an employer, it reports income from mutual funds that you hold outside of retirement accounts. By income, I mean capital gains and dividend distributions, which I explain in Chapter 17.

Like the W-2, Form 1099-DIV should arrive in your mailbox in late January or early February. You should get one for every nonretirement account you held money in during the tax year. Call the responsible company if you don't get one for an account that you think you should. (And if you're tired of receiving these forms from so many fund companies, visit Chapter 9, where I explain the paperwork-friendly benefits of consolidating your mutual fund holdings into a discount brokerage account.)

Also like the W-2, a copy of each of your 1099-DIVs is sent to the IRS and your state authorities, so don't get any ideas about fudging the information on your tax return.

Figure 18-1 is a sample Form 1099-DIV, which I use to walk you through the form. First, notice that the distributions are divided into various boxes. (Actually, most mutual fund companies display this information in columns, but they're still called boxes.) This division is done because different parts of your distributions are taxed at different rates, and the IRS wants to know what is what.

Jump in to these boxes and see what you find. In the following sections, I discuss the boxes that pertain to mutual funds.



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PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Total ordinary dividends $	OMB No. 1545-0110 2010 Form 1099-DIV	Dividends and Distributions
		1b Qualified dividends $		
		2a Total capital gain distr. $	2b Unrecap. Sec. 1250 gain $	Copy A For Internal Revenue Service Center File with Form 1096
PAYER'S federal identification number	RECIPIENT'S identification number	2c Section 1202 gain $	2d Collectibles (28%) gain $	
RECIPIENT'S name		3 Nondividend distributions $	4 Federal income tax withheld $	For Privacy Act and Paperwork Reduction Act Notice, see the 2010 General Instructions for Certain Information Returns.
			5 Investment expenses $	
Street address (including apt. no.)		6 Foreign tax paid $	7 Foreign country or U.S. possession	
City, state, and ZIP code		8 Cash liquidation distributions $	9 Noncash liquidation distributions $	
Account number (see instructions)	2nd TIN not. ☐			

Form 1099-DIV Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

Figure 18-1: Form 1099-DIV reports dividends and capital gains your funds paid.

Box 1a: Total ordinary dividends

All types of mutual funds pay dividends, which account for all of a money market's return, most of a bond fund's return, and part of a stock fund's return. Thanks to tax laws passed in 2003, dividends paid by stocks are taxed at the same reduced tax rate that applies to long-term capital gains, which I discuss in just a bit. Stock dividends are termed *qualified dividends* and reported in Box 1b (discussed in the next section). Thus, Box 1a only includes dividends from taxable money market and bonds that are held by mutual funds.

Untrue to its name, however, ordinary dividends also include *short-term capital gains distributions* — profits from securities that the mutual fund bought and sold within a year. These short-term capital gains are lumped together with your dividend income because they're both taxed at your ordinary income tax rate.

The distributions reported as ordinary dividends are taxed at your highest possible rate: up to 35 percent on your federal income tax return depending on your annual income. If you're in a higher tax bracket, you don't want to see big ordinary dividends. You'd be better off with investments that don't produce so much taxable income. (Chapters 11 and 12 explain how to select tax-friendly money market and bond funds.) For stock mutual funds, if you're seeing big ordinary dividends, your fund must be making a lot of short-term trades. Outside of retirement accounts, regardless of your tax bracket, you have no reason to own mutual funds that generate a lot of short-term capital gains. Chapter 13 gives recommendations for tax-friendly stock funds.

Box 1b: Qualified dividends

Qualified dividends include dividends paid by corporations to their stockholders (stock dividends). If you're in the 10 or 15 percent federal income tax bracket, qualified (stock) dividends are tax-free — a 0 percent tax rate! For those in the higher federal tax brackets, the qualified dividend tax rate is 15 percent.

Box 2a: Total capital gains distributions

Because short-term capital gains are reported in Box 1a, this box would be more appropriately called "Long-term capital gains distributions," which are profits from securities sold more than 12 months after their purchase. Long-term capital gains are taxed at a lower rate than regular income, taxable money market and bond dividends, and short-term capital gains. The federal tax rate on long-term gains is 15 percent for those in an ordinary tax bracket of 25 percent or higher and long-term capital gains are tax-free for those in the 10 or 15 percent ordinary tax brackets.

You can count the lower tax rate on long-term capital gains as one more benefit of the buy-and-hold investing strategy (see Chapter 10). Not only does this strategy typically generate higher returns than short-term trading, but also for investments held outside of retirement accounts, it's gentler on your tax bill. The tax relief and the potential for higher returns are why mutual funds that tend to buy and hold their securities are preferable for nonretirement accounts.

Box 3: Nondividend distributions

You rarely see numbers in the *nondividend distributions* section of Form 1099-DIV. This box is where funds report if they made distributions during the year that repaid a shareholder's original investment. Like the principal returned to you if a bond or CD you've invested in matures, this chunk of money isn't taxable.

For shares held outside of retirement accounts, these nondividend distributions factor into your computation of the gain or loss when the shares are sold. For purposes of calculating any gain, if and when you sell these shares, you must subtract nondividend distributions from the amount you originally paid for these shares.

Box 4: Federal income tax withheld

If your funds report that federal income tax was withheld, that can be bad news. It means that you're being subjected to the dreaded *backup withholding.* If you don't report all your mutual fund dividend income (or don't furnish the fund company with your Social Security number), your future mutual fund dividend income is subject to backup withholding of *28 percent!* To add insult to injury, in the not-too-distant future, you'll receive a nasty notice from the IRS listing the dividends you didn't report. You end up owing interest and penalties.

Find out right away what's going on here. Either you or the IRS could've made a mistake. Perhaps you didn't provide a correct Social Security number or you've been negligent in reporting your previously earned taxable income to the IRS. Fix this problem as soon as you can. Call the IRS at (800) 829-1040.

Don't despair about the tax that your fund withheld. The withholding wasn't for nothing — you'll receive credit for it when you complete your Form 1040 on the line "Federal income tax withheld."

Box 6: Foreign tax paid

If you invest in an international mutual fund, the fund may end up paying foreign taxes on some of its dividends. The foreign taxes paid by the fund are listed on Form 1099-DIV because the IRS allows you two ways to get some of this money back. You can choose one of the following:

- Deduct the foreign tax you paid on Schedule A (the "Other taxes" line), as long as you have enough deductions to itemize on Schedule A.

- Claim a credit on Form 1040 (“Foreign tax credit” line).

Because a credit is a dollar-for-dollar reduction in the tax that you owe, the latter move may save you more taxes — but it may also be more of a headache because you may need to complete *another* IRS form, Form 1116, which is a doozy. However, if the total foreign taxes you pay are $300 or less ($600 or less for a married couple filing jointly), you can claim the credit directly on Form 1040 without having to fill out Form 1116.

Get out last year’s tax return

With all the fuss and muss over mutual fund distributions, you should note how the rest of your nonmutual-fund investments are positioned. Although taxes aren’t everything, you may be paying much more than you need to.

Look at your Form 1040 to see how much taxable interest income you had to pay tax on. On Forms 1040 and 1040A, this figure goes on line 8a. If you filed 1040EZ (don’t you just love that name?), the figure goes on line 2.

Now find out the rate of interest (percent yield) paid that generated this interest income. If it came from money in a bank account, odds are quite good that you could be earning more in a money market mutual fund (see Chapter 11).

When You Sell Your Mutual Fund Shares

Besides distributions, the other way to make money with a mutual fund is through appreciation. If the price of your shares moves higher than the price at which you bought them, your investment has appreciated. Your profit is the difference between the amount you paid for the investment and the amount the investment is currently worth. For investments held outside of retirement accounts, that profit is taxable.

However, you don't actually owe any tax on the appreciation until you sell the shares and lock up your profit. Then you must report that profit on that year's tax return and pay capital gains tax on it. Conversely, when you sell a fund investment at a loss, it's generally tax deductible. You should understand the tax consequences of selling your fund shares and always factor taxes into your selling decisions.

What's confusing to some people about this talk of capital gains and losses is that each year your fund(s) may have been paying you capital gains distributions (see the preceding section) which you also owed tax on. So you may rightfully be thinking, "Hey! I'm being taxed twice!"

It's true that you're being taxed twice but not on the same profits. You see, the profits the fund distributed, which resulted from the fund manager selling securities in his fund at a profit, are different from those profits that you realize by selling your shares.

You have no control over fund distributions. They happen at regular intervals — at least once a year — whether you like it or not, and you must pay taxes on them when they occur from nonretirement account holdings. Taxes on fund appreciation, on the other hand, can be indefinitely delayed if you choose. As long as you hold the investment and don't sell it, the federal and state governments can't get their hands on the profit — one more advantage of buy-and-hold investing. In fact, if you hold an appreciated asset outside of retirement accounts, that asset can be transferred at your death to your heirs, and the capital gain is eliminated for tax purposes. Of course, the other way to avoid taxes on mutual fund profits is to hold them inside retirement accounts; then you don't owe taxes at all (until, of course, you start taking retirement withdrawals).

Introducing the "basis" basics

Suppose that you sell a mutual fund. In order to compute the taxable capital gain or the deductible capital loss, you have to compute your fund's tax basis. *Basis* is the tax system's way of measuring the amount you originally paid for your investment(s) in a mutual fund. I say investments (plural) because you may not have made all your purchases in a fund at once; you may have reinvested your dividends or capital gains into buying more shares or simply bought shares at different times by sending the fund company additional money. For example, if you purchase 100 shares of the It's Gotta Rise mutual fund at $20 per share, your cost basis is $2,000, or $20 per share. Simple enough.

But now suppose that this fund pays a dividend of $1 per share (so that you get $100 in dividends for your 100 shares) and suppose further that you choose to reinvest this dividend into purchasing more shares of the mutual fund. The price of shares has gone up to $25 per share since your original purchase, so the reinvested $100 buys you four new shares. You now own 104 shares, which, at $25 per share, are worth $2,600.

But what's your basis now? Your basis is your original investment ($2,000) plus subsequent investments ($100) for a total of $2,100. Thus, if you sold all your shares at $25 per share, you'd have a taxable profit of $500 (current value of $2,600 less $2,100 — the total amount invested or basis).

For recordkeeping purposes, save your statements detailing the purchases in your accounts. Most mutual fund companies provide year-end summary statements that show all transactions throughout the year. Thanks to their computer systems, fund companies also should be able to tell you your average cost per share when you need to sell your shares. As I discuss in the following sections, using the average cost method isn't necessarily the optimal method to minimize your taxes.

Accounting for your basis

If you understand the concept of basis for your fund investments (see the preceding section), you can put that understanding to work. Here I introduce you to the different ways that taxpayers commonly use (and that the IRS approves) to calculate a basis when selling nonretirement account mutual fund investments.

If you sell all your shares of a particular mutual fund that you hold outside a retirement account at once, you can ignore this issue. (After reading through the accounting options that the IRS offers, you'll probably feel that you have more incentive to sell all your shares in a fund at once!)

Be aware that after you elect one of the following tax accounting methods for selling shares in a particular fund, you can't change to another method for the sale of the remaining shares. Regardless of the method you choose, your mutual fund capital gains and capital losses are recorded on Schedule D of IRS Form 1040.

Regardless of which tax cost accounting method you choose for your fund sales, be careful not to overpay your capital gains tax when completing your annual tax return. Remember that the maximum tax rate for long-term capital gains (investments held more than 12 months) is 15 percent (tax-free if you're in the 10 or 15 percent federal tax bracket). Be sure to complete all the relevant portions of IRS Form 1040 Schedule D.

Specific identification method

The first fund basis option that the IRS allows you to use when you sell a portion of the shares of a fund is the *specific identification* method. Here's how it works. Suppose that you own 200 shares of

Global Interactive Couch Potato fund (you laugh — but there really was a fund with a name similar to this!), and you want to sell 100 shares. Suppose further that you bought 100 of these shares ten years ago at $10 per share and then another 100 shares two years ago for $40 per share. (To keep this example simple, I'm assuming that you didn't make any other purchases from reinvestment of capital gains or dividends.) Today, the fund is worth $50 per share. (Being a couch potato has its rewards!)

Which 100 shares should you sell? The IRS gives you a choice. You can identify the *specific* shares that you sell. With your Global Interactive Couch Potato shares, you may opt to sell the last or most recent 100 shares you bought — or some combination of shares from each purchase that totals 100. (Selling the most recent shares will minimize your tax bill because you purchased these shares at a higher price.) If you sell this way, you must identify the specific shares you want the fund company (or broker holding the shares) to sell. To identify the 100 shares to be sold, use either or both of the following ways:

- Original date of purchase
- Cost when you bought the shares

You may wonder how the IRS knows whether you specified shares before you sold them. Get this: The IRS doesn't know. But if you're audited, the IRS will ask for proof that you identified the shares to be sold before you sold them. It's best to put your sales request to the fund company in writing and keep a copy for your tax files.

Although you can save taxes today if you specify selling the shares that you bought later at a higher price, don't forget (the IRS won't let you) that when you finally sell the other shares, you owe taxes on the larger profit. The longer you expect to hold these other shares, the greater your chances of earning more money when you sell (and thus owing more in taxes). Of course, you always run the risk that Congress raises tax rates in the future or that your particular tax rate rises.

The “first-in-first-out” method

Another method of accounting for which shares are sold is the method the IRS forces you to use if you don’t specify before the sale which shares you want to sell: the *first-in-first-out* (FIFO) method. FIFO means that the first shares you sell are simply the first shares that you bought. Not surprisingly, because most stock funds appreciate over time, the FIFO method leads to paying more taxes sooner. In the case of the Global Interactive Couch Potato fund, FIFO considers that the 100 shares sold are the 100 that you bought ten years ago at the bargain-basement price of $10 per share.

The average cost method

Had enough of fund accounting? Well, unfortunately, we’re not done yet. The IRS, believe it or not, allows you yet another fund accounting method: the *average cost method*. If you bought shares in chunks over time and/or reinvested the fund distributions (such as from dividends) into more shares of the fund, then tracking and figuring which shares you’re selling could be a real headache. So the IRS allows you to take an average cost for all the shares you bought over time.

If you sell all your shares of a fund at once, you use the average cost basis method. You may also prefer this method when you sell a portion of a fund that you hold. Because many fund companies calculate this number for you, you can save time and possible fees paid to a tax preparer to crunch the numbers.

Deciding when to take your tax lumps or

deductions

If funds held outside of retirement accounts increase in value, you won't want to sell them because of the tax bite. If, on the other hand, they decline in value, you may not know whether to sell them and, thus, lock in your losses. So how do you decide what to do and what role taxes should play in your decisions? As I discuss in Chapter 17, several issues can factor into your decision to sell a fund or hold on to it. Taxes are an important consideration. So, what do you need to know about them?

Cashing in long-term gains and keeping taxes low

You do need to realize that taxes are important, but don't let them keep you from doing something you really want to do. Suppose, for example, that you need money to buy a home or take a long-postponed vacation — and selling some mutual funds is your only source of money for this purpose. I say go for it. Even if you have to pay state as well as federal taxes totaling, say, 20 percent of the profit, you'll have a lot left over. Before you sell, however, do some rough figuring to make sure that you have enough money to accomplish your goal. Remember, you pay far lower tax rates when selling at a profit if you've held the fund for more than one year.

If you hold a number of funds, give preference to selling your largest holdings (that is, the ones with the largest total market value) with the smallest capital gains. If you have some funds that have profits and some with losses, you can sell some of each, subject to IRS rules, in order to offset the profits with the losses.

Selling for tax deductions and the famous wash sale rule

Some tax advisers advocate doing *year-end tax-loss selling.* The logic goes something like this: If you hold a mutual fund that has declined in value and you hold that fund outside a retirement account, you should sell it, take the tax write-off, and then buy the fund (or something similar) back. (In fact, you can employ this strategy at any point during the year, not just at year's end.)

I don't think that selling solely for taking a tax loss is worth the trouble, particularly if you plan on holding the repurchased shares for a long time. Remember that by selling and buying back the shares, you've lowered your basis, which increases the taxable profit after you sell the repurchased shares (assuming, of course, that they appreciate). To find out about your basis, see the section "Introducing the 'basis' basics," earlier in this chapter.

Plus, if you sell a fund for a tax loss and buy back shares in that same fund within 30 days of the sale, you can't deduct the loss because you violated the *wash sale rule.* The IRS won't allow deduction of a loss for a fund sale if you buy that same fund back within 30 days. As long as you wait 31 or more days, you won't violate the wash sale rule. If you're selling a mutual fund and want to reinvest that money soon, you can easily sidestep this rule simply by purchasing a fund similar to the one you're selling.

Try not to have *net losses* (losses plus gains) that exceed $3,000 in one year. You can't claim more than $3,000 in net short-term or long-term losses in any one year. If you sell funds with net losses that total more than $3,000 in a year, you must carry the excess losses over to future tax years. This situation not only creates more tax paperwork, but also it delays taking the tax deduction.

Looking at fund sales reports: Form 1099-B

When you sell shares in a mutual fund, you receive Form 1099-B early in the following year. This document is fairly useless because it doesn't calculate the cost basis of the shares that you sold. Its primary value to you is that it nicely summarizes all the transactions that you need to account for on your annual tax return. This form, which is also sent to the IRS, serves to notify the tax authorities of which investments you sold so that they can check your tax return to see if you report the transaction.

If some of the sales listed on your Form 1099-B are from check-writing redemptions, stop writing checks on those funds! Keep enough stashed in a money market fund and write checks only from that type of account. Money market fund sales aren't tax reportable because a money fund's share price doesn't change. Thus, you get fewer tax headaches!

Getting help: When you don't know how much you paid for a fund

When you sell a mutual fund that you've owned for a long time (or that someone gave you), you may have no idea of its original cost (also known as its *cost basis*).

If you can't find that original statement, start by calling the firm where you bought the investment. Whether it's a mutual fund company or brokerage firm, it should be able to send you copies of old account statements. You may have to pay a small fee for this service. Also, increasing numbers of investment firms (particularly mutual fund companies) automatically calculate and report cost-basis information on investments that you sell. Generally, the cost basis they calculate is the average cost for the shares that you purchased.

For a small fee, the research firm of Prudential American Securities may be able to help you figure out how much you originally paid for your funds. Contact the firm at (626) 795-5831 or online at www.securities-pricing.com.

Retirement Fund Withdrawals and Form 1099-R

Someday, hopefully not before you retire, you'll need or want to start enjoying all the money that you've socked away into great mutual funds inside your tax-sheltered retirement accounts. The following sections explain what you need to know and consider before taking money out of your mutual fund retirement accounts.

Minimizing taxes and avoiding penalties

Although many different types of retirement accounts exist (IRAs, SEP-IRAs, Keoghs, 401(k)s, 403(b)s, and so on), as well as many tax laws governing each, the IRS has declared one rule that makes understanding taxes on withdrawals a little easier. All retirement accounts allow you to begin withdrawing money, without penalty, after age 591//2. (Why they didn't use a round number like 60 is beyond me.)

If you withdraw money from your retirement accounts prior to age 591//2, in addition to paying current income tax on the distribution, you also must pay penalties — 10 percent of the amount of the taxable distribution at the federal level and whatever penalties your state charges. (You compute the penalty on Form 5329 — "Additional Taxes on Qualified Plans [Including IRAs] and Other Tax-Favored Accounts.")

Exceptions to the early withdrawal penalty do exist: You're allowed to make penalty-free withdrawals before the age of 591//2 if any of the following conditions apply:

- You've stopped working after you reach age 55 (whether by retirement or termination).

- The withdrawal was mandated by a qualified domestic relations court order.
- You have deductible medical expenses in excess of 7.5 percent of your adjusted gross income.

Early retirement account distributions are also exempted from a penalty if they're paid because of death or disability, paid over your life expectancy, or rolled over to an IRA. Withdrawing money from an IRA for a first-time home purchase (up to $10,000) or higher education expenses is also permitted.

Issues to consider before making retirement account withdrawals

Generally speaking, most people are better off postponing withdrawals from retirement accounts until they need the money. But don't delay if waiting means that you must scrimp and cut corners — especially if you have the money to use and enjoy.

Suppose that you retire at age 60. In addition to money inside your retirement accounts, you have money available outside as well. If you can, you're generally better off using the money outside of retirement accounts *before* you start to tap the retirement account money.

If you're not wealthy, odds are good that you'll need (and want) to start drawing on your retirement account soon after you retire. By all means, do it. But have you figured out how long your nest egg will last and how much you can afford to withdraw? Most folks haven't. It's worth taking the time to figure how much of your money you can afford to draw on per year, even if you think that you have enough. Many good savers have a hard time spending and enjoying their money in retirement. Knowing how much you can safely use may help you loosen your purse strings.

One danger of leaving your money to compound inside your retirement accounts for a long time — after you're retired — is that the IRS *requires* you to start making withdrawals by April 1 of the year following the year you reach age 701//2. If you don’t, you pay a whopping 50 percent penalty on the amount that you should’ve taken out but didn’t. (***Note:*** This requirement doesn’t apply to the new Roth IRAs.)

It’s possible that because of your delay in taking the money out — and the fact that it’ll have more time to compound and grow — you may need to withdraw a hefty chunk each year. Doing so could push you into higher tax brackets in those years that you’re forced to make larger withdrawals.

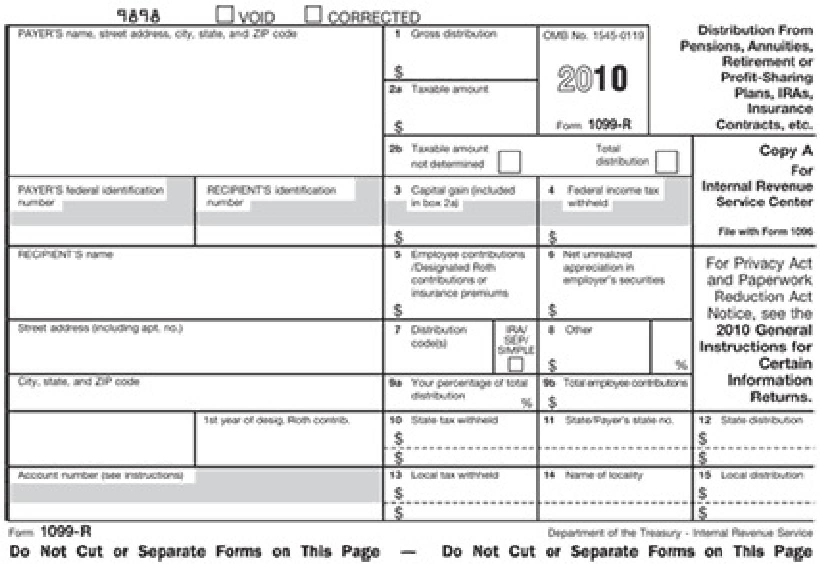
If you want to plan how to withdraw money from your retirement accounts in order to meet your needs and minimize your taxes, some of the larger mutual fund companies that I recommend in this book have resources that can help you do the calculations. You can also hire a tax adviser to help. If you have a lot of money in retirement accounts, as well as the luxury of not needing the money until you’re well into retirement, tax planning will likely be worth your time and money.

Of course, you pay current income taxes, both federal and state, when you withdraw money that hasn’t previously been taxed from retirement accounts. The one exception is for withdrawing money early from the new Roth IRA accounts for a home purchase — in this case, you don’t owe any income tax on the withdrawn investment earnings as long as you meet eligibility requirements.

Making sense of Form 1099-R for IRAs

If you receive a distribution from your mutual fund IRA, the mutual fund company or brokerage firm where you hold your funds will report the distribution on Form 1099-R (see Figure 18-2). These distributions are taxable unless you made nondeductible contributions to the IRA (a situation I cover momentarily).

Figure 18-2: Here’s where funds report your retirement plan distributions.


9898 VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code

1 Gross distribution $

2a Taxable amount $

2b Taxable amount not determined — Total distribution

OMB No. 1545-0119

2010

Form 1099-R

Distribution From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

Copy A For Internal Revenue Service Center

File with Form 1096

PAYER'S federal identification number

RECIPIENT'S identification number

3 Capital gain (included in box 2a) $

4 Federal income tax withheld $

RECIPIENT'S name

5 Employee contributions /Designated Roth contributions or insurance premiums $

6 Net unrealized appreciation in employer's securities $

For Privacy Act and Paperwork Reduction Act Notice, see the 2010 General Instructions for Certain Information Returns.

Street address (including apt. no.)

7 Distribution code(s)

IRA/ SEP/ SIMPLE

8 Other $ %

City, state, and ZIP code

9a Your percentage of total distribution %

9b Total employee contributions $

1st year of desig. Roth contrib.

10 State tax withheld $ $

11 State/Payer's state no.

12 State distribution $ $

Account number (see instructions)

13 Local tax withheld $ $

14 Name of locality

15 Local distribution $ $

Form 1099-R

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Here's a rundown of the relevant boxes on your 1099-R:

- **Box 1, Gross distribution:** The amount of money that you withdrew from your IRA. Make sure that this figure is correct: Check to see if it matches the amount withdrawn on your IRA account statement. This amount is fully taxable if you've never made a *nondeductible contribution* to an IRA — that's an IRA contribution in which you didn't take a tax deduction and, therefore, filed Form 8606 ("Nondeductible IRA Contributions, Distributions and Basis").

- **Box 2a, Taxable amount:** The taxable amount of the IRA distribution. However, the payer of an IRA distribution doesn't have enough information to compute whether your entire IRA distribution is completely taxable or not. Therefore, if you simply enter this amount on your tax return as being fully taxable, you'll overpay on your taxes if you've made nondeductible contributions to your IRA. If you made nondeductible contributions, compute the nontaxable portion of your distribution on Form 8606, which you need to attach to your annual tax return.

Withdrawing from non-IRA accounts

Retirement account withdrawals from non-IRA accounts — such as 401(k), SEP-IRA, or Keogh plans — are taxed depending on whether you receive them in the form of an *annuity* (paid over your lifetime) or a lump sum. The amount you fill in on your 1040 tax return is reported on a 1099-R that you receive from your employer or another custodian of your plan, which may include an investment company, such as a mutual fund company or discount broker.

If you made nondeductible contributions to your retirement plan or contributions that were then added to your taxable income on your W-2, you aren't taxed when withdrawing these contributions because you've already paid tax on that money. The rest of the amount you receive is taxable.

Understanding form 1099-R for non-IRAs

You report non-IRA retirement account distributions on Form 1099-R, which is the same one you use to report IRA distributions. Sometimes people panic when they receive a 1099-R, and they intend to rollover their retirement account money into a fund from, say, their employer's retirement plan after they leave their job. Don't worry. You received this form because you *did* do a legal rollover and, therefore, won't be subjected to the tax normally levied on distributions.

The following list highlights how some of the other boxes on distributions for non-IRA retirement accounts come into play:

- **Box 3:** If the distribution is a lump sum and you were a participant in the plan before 1974, this amount qualifies for capital gain treatment.
- **Box 4:** This box indicates federal income tax withheld. (You get credit for this amount when you file your tax return.)

- **Box 5:** Your after-tax contribution is entered here.
- **Box 6:** Securities in your employer's company that you received are listed here. This amount isn't taxable until the securities are sold.
- **Box 7:** Your employer enters a code that explains the type of distribution you're receiving and why you're receiving it. (See the back side of your Form 1099-R for an explanation of the code.)
- **Box 8:** If you have an entry here, seek tax advice.
- **Box 9a:** This amount is your share of a distribution if there are several beneficiaries.

Chapter 19

Common Fund Problems and How to Fix Them

In This Chapter

- Dealing with fund company representatives
- Moving money into and out of funds
- Fixing paperwork, online snafus, and other problems

Established fund companies and discount brokerages have hundreds and, in some cases, thousands of telephone representatives who field phone calls and process stuff you send them in the mail. Most of the bigger and better companies recommended in this book do a good job of training their employees, so you should receive competent assistance. But keep in mind that these people are human — that is, not perfect. Some are more competent and service-oriented than others at getting the job done right the first time with the proper attitude. Although I can't guarantee that this chapter is a page turner, it can help bail you out and soothe your nerves when you just don't know how to get a problem fixed.

Playing the Telephone Game

When you call fund companies to ask a question or express a concern, you may end up speaking with someone who doesn't know how to fix your problem, gives you the runaround, or worse — gives you incorrect information. Here's what you can do to ensure that you get accurate solutions:

- **Know the representatives' limitations.** Fund company reps are there to provide assistance. Don't depend on them for tax advice. (Most of the larger fund companies have retirement account specialists who have more detailed knowledge about tax issues relating to those accounts.)
- **Talk to someone else.** If you don't get clear answers or answers that you're satisfied with, don't hesitate to ask for a supervisor. Or you can simply call back on the toll-free line, and you're sure to get another rep. This method is a proven way to get a second opinion to make sure that the first person knew what he was talking about.
- **Take names and notes for thorny problems.** If you're dealing with a problem that could cost you big bucks if not properly solved, take notes of your conversation. Write down the name of the representative you spoke to, the office she's located in, and her telephone extension. That way, you have some proof of your good efforts to fix things when you need to complain to or are summoned by a higher authority (for example, a supervisor, the IRS, and so on). E-mail or a written letter can be effective ways to document your problems and concerns, although some companies don't provide e-mail addresses.
- **Visit the fund company's Web site.** The larger fund companies have extensive Web sites that are equipped with good search capabilities. (See the Appendix for the addresses of the fund companies.)

Trouble-Shooting Bungled Transactions

With all the sound-alike fund names, you can mistakenly have your money deposited into the wrong fund at some firms. That’s why it’s a good idea to look at the statement that confirms your purchase to verify that the deposit amount and the fund into which the money was deposited are both correct.

If the fund company makes a mistake, it should cheerfully fix the problem. (It may need to do a bit of research first.) It should be willing to credit the correct amount to the fund you requested as of the date the money was originally received.

With increasing numbers of fund investors conducting transactions online, I’m hearing about more problems with such trades. Don’t get me wrong — trading online is a fine thing to do, and the vast majority of transactions occur without a hitch. However, accidentally duplicating an online trade is a good example of a common mistake.

If you make a mistake trading online (or by phone), get on the phone and request help. Ask for a supervisor if frontline employees are unhelpful. Don’t accept a response such as, “We can’t correct online trades.”

Specifying Funds to Buy at Discount Brokers

When you invest through most mutual fund companies, their account application and other forms allow you to indicate what fund(s) you want to make your deposit into. Not so at discount brokerage firms.

If you want your deposit to a discount brokerage to be immediately invested into a particular fund or funds, write your instructions and send them with your deposit. For example, if you mail $5,000 for an IRA deposit to a discount brokerage firm and you want the money divided between, say, the Fairholme Fund (FAIRX) and the Dodge & Cox International fund (DODFX), Figure 19-1 shows you how to word the letter.

Figure 19-1: A sample letter to specify funds with discount brokers.

Dear Sir or Madam:

Enclosed please find a check in the amount of $5,000 that I would like invested in my IRA account as a 2010 contribution (reference your account number or specify if new application is attached) as follows:

$3,000 into Fairholme Fund (FAIRX)

$2,000 into Dodge & Cox International (DODFX)

Please reinvest dividends and capital gains distributions.

Thanks a million,

Note the last sentence in the figure is a reference about what to do with dividends and capital gains distributions. Try to be as precise as possible with the fund names. The ultimate in precision for a broker is the fund's unique, five-letter trading symbol (three letters for exchange-traded funds).

Making Deposits in a Flash

Maybe you have an account open and just need to feed it in a hurry. Most often, this situation happens when you need to fund a retirement account, but it may also happen if you're on the verge of overdrawing a money market account due to outstanding checks and withdrawals.

If you need to make a deposit in a flash, you basically have the three following options:

- **Write a check.** You can stop by and deposit it at the company's local branch office if you're dealing with a company with a branch location near you.
- **Wire the money from your bank account.** If the fund company isn't in your neighborhood, don't despair. However, note that wiring usually costs money on both ends.

  After you've set up the wiring feature on your fund account (see Chapter 16), call your fund company to see what information you need to provide to your bank in order for the wire to be correctly sent. This usually includes

  • The name of the bank your fund uses for wires
  • The bank's identification number (the nine-digit ABA number)
  • The title and account number of the fund company's account at that bank
  • Your name as it appears on your fund account
  • The name of the fund account
  • Your own account number

  If you don't have the wiring feature set up on your account, establishing this feature takes some time because you must request, fill out, and mail a special form.

- **Electronically transfer the funds.** Electronic funds transfer, which is like a paperless check, usually takes a day longer than a wire, but it's free. Simply call your fund company and say how much money you want to move. As with wiring, if you don't have this feature set up, you can establish it by requesting and filling out a form from the fund company.

Verifying Receipt of Deposits

When you send money to a fund company, how do you know if the fund company received your money? Unlike when you use a bank ATM, you won't get a deposit slip with your transaction — at least, not right away. Fund companies mail you a statement (usually the day after they receive and process the deposit) that shows you the transaction. You can keep a log of deposits on paper or with a computer program and check them off when you receive the deposit statement, once a month, or quarterly.

If you can't wait for the mail, you can call the fund company's toll-free number and verify receipt over the phone. Many fund companies have secure Web sites and automated phone systems that allow you to check on stuff like this quickly, without waiting for a live person to talk to.

Transferring Money Quickly

For nonretirement accounts, if you have a money market fund with check-writing privileges, writing a check to get money is quick and simple and costs nothing. Another option, which you can use on all types of accounts, is to call the fund company and request a *telephone redemption.* The day after the next financial market close, a check should be cut and mailed to you. If you need the check faster than the mail service can get it to you, you can provide your express mail company (for example, FedEx, UPS, or DHL) account number. Some fund companies also allow you to pick up redemption checks at their headquarters. Call to see whether they provide this service.

Banks and other recipients of checks from your account may annoy you by placing a hold for a number of days on the funds from your checks. For checks that you write yourself, the hold is understandable because the check recipient has no way of knowing whether the money will be in the account when the check is ready to clear. But if the check was issued by the fund company, then the money has already been taken from your account, so the check is almost as good as cash to recipients — they just need to wait a couple of days for receipt of the funds.

Banks normally place up to a five-day hold on out-of-state checks. (Odds are that your fund company clears checks through an out-of-state bank.) If a bank doesn't make the money available to you quickly, ask to speak to the branch manager or some other higher-up. Gently remind him that you can move your bank accounts to a less bureaucratic bank.

Wiring and electronic funds transfers are other alternatives that you may prefer because you don't need to wait for a paper check to clear. If you just realized that you need money to close on a home purchase tomorrow, these are your best bets. See the section "Making Deposits in a Flash" earlier in this chapter for how these services work.

For retirement account withdrawals, you need to make requests in writing. Perhaps you need to withdraw money before the end of December to meet the IRS's mandatory withdrawal requirements after age 701//2. The good news here is that you don't need to have received the funds before the end of the year. As long as the distribution is made by the end of December, the IRS will be satisfied.

Losing Checks in the Mail

Checks and other stuff can get lost in the mail. If you wrote a check and made it payable to the fund company, you don't need to stop payment. If you're depositing checks with your fund company that someone else wrote to you, the check's issuer may want to stop payment when you report to it that the check is lost and you want it reissued, if it's concerned that you might cash it.

A bigger pain is having to redo a bunch of account applications that you may have sent with the check(s). If you are completing a pile of applications and transfer forms, you may want to keep copies. Or, you investigate if the fund company allows you to complete forms through its Web site.

Registered mail and certified mail don't eliminate the problem of lost mail. They just indicate whether the mail was received. Don't waste the money or the time needed to go to the post office to use these extra mail services.

Changing Options after Opening Your Account

Perhaps now you wish you had check writing on your money market fund. Or you want to establish a regular monthly investment plan so that money is sent electronically from your bank account to some funds. How do you add these features after you've opened an account?

Although you can add some features over the phone, you can only set up most features, particularly the ones that require your signature — such as check writing — through short forms that you request by phone. (Some fund companies allow you to add these account features via their Web sites, as I discuss in Chapter 16.) You can change previously established options, such as reinvestment of dividends, over the phone or via the fund company's Web site.

Changing the registration of your accounts is more of a pain. A letter is generally required, for example, if you marry and change your name or want to add your spouse to the account. A *signature guarantee* may be required — these guarantees are provided by banks and brokerage firms. Don't confuse this requirement with getting something notarized, which is different.

Making Sense of Your Statements and Profits

Can't understand your fund statement? Don't know how much money your fund is making for you? Welcome to a large and nonexclusive club. See Chapter 17 for the full scoop.

If you want a tax, financial, or legal adviser — or a savvy relative — to help you keep an eye on your investments, you can ask that she be listed on your account as an *interested party* to receive duplicate statements. Simply write to the fund company and include the accounts you want the interested party to receive statements for and provide that person's name and mailing address.

Changing Addresses

Normally, fund companies require that you make a change of address in writing, but over time more fund companies are establishing security procedures that allow you to make a change of address by phone or via a Web site. The safeguards include a requirement that you prove that you're who you say you are on the phone (give your mother's maiden name and all that). The fund companies also mail confirmations of the changed address to both old and new addresses and don't allow money to be transferred out to the address for, say, 15 days to give the mail sufficient time to deliver confirmation of the address change to both the new and old addresses.

Finding Funds You Forgot to Move

Every year, people literally throw away hundreds of millions of dollars in investments, including investments in mutual funds. You may have done this if you've moved around a lot without systematically sending changes of address to fund companies and placing mail-forwarding orders with the post office. After fund companies try for a long time to send mail to your old address, they eventually throw in the towel, and your account becomes dormant. No more statements are sent for a number of years, after which time your account is considered abandoned!

By law, the mutual fund company must transfer your abandoned money to the treasurer's office (called *escheatment,* for you Trivial Pursuit or game show buffs) of the state in which the fund company does business or the state in which the last registered address appeared on your account. This transfer may happen from within a few years to more than a decade after the fund company loses contact with you. If you don't claim the money within a certain number of years after that, the state gets to keep it.

If you vaguely recall that you had funds with a particular fund company way back when, call the company. You don't need to remember the specific funds you invested in. By using your name, Social Security number, old mailing addresses, and personal stuff like that, the fund company's computer system can find your accounts and determine whether they were turned over to the state. You can also try contacting the state treasurer's office in the states in which you've lived to see whether they have any of your abandoned accounts. (You can do this as well for recently deceased relatives in the event you're concerned that you may have overlooked some of their accounts.) If you find your accounts, please write to me in care of the publisher and let me know — these successes make me happy!

Untangling Account Transfer Snags

Transferring accounts from one investment firm or bank to another can be a big pain. Even obtaining the correct transfer paperwork and completing it are challenges — that's why I detail how to do these steps in Chapter 16.

Problems happen most often with retirement accounts and with brokerage account transfers. Some firms are reluctant to give up your money, and so they drag their feet, doing everything they can to make your life and the lives of employees who transfer accounts at your new investment company a nightmare. The biggest culprits are the supposed "full-service" brokerage firms that employ commission-based brokers. They've lost a lot of money flowing out to no-load and discount brokers' mutual funds, and they do what they can to hang on. The unfortunate reality is that they'll cheerfully set up a new account to accept your money on a moment's notice, but they'll drag their feet, sometimes for months, when it comes time to relinquish your money.

Don't let this foot dragging on the part of brokerage firms deter you from moving your money to a better investment firm.

Remember that the transfer should, under securities industry regulations, be done within 30 days. If it's not, hammer the villains! Should the transfer not be complete within a month, get in touch with your new investment firm to determine what the problem is. If your old company isn't cooperating, a call to a manager there may help get the ball rolling. To light a fire under his behind, tell the manager at the old firm that you'll be sending letters to the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC) if he doesn't complete your transfer within the next week. Then do it.

In addition to uncooperative brokers, certain assets present problems with transfers. If you purchase any house-branded mutual funds at commission-based brokerage firms, in addition to buying into what's likely a relatively mediocre family of funds, you also can't transfer their funds as they are. You must first have them liquidated through the broker whose name is on them so that the cash proceeds can be transferred. Most annuities work the same way.

Transfer individual securities, such as stocks and bonds, to a discount broker. That way, if you later decide to sell them, you save on commission charges. Limited partnerships generally can't be liquidated, and everybody levies fees to hold them — another reason not to buy them in the first place. If you want less account clutter, transfer these to the discount broker you're otherwise going to be using.

Eliminating Marketing Solicitations

If you do business with many companies and their marketing folks are driving you batty, call your fund companies and ask them to code your account on their advanced computer systems so that you won't receive anything other than statements and reports on your funds. Fund companies are required under SEC regulations to honor such a request. Fund companies are happy to oblige — they don't want irritated customers.

As for all the other junk mail you get, send a request not to receive junk mail (including your name, complete home address) to the Direct Marketing Association, Mail Preference Service, P.O. Box 643, Carmel, NY 10512. You can also complete the form on the association's Web site at www.dmachoice.org.

Some fund companies and brokers may call you at home soliciting your purchase of investments. They tend to focus on people with large cash balances sitting in their accounts. To stop any type of sellers from calling you in the future, you have the Do Not Call Registry on your side. Register for free either online at www.donotcall.gov or call (888) 382-1222 from the number you want to register.

Digging Out from under the Statements

If you're being buried in paperwork from statements and transaction confirmations from too many fund companies, consider consolidating your fund holdings through a discount broker. Trade-offs do exist — you pay more in fees for the convenience that these accounts offer (see Chapter 9). Some fund companies also have ways to consolidate statements, but you may have to specifically request this service for your statements.

If you truly abhor getting paper statements in the mail, increasing numbers of fund firms allow you to “turn off” receiving such clutter and view your statements online. Visit your favorite fund company Web sites for details.

Getting Older Account Statements

Perhaps, for reasons of nostalgia or taxes, you need copies of a statement that’s more than a year old. Most companies should have no problem providing it (and some have Web sites allowing you to retrieve such history). Some smaller companies may, however, charge you something like $10 per fund per year requested. So be choosy. The main reason you’d request a statement is to research how much you originally invested in a mutual fund held outside of a retirement account. If you sold or are thinking about selling shares of the fund, you may have to figure out the fund’s cost basis for tax reporting purposes (see Chapter 18). In the future, be sure to keep your statements so you don’t need to ask for copies.

If you’re going to sell *all* the shares that you hold in a fund, check to see if your firm can report the average cost of the shares sold. If its accounting system can do this, you’re golden, and you don’t need to bother with getting the old statements.

Chapter 21

Harnessing Your Computer's Power

In This Chapter

- Finding your way around mutual funds with software
- Locating the best mutual fund Web sites

When you invest your money, especially in mutual funds, having a computer at your disposal to make wise investing decisions and to manage your portfolio is *not* necessary nor is it advantageous. In fact, the use of a computer when investing may prove detrimental to your investing success. Why?

My experience with counseling clients, reading letters and e-mails from readers and visitors to my Web site, and instructing students in my courses is that heavy computer users tend to focus too much on daily price changes and the short-term news and, thus, they trade too much — losing sight of the important bigger-picture issues. So if you're not online yet or don't own a computer to play around with investing software or Internet sites, don't be sad. If you decide to spend money on a computer or you already own one but don't know how it can help you invest in funds, this chapter assists you with finding out how to put it to work.

I divide this chapter into two parts — software and Web sites. Some of the stuff I discuss does some of both categories. Those that do are generally placed in the category that they do more of.

Using Computer Software

Most software reviewers can agree that good software must be easy to use. Software that helps you make mutual fund and other investing decisions must also provide well-founded advice and information. Not all of it does.

Knowing which software is best for you depends on your goals and level of investment expertise. The financial software in the marketplace today can help you with a variety of activities that range from simply tabulating your mutual fund's values and getting current prices to researching investment choices. You can even execute fund trades on your computer.

As I discuss later in this chapter (see the section, "Entering Cyberspace: Internet Sites"), thanks to technological advances, Web sites are offering features that were once the exclusive domain of software programs. Before you rush out to purchase a specific software program to accomplish a certain task, check to see what the Internet has to offer in that area.

Getting-and-staying-organized software

Checkbook software programs, such as Quicken, help with checkbook accounting, expense tracking, and bill paying. But checkbook software is also useful for keeping track of your mutual fund investments. By remembering your original purchase price, as well as factoring in dividend and capital gains distributions, checkbook software automatically calculates your current rate of return, both annualized and cumulative, for each individual fund, as well as for your entire portfolio.

However — and this is a big however — in order for software to keep track of your returns, you must plug in *all* your transactions, distributions, and share price changes when you receive your account statements. If you have a lot of funds at different accounts, this process could be tedious, depending on how much you like detail work. Some (primarily) larger investment companies allow you to download your account statement details directly into your software program. But even this procedure usually requires you to work with the downloaded transactions and assign them to appropriate categories.

Software can be useful if you have accounts at numerous investment firms and want to keep tabs on your various accounts and overall performance. But remember that consolidating your investments at a larger mutual fund company or through a discount brokerage account can accomplish the same goals for you — without your having to invest hours in studying software and entering data.

Also keep in mind that one of the most attractive features of checkbook software — its ability to track your cost basis — is irrelevant for funds held in retirement accounts. (See Chapter 18 for more information on cost basis as used for tax purposes.) Most mutual fund companies in this day and age track your cost basis for you, too.

Accessing investment research software

Investment research software packages usually separate investment beginners (and others who don't want to spend a lot of time managing their money) from those who enjoy wallowing in data and conducting primary research. The best reason to use research software is to access quality information in a way that may be more cost-effective than doing so through traditional channels. Research software may allow you to peruse more information more efficiently.

Although these packages can be cost-effective, they're still expensive. Don't jump in to one of these programs until you've done a careful comparison between the information it offers and the data you need. Most investment software packages offer more raw data than you can ever use.

Mutual fund data hounds delight in the software products that Morningstar offers. However, if you’re an investing and mutual fund novice, don’t expect an easy time working with these sometimes jargon-laden and costly packages. Also expect to invest several hours of your time to figure out how to work with a program. (Morningstar offers more affordable and scaled-down information through its Web site, which I discuss later in this chapter.) Here’s my take on Morningstar’s mutual fund software:

- **Principia Mutual Funds:** This software provides most of the data that’s provided on Morningstar’s fund reports, which I discuss in Chapter 20. You can search and screen for funds that meet the specific criteria that you enter into the program. The program also comes with a feature called the Portfolio Developer, which allows you to gather a portfolio of funds and then view a pie chart of that particular portfolio’s asset allocation. A subscription is $675 a year. Call (877) 586-5405 for more info.
- **Principia Mutual Funds Advanced:** The ultimate for the mutual fund data junkie, its interface is similar to Principia Mutual Funds’, but you get more historical data and features. All the data available on Morningstar’s reports comes with this program, and then some. For example, each fund has an archive of all the analyst’s reviews of that fund. The program also lets you print these reports on your own printer. The Portfolio Developer allows you to track the performance of your mutual fund portfolio over time. The price for Morningstar’s first-class ticket is steep: An annual subscription is $1,220. Call (877) 586-5405 for more information.

Before plunging in to the data jungle, be honest about your reasons for doing research. Some investors fool themselves into believing that their research will help them beat the markets. As I say many times in this book, though, few of even the so-called professional investors ever beat the markets.

Entering Cyberspace: Internet Sites

The Internet is a vast network of computers all over the world that share information. Just about anyone can plug in to the Internet right from home — all you need is a personal computer and a connection. Fund investors online have some of the following possible benefits:

- **Quick access to info:** The Internet can give you faster access to important resources than traditional channels allow. Before the Internet, investors had only one way to get their hands on, say, a fund prospectus: Call the folks at the fund company, give them an address, and wait up to a week for the mailman to deliver the goods. With Internet access, you can log on to the fund company's Web site and view the prospectus immediately, and even print it, if you want to. The same goes for annual reports, account applications, research reports, account statements, and so on.
- **Interactive features:** The best Internet sites are similar to software programs in that they're interactive. The phenomenon of retirement-planning calculators is a good example. The best online calculators ask you questions, you plug in the answers, and on your computer screen you see your personalized plan calculated for you, complete with graphs and charts — sure beats slugging it out with a calculator and pencil over a fill-in-the-blank retirement-planning workbook.
- **Up-to-date info:** Information on the Internet can be kept up-to-date, even up-to-the-minute. Larger companies have entire staffs that are responsible for keeping their Web sites current. If a prospectus is revised or a new tax law affects a retirement-planning calculation, a well-maintained Web site can reflect these changes the next time you log on. This advantage is one over the traditional print medium and software programs.

Of course, every coin has a flip side. The Internet has introduced plenty of hazards for mutual fund investors to be concerned about, but here, to steer clear of the pitfalls, I give you a few tips:

- **Free information, at a price:** After you've paid your toll to get on the Information Superhighway, many things that you find there have the illusion of being free. Don't be fooled. Somebody has to pay to put that info on the Internet, and nine times out of ten it's a company that's trying to sell you stuff that you're better off not buying. Before you trust a Web site with information on mutual funds, find out who's paying the bucks for the site to be there. (See the sidebar, "Who's footing the bill?")

- **Minutia to fixate on:** An advantage of the Internet — its capability to keep information up-to-date — is also its Achilles' heel. Too many Internet sites get so focused on the short term that they lose sight of the big picture. For example, many Web sites center on up-to-the-minute investment price quotes and late-breaking financial news: This type of information doesn't serve a healthy, long-term investment strategy perspective. Don't let the Internet distract you from your focus on the investment horizon. Don't be as enamored with the Internet's up-to-the-minute update ability as most Web sites seem to be.

- **Too many "experts":** Message boards and chat rooms are a unique aspect of the Internet. The way that these mediums can facilitate communication between people in various towns, cities, and states is potentially exciting. But message boards and chat rooms are dangerous places to tread for the naive and too trustful. Remember, you don't have to take an entrance exam or have a license requirement for joining a chat room or posting a message on an electronic bulletin board. The anonymity makes pretending to be someone you're not easy. Therefore, *participate cautiously.* Never trust any advice you get from a chat room or message board without verifying it through a reliable independent source. And never share confidential personal or financial details online.

- **Information overload:** The possibilities on the Internet are so endless that they can be overwhelming, and the easiest way to find bad advice is to be unsure about what you're looking for in the first place. Knowing what information you want before you start searching pays. If you enter a vague term into an Internet search engine — say, "mutual funds" — you'll probably end up more lost than you were to begin with. If, on the other hand, you enter a specific term — such as *TIAA-CREF mutual funds* — you'll probably find the information you're looking for.

That said, let me speed up your search for good resources on the Internet by recommending what I think are the best mutual fund Web sites out there. You'll recognize some of the names behind these sites because they're companies I recommend throughout the book. Not surprisingly, the organizations that demonstrate excellence offline seem to be the ones that do best online as well.

Who's footing the bill?

You need to know that the Internet is primarily funded by companies' marketing departments. Of course, nothing is intrinsically wrong with this arrangement; magazine articles and television programs are also paid for with advertising dollars. What's problematic about the Internet, however, is that the line between advertising and content is much fuzzier and more blurred than in other mediums. In fact, some Web sites obscure the difference between content and advertising in a manner that could be called deliberate.

For example, consider a Web site that hypes itself as the "best independent mutual fund resource" and even goes on to boldly declare that "Content is what makes us different." However, this content, such as the text that appears in the site's "Expert's Corner," turns out to be nothing more than thinly veiled marketing fodder from financial newsletter writers who are intent on selling you a subscription to their wares.

So how can you tell whether the objective content you're reading on the Web is really just a paid advertisement? Begin by thoroughly checking out the fine print. In the preceding example, I found this little disclaimer in the corner: "These articles are sponsored by the featured experts. . . ." *Sponsored* means that the "experts" (newsletter writers) were paying to put their articles on the Web site.

If the Web page has a button that reads something like *About Us,* click it. Sometimes you can get information on who's sponsoring the site. Also click any buttons that say something such as *For Clients Only* or *How to Join Us.* You may discover that the site only mentions fund companies that pay a fee to be represented.

Keep an eye out for advertisements that spill over into the content when you read articles on independent sites. For example, if an article recommends a fund company whose advertisement appears at the top of the page, consider surfing elsewhere.

If you can't find out who's behind a particular site, don't trust it. A Web site that has nothing to hide has no reason to be evasive. To be safe, stick with sites that are totally upfront about who's paying for them. A site whose Web address is www.fundcompanyxyz.com is obviously not trying to fool anybody.

Investment Company Institute

The Investment Company Institute (ICI) is the investment companies' trade association; it includes mostly mutual funds but also closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). This site has a wealth of industry data that's of greater use to financial professionals who enjoy wallowing around such numbers. Check it out online at www.ici.org.

Be forewarned, however, that the educational materials on this site won’t show you to avoid load funds or other high-cost investments, such as most UITs — some ICI members sell them, so telling you to avoid these investments would be self-detrimental.

Morningstar.com

Morningstar’s site (www.morningstar.com) is one of the better mutual fund Web resources. You find Morningstar’s well-known research reports on individual funds, which feature long-term performance data and graphs, risk ratings, manager profiles, information on fees, and a list of discount brokers who sell the fund. Surprisingly, considering that Morningstar was built on the basis of research and no advertising, the mutual fund companies with their banner advertisements at the top of every page pay for this Web site.

The site also features articles on advanced concepts of fund investing and developments in the fund industry. For $179 per year, a premium membership gives you online access to more fund information and tools.

T. Rowe Price

On this site (www.troweprice.com), you can find some of the best retirement-planning tools available — for individuals saving for retirement, as well as for those already in or near retirement. Interactive worksheets can help you determine which type of IRA may be best for you to invest through.

This site also has a good selection of articles on various fund-investing topics as well as interviews with leading fund managers at the company. Should you invest in any of T. Rowe Price’s solid mutual funds, the Web site provides convenient access to your account information.

Securities and Exchange Commission

Although the government's Securities and Exchange Commission (SEC) Web site is far from being the most user-friendly one, it contains a truckload of the required documents that all funds must file with this agency, whose purpose is to oversee the investment industry. The EDGAR database enables you to access documents that mutual funds have filed with the SEC at www.sec.gov/edgar/searchedgar/webusers.htm.

To look at a particular fund's documents on file with the SEC, simply choose the general-purpose search option for companies and other filers. The site then provides a few different ways to search, but the easiest is to enter as much of the fund's name as possible — don't use abbreviations or acronyms — in the company-name search box. If the fund name you provide is associated with more than one particular fund (for example, if you simply type Vanguard), a list of choices appears from which you can choose. After you narrow it down to the particular fund you're looking for, you get a laundry list of all the documents that the fund has filed with the SEC in recent years. (The most recent filings will be at the top of the screen.)

Vanguard.com

Among the fund company Web sites that I've examined, Vanguard's (www.vanguard.com) is unsurpassed. In addition to housing an extensive online library of brochures on important fund-investing topics, this site also boasts numerous planning tools. For example, you can calculate how much to save for retirement or determine whether to convert your regular IRA into a Roth IRA.

Vanguard's Web site also enables you, if you so desire, to track and manage your investments in one central location. You can buy and sell mutual funds from hundreds of fund companies, stocks, bonds, and many more investments all in one account.

Chapter 22

Ten Common Fund-Investing Mistakes and How to Avoid Them

In This Chapter

- Designing the right plan for you
- Keeping taxes and fund fees in mind
- Staying away from shady advisers and market predictors

From getting your finances in order to selecting funds to maintaining your portfolio over time, various potholes and dangers can get in your way. This chapter highlights the ten most common fund-investing mistakes you're likely to make and how you can sidestep them.

Lacking an Overall Plan

Just as you shouldn't build a house without an overall plan, you shouldn't start buying funds until you have your arms and mind wrapped around a sound financial plan. The plan doesn't have to be a fancy, professionally or computer-generated one, but it should include the basics:

- Proper insurance coverage, like health, disability, auto, home, excess liability if you hold sufficient assets, and life insurance if others depend on your income
- A plan for paying off consumer debt on credit cards and

auto loans, if you have any

- Savings goals for retirement, buying a home, starting a business, putting your kids through college, and anything else your heart desires
- An overall *asset allocation* — what portion of your money should be invested in different assets, such as stocks (foreign versus domestic), bonds, and so on

Failing to Examine Sales Charges and Expenses

Would you ever buy a car without considering its sticker price? How about checking out the car's safety record and insurance costs? Mutual funds are like cars in one respect — you should check under the hood before you buy. But the good news is that fund fees are actually a lot easier to comprehend compared to the various car costs.

Before you consider buying any mutual fund, be sure you understand precisely any sales charges as well as the fund's ongoing operating expense ratio. Over the long term, a fund's fees are one of the biggest (and most predictable) determinants of the fund's likely future returns. This point is especially true with boring old money market and conservative bond and stock funds. Please see Chapter 7 for more on fees.

Chasing Past Performance

Before anyone hires a job applicant, he likes to know that person's track record. Ditto for professional sports teams seeking new players. Of course, when hiring a money manager, which is what you're doing when you invest in a mutual fund, you should examine that manager's prior experience. However, many investors simply throw money at funds currently posting high returns without thoroughly examining a fund manager's experience.

More often than not, current hot funds cool off (especially as small funds get larger and market conditions change), and many underperform in the future. The reason is quite simple: The market forces that lead to the relatively brief period of high performance inevitably change. Peruse Chapter 7 for how to avoid tomorrow's losers and maximize your chances of picking a consistent winner.

Ignoring Tax Issues

Do you know your current federal and state income tax brackets? When a particular type of stock or bond fund makes a dividend or capital gains distribution, do you know what rate of tax you'll pay on that?

Many fund investors aren't well informed when it comes to the tax consequences of their fund purchases and sales. Although you don't want the tax tail to wag the fund selection dog, you should know how taxes work on your funds and which funds fit best for your tax situation. See Chapter 10.

Getting Duped by "Advisers"

Some people want to hire a financial adviser to help them navigate financial choices. But many so-called financial consultants or advisers have serious conflicts of interest. Their recommendations and objectivity are tainted by commissions earned from products that they sell or from their money-management services.

If you seek to hire a financial planner/adviser, it's a good rule of thumb to hire someone who’s selling his time and nothing else. If what you’re really looking for is someone to manage your money, seek out a money manager. See Chapter 24.

Falling Prey to the Collection Syndrome

Some people buy mutual funds the way they build a clothing collection. Visits to different stores and articles recommending specific items lead to purchases. Before you know it, you may own numerous funds that don’t really go together well.

This mismatching is another reason you should develop your overall plan first. For example, after you decide that you’re going to invest, say, 20 percent of your retirement plan money into international stock funds, then you can set out to identify and then invest that amount of money into your chosen foreign funds. Check out Chapter 10, which provides a guide to putting together a sound portfolio that matches your needs.

Trying to Time the Market’s Movements

Just as no one enjoys losing a game, who wants to invest in a fund only to see it fall in value? Sometimes, though, that may happen even though you’ve done your homework and selected a good fund.

Stock and bond funds fluctuate in value, and you must accept that inevitability when you invest. Some people like examining pricing charts online to guess when a fund is about to turn around and increase in value. Don’t waste your time on such unproductive and time-consuming endeavors. Identify good funds, buy into them over time, and don’t jump in and out.

Following Prognosticators’ Predictions

Don’t make the mistake of believing that some supposed expert bold enough to make financial market forecasts on television, on radio, or in print actually has any proven talent to do so. Such blustery babblings are merely for the publicity of a given firm or individual.

Your long-term goals and desire or lack thereof to accept risk and volatility in your investments should drive your fund selection. Please read Chapter 20 to discover how to use information, not predictions, in building a winning fund portfolio.

Being Swayed by Major News Events

You’re human and have emotions. September 11, 2001, was a horrible day for Americans (and many other people around the world) that caused some people to panic and sell investments when the financial markets reopened. Similar emotions and reactions happened during the 2008 financial crisis/panic. Wars, oil price spikes, large corporate layoffs, the latest retail sales and consumer confidence reports, and Federal Reserve meetings and interest rate changes are but a few of the news reports that can move the markets.

Don’t make your investing decisions based on the news of the day. The only action you should consider taking if doom and gloom are in the air is to consider using some of your spare cash and buying when a sale is going on.

Comparing Your Funds Unfairly

While teaching adult courses and working with clients as a counselor, I've witnessed many people who were disenchanted with otherwise good funds. Often this effect was the result of their knowledge that other funds, often seeming similar on the surface, were doing better. Perceptions changed when these people found out that the other funds weren't holding the same types of securities and that their funds were actually doing fine compared with a relevant market index (see Chapter 17).

Don't be quick to assume that your funds aren't doing well simply because they've gone down recently or are producing lower returns than some other funds. Compare them fairly over a long enough period (years, not months or weeks) and then decide.

Chapter 24

Ten Tips for Hiring a Financial Adviser

In This Chapter

- **Knowing what services to expect and how much you pay**
- **Hiring someone you can count on**

Hundreds of millions of people worldwide have successfully invested in mutual funds on their own. Investing in mutual funds isn't difficult; common sense and an ounce of financial sense are all you need.

You have no compelling reason to hire a financial adviser in order to invest in mutual funds. So if you jumped to this chapter first, *stop!* I recommend that you march back to the earlier chapters. You'll be better able to understand this chapter after you've read the ones that come before it, not to mention the fact that you'll be improving your ability to save yourself possibly thousands of dollars in financial advisory fees. But if you've arrived here because you just don't want to deal with handling fund-investing or financial-planning decisions on your own, keep on keepin' on.

Communicator or Obfuscator?

In your preliminary meetings with a financial adviser, develop a sense and opinion about the person's ability to clearly communicate with you. Take your time and speak with prospective advisers before deciding whom to hire. Don't rush yourself or allow an adviser to pressure you into making a decision before you're ready and comfortable.

Consider these questions: Does he clearly and patiently explain things or use a lot of jargon and talk down to you? Is he forthright and candid or evasive?

Financial Planner or Money Manager?

As you search for help, you'll confront a variety of people who call themselves "advisers" and who're eager to assist you with investing and other financial matters. People who claim to be advisers but who derive commissions from the products that they sell are salespeople (Chapter 9). Keep this warning in mind as you consider the different types of people you could hire: ✓**Financial planner:** True financial planners generally provide objective help with issues, such as retirement planning, using and paying off debt, investing, insurance, and even real estate. The charge for these services should be a fee based on the time involved. A good planner should help restructure your financial situation before your money gets invested in funds. If a planner provides specific fund recommendations, implement them on your own and save yourself ongoing advisory fees.

- **Money managers:** Money managers or financial advisers who perform money management invest your money and charge you a fee — usually expressed as a percentage of assets under management (that's the money you turn over to them to manage). Some advisers only do money management, but increasing numbers of financial planners offer money-management services as well. Using money managers can make sense for people who've finished their planning and need someone to help manage their money. Money managers argue that, because they devote themselves full time to investing, they're more adept at it.

Planner/money managers may be reluctant to recommend — and, in fact, have an incentive to ignore — strategies that deplete the money you have to invest. The more you have to invest with them, the greater the fees they earn. All the following financial moves result in less money that you can invest, so planners/money managers may not recommend these often-advisable paths: ✔Paying down debt of all types, such as credit cards, auto loans, mortgages, business loans, and the like ✔Maximizing saving through your employer's retirement savings plan(s) ✔Purchasing real estate — either through buying a primary home or investing in rental property ✔Buying and investing in your own business or someone else's privately held business Another problem with planners who also manage money is that they may be short on specific advice in the planning process. Sadly, I've seen cases in which people paid planners thousands of dollars for a largely boilerplate, computer-generated financial plan and received little, if any, specific financial planning and investment advice. If you want to invest in no-load funds, the planner should willingly and happily provide specific fund recommendations and help you build a portfolio for the fee that you pay her.

Market Timing and Active

Management?

Much of what you're paying a planner for is the time spent reviewing your financial situation and matching your needs and goals to a suitable portfolio of funds. If your needs and situation are relatively stable and you do your homework right the first time and select good mutual funds, you shouldn't need to make frequent changes to your portfolio.

If anything, constant tinkering with a portfolio tends to lower returns. In Chapter 20, I cover this same issue on the perils of blindly following some newsletters' and gurus' timing advice to switch into this fund and out of that one. Trading in nonretirement accounts also increases your tax burden.

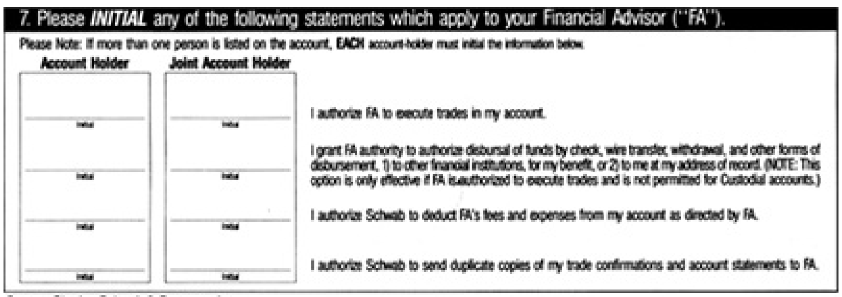
Who's in Control?

If you hire a money manager, you should consider if the manager requires that you turn control of the account over to him. Specifically, you'll sign or initial a form, as shown in Figure 24-1. Here's the outline of the form: **Line 1:** Grants the adviser authority to execute trades in your account — otherwise known as granting a *limited power of attorney.*

- **Line 2:** Gives your adviser power to move money out of your account. I recommend against giving your adviser this power unless you need to withdraw money from your account frequently and find it more necessary to have your adviser do it for you.
- **Line 3:** Allows your adviser to deduct his ongoing fees from the account. Definitely do *not* allow this deduction to be taken from retirement accounts because it diminishes the amount of money that you have compounding tax deferred.

(But, unless you're already well into retirement and taking plan distributions, paying fees from your retirement account may be okay — you're paying with before-tax dollars that would otherwise be withdrawn and taxed.) For nonretirement accounts, it's up to you, although many advisers insist on this feature to make collecting their fees easier.

- **Line 4:** Requests the brokerage firm to send duplicate copies of your account statements and trade confirmations to your adviser. That's acceptable and to be expected.



7. Please ***INITIAL*** any of the following statements which apply to your Financial Advisor ("FA").

Please Note: If more than one person is listed on the account, **EACH** account-holder must initial the information below.

Account Holder	Joint Account Holder	
Initial	Initial	I authorize FA to execute trades in my account.
Initial	Initial	I grant FA authority to authorize disbursal of funds by check, wire transfer, withdrawal, and other forms of disbursement, 1) to other financial institutions, for my benefit, or 2) to me at my address of record. (NOTE: This option is only effective if FA is authorized to execute trades and is not permitted for Custodial accounts.)
Initial	Initial	I authorize Schwab to deduct FA's fees and expenses from my account as directed by FA.
Initial	Initial	I authorize Schwab to send duplicate copies of my trade confirmations and account statements to FA.

Source: Charles Schwab & Company, Inc.

Figure 24-1: Initialing this section gives the adviser control over investing your funds.

Almost all money managers manage money on what's called a *discretionary basis* — they make decisions to buy and sell funds without your prior approval. In other words, you're turning control over to them. You find out about transactions *after* they've occurred, usually when you receive the trade confirmations in the mail and through your monthly or quarterly statement.

TIP

At a minimum, before you turn control over to the money manager, make sure that you discuss your investment objectives with him. These overall goals should drive the way he manages your money.

Fees: What's Your Advice Going to Cost?

If you hire a planner on an hourly basis, expect to pay at least $100 per hour — you can easily pay more; planners with the $300+ per-hour billing rates tend to work exclusively with affluent clients.

Fee-based money managers work on an entirely different basis. See this fee schedule example: ***Amount You Invest Fee Percentage Annual Fee*** $1,000,000 1.10% $11,000

$2,000,000 1.00% $20,000

$5,000,000 0.90% $45,000

What's amazing to me about this type of fee schedule is that, although the percentage charge declines slightly as the amount you invest increases, look at how the total charges increase. This firm sends the same quarterly reports out to the client with $5 million invested, who pays $45,000 per year, as it does to the client with $1,000,000 invested, who pays $11,000 per year for the same service. Advisers' fees are often negotiable. The more you have to invest, the greater your ability should be to negotiate lower fees.

Also, ask what sort of transaction and other fees you have to pay in addition to the advisory fee paid to the money manager. Most money managers ask that you establish an account at one of the discount brokerage firms, such as Schwab, Fidelity, TD Ameritrade, or with a mutual fund company. Ask who they use and why. If you're going to consider hiring a mutual fund money manager, add up all the costs. Table 24-1 helps you do the job.

Table 24-1 Adding Up All the Costs

Cost	Annual Percentage of Your Assets
Money manager's fee	For example,

	1.0%
Operating fees on mutual funds invested in (Don't let the adviser say that she can't figure this amount because the funds she uses vary over time — she can base the calculation on her current portfolio or the amount she used over the past year.)	For example, 1.0%
Transaction and other fees (Your adviser can convert these dollar expenses to a percentage.)	For example, 0.2%
Total	For example, 2.2%

Over the long haul, a diversified portfolio that's primarily invested in stocks has usually returned around 9 to 10 percent annually. If you're paying a total of 2.5 percent to have your money managed, you're giving away 25 to 28 percent of your expected return. And don't forget, because the IRS sure won't, that you'll owe taxes on your nonretirement account profits, so you're giving away an even greater percentage of your after-tax returns.

How Do You Make Investing Decisions?

Throughout this book, I discuss the good and bad ways people can and have invested in mutual funds over the years (Chapter 7, in particular). The process isn't rocket science — it can be as simple as picking any other product or service. You want value — where can you invest in funds that meet your needs and that are managed by a fund company and fund managers that have good track records and that charge competitive fees. Most advisers try to factor their economic expectations and prognostications into their investment strategies. But this is much easier said than done.

The fundamental problem with some money managers is they try to convince you that they have a crystal ball. Specifically, some claim (explicitly or implicitly) that they can time the markets, that they'll get you out of the market before it falls and put your money back in time for the next rise. Over long time periods, beating the markets is virtually impossible, even for acknowledged experts (see Chapter 20). Great investors, such as Warren Buffett and Peter Lynch, say you can't time the markets. Believe 'em!

What's Your Track Record?

Mutual fund companies must have their performance records audited and reviewed by the United States (U.S.) Securities and Exchange Commission (SEC). Most also provide an independent auditor's report. Private money managers face no such SEC requirement. Few provide independent audits. Of course, you really want to know the performance facts about the money manager who you're considering for ongoing management of your funds. What rate of return has he earned year by year? How has he done in up and down markets? How much risk has he taken, and how have his funds performed versus comparable benchmarks (see Chapter 17)? These are important questions. Getting objective and meaningful answers from most investment advisers who manage money on an ongoing basis is difficult.

Money managers play a number of marketing games to pump themselves up. If all the money managers are telling the truth, 99 percent of them have beaten the market averages, avoided major market plunges over the years, and just happened to be in the best-performing funds last year. Money managers pump up their supposed past performance to seduce you into turning your money over to them through common marketing ploys:

Select accounts: If you can get the money manager to give you performance numbers and charts, too often an asterisk refers you to some microscopic footnote somewhere. If you have a magnifying glass handy, you can see that the asterisk states something like *select* or *sample accounts.* What this term means, and what they should've said instead is "We picked the accounts where we did best, used the performance numbers from those, and ignored the rest." (Interestingly, using smaller type in this way is a violation of SEC regulations.) Advisory firms also may select the time periods when they look best. Finally, and most flagrantly, some firms simply make up the numbers (such as Bernie Madoff did).

- **Free services:** Some money managers will produce performance numbers that imply that they're giving their services away. Remember, money managers charge a fee (a percentage of assets) for their services — they are required to show your returns net of fees [or after fees have been deducted] to clearly show the amount that, as an investor using their services, would've made. Because most money managers place their fund trades through discount brokers who charge transaction fees, they must deduct these fees from returns as well.
- **Bogus benchmarks:** Some money managers make their performance numbers higher than they really are; some also try to make themselves look good in relation to the overall market by comparing their performance numbers to inappropriate benchmarks. For example, money managers who invest worldwide (including in international stocks) may compare their investment performance only to the lowest-returning U.S.-based indexes.
- **Switching into (yesterday's) stars:** Money managers don't want to send out updates that show that they're sitting on yesterday's losers and missed out on yesterday's winners. So guess what? They may sell the losers and buy into yesterday's winners, creating the illusion that they're more

on top of the market than they are. (Some newsletters also engage in this practice.) This strategy, known as *window dressing,* is potentially dangerous because they may be making a bad situation worse by selling funds that have already declined and buying into others after they've soared (not to mention possibly increasing transaction and tax costs).

What Are Your Qualifications and Training?

An adviser should have experience in the investing or financial services field — generally, the more the better. But also look for someone with intelligence and ethics who has good communication skills.

Check out credentials but don't be overly impressed by some, such as the CFP (Certified Financial Planning) degree. Too many planners with this "credential," which you can largely earn by taking a self-study course at home and then an exam, sell financial products. Other common credentials include ✔**CFA (Chartered Financial Analyst):** This credential means that the adviser knows how to analyze securities and investments and the fundamentals of portfolio management.

- **MBA (Master of Business Administration):** An adviser with an MBA should've had coursework dealing with investments and finance. Find out where he earned the MBA and check out the school's reputation.
- **PFS (Personal Financial Specialist):** A PFS is a credential conferred on accountants who pass an exam similar to the CFP.
- **CLU (Chartered Life Underwriter) and ChFC (Chartered**

Financial Consultant): These credentials are for insurance and carry little, if any, value in advising on mutual funds. These credentials may be a red flag that you're dealing with a salesperson or with someone who knows more about insurance than investments.

The term *Registered Investment Adviser* denotes that the adviser is registered with the SEC; it means nothing as a professional credential. (Smaller advisory firms with assets under management of less than $25 million generally register with state regulatory agencies.) The SEC doesn't require a test; however, it does require that the adviser file *Form ADV,* also known as the Uniform Application for Investment Adviser Registration. This document asks for specific information from investment advisers, such as a breakdown of the sources of their income, relationships and affiliations with other companies, each adviser's educational and employment history, the types of securities the firm recommends, and the firm's fee schedule. (Many states require passing a securities exam, such as a Series 2, 63, or 65.) In a pitch over the phone or in marketing materials sent by mail, an adviser may gloss over or avoid certain issues. Although it's possible for an adviser to lie on Form ADV, it's likely that an adviser will be more truthful on this form than in marketing materials. Ask the adviser to send you a copy of his Form ADV, or visit the SEC Web site at www.sec.gov. You can also call them at (202) 551-8090 or fax your request to (202) 777-1027.

What Are Your References?

Ask other people about how the adviser benefited them. This process is one way to verify the rates of return the adviser may claim (although you're smart enough to recognize that the adviser will refer you to the clients who've done the best with her). Also ask about the adviser’s strengths and weaknesses.

Virtually all money managers offer a free introductory consultation if you meet their minimum investment requirements. Planners who work on commission also tend to offer free sessions. So the “free” consultation ends up being a sales pitch to convince you to buy certain products or services.

Busy advisers who charge by the hour usually can’t afford to burn their time for a free in-person session, especially a lengthy one. Don’t let this deter you; this fee is probably a good sign. These advisers should be willing, however, to spend a modest amount of time in person or on the phone answering background questions free of charge. They should also send background materials and provide references if you ask.

Do You Carry Liability Insurance?

Some advisers may be surprised by the question of liability insurance or may think that you’re a problem customer looking for a lawsuit. On the other hand, if your adviser gets you into some disasters, you’ll be happy you have the insurance coverage. Financial planners and money managers should carry *liability insurance* (sometimes called *errors and omission insurance*). This coverage provides you (and the adviser) with protection in case a major mistake is made for which the adviser is liable.

Appendix

Recommended Fund Companies and Discount Brokers Artisan Funds

800-344-1770 www.artisanfunds.com

Cohen & Steers Capital Management Inc.

800-330-7348 www.cohenandsteers.com

Dodge & Cox Funds

800-621-3979 www.dodgeandcox.com

The Fairholme Fund

866-202-2263 www.fairholmefunds.com

Fidelity Brokerage

800-544-6666 www.fidelity.com

Fidelity Funds

800-343-3548 www.fidelity.com

Harbor Funds

800-422-1050 www.harborfunds.com

Masters' Select Funds

800-960-0188 www.mastersselect.com

The Oakmark Funds

800-625-6275 www.oakmark.com

Sequoia Fund

800-686-6884 http://www.sequoiafund.com

T. Rowe Price Brokerage

800-225-7720 www.troweprice.com

T. Rowe Price Funds

800-638-5660 www.troweprice.com

TD Ameritrade

800-454-9272 www.tdameritrade.com

TIAA-CREF

800-223-1200 www.tiaa-cref.org

Tweedy, Browne Funds

800-432-4789 www.tweedybrowne.com

USAA Funds

800-382-8722 www.usaa.com

Value Line Funds

800-223-0818 www.vlfunds.com

Vanguard Brokerage

800-992-8327 www.vanguard.com

The Vanguard Group

800-662-7447 www.vanguard.com