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A Primer On Savings & Investing

If you look at the people who are successful savers and investors, you will find they share a number of common denominators in their planning, timing, and implementation. The thought here is to share these "secrets to savings success" with you. This is not an attempt to provide investment advice, or usurp the authority of any investment or financial adviser you may be using. In fact, if they were to read this primer, they would probably agree with it wholeheartedly.

First Step: Get Your Ducks In Order

Before you consider any significant investing plan, you should first make sure your "financial basics" are covered in related areas because they are investments in their own right.

Make sure you are adequately covered with the right kind and amounts of insurance for you and your family. Do you have the proper amount of life insurance? How about disability insurance? In fact, you are statistically 5 times more likely to become disabled than to die. If you own vehicles or property, are they properly covered in case of accidents, and lawsuits?

Next, do you have any emergency money on hand? A common rule of thumb is to have the equivalent of 3 months of living expenses in an account that you can liquidate at a moment's notice. That doesn't mean you need to put this money under your mattress, or in a checking/savings account. You can put the money into higher yielding investments as long as you can get the principal out immediately.

Third, are you comfortable with your home ownership(or lack of it) situation? For qualitative as well as quantitative reasons, you should be satisfied here. If not, it is a very significant foundation to get in order first. In this topsy turvy world, it's important that you feel secure about your shelter.

Fourth, how is your overall debt structure? Do you have a lot of consumer-type loans outstanding with high interest rates? If so, paying them down is actually a good investment. If you have $3000 outstanding on a credit card that is charging you 18% annualized, non-tax deductible interest, by paying it off you are actually making nearly 18% on your moneywith no risk. So you should compare the amount of interest you are paying on debts to the amount of return you will make on your money to determine how much debt to retain vs. pay off.

Finally, should you be investing in any extra education for yourself? The proper kind of advanced learning for your job can pay for itself many times over. In fact, it is probably the best overall investment you can make for yourself.

Step Two: Establish Your Specific Investment Goals

The secret to success in anything is to know your strengths and weaknesses. For investing, the strongest point is to **HAVE A SPECIFIC GOAL**! What are you trying to achieve? Retirement? College? A Big Purchase like a house, boat, or wedding? Or extra income? Knowing this sets the stage for everything else. It tells you whether your objective is income vs. appreciation, and it sets up a strategy that is used in conjunction with your life cycle and risk tolerances.

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Next, try to **QUANTIFY THE GOAL**. This allows you to make reasonable estimates as to how much you will need to invest, for how long, and at what rate of return in order to reach the goal. This helps you to understand and quantify your risk/reward factors, and gives you the "trade off" figure that is, the amount of money you must put away today instead of spending it on something else in order to reach a goal down the road. In short, you are trading off a short term pleasure for a long term one, and investing the proper amount to get there.

Step Three: Understand Your Risk/Reward Tolerances

Everyone is different. Some are conservative by nature, some are high risk takers. Some enjoy working with numbers, others hate it. It's the same for investing. Successful investors understand their tradeoffs in achieving investment rewards against the appropriate risks. It's how they arrive at their investment style.

But what are these various risks? Coming to grips with them, and establishing boundaries for your individual personality and goals is the issue. Bottom line is that you should have a good feel for your risk tolerances, because every type of investment comes with a price. That price is how much risk you are willing to take for a given return. The most common factors to understand your risk tolerance level are as follows:

1. Ease of Management: This determines how much of the investment process you will be doing as opposed to using a professional. If you enjoy doing hands on work, if you have a considerable amount of free time to do the research, selections, and management, your overall gameplan will differ from one who elects to "farm out" the work to a financial advisor. Similarly, the types of investments, and the volatility of them are related to one's available time budget.
2. Time Horizon: The amount of time you have in order to achieve your financial goals is critical. It affects the type of investments, the rate of return you must shoot for, the actual portfolio mix, and the general risk factor. If you have a long time to reach your goal, you can use more conservative investments with lower yields since the power of compounding is working for you.
3. Liquidity Needs: Liquidity is the amount of money you should have available for unforeseen changes in your financial situation. If you are 100% certain you will not need to liquidate the investment over the amount of time in question, you have no liquidity need. On the other hand, if there is substantial uncertainty, you have significant liquidity needs. This affects the type of investments you will make, and when you will make them. If you are considering stocks, and you will not need the money for 5 years, then this is an acceptable type of investment. A 5 year time span in the market reduces the volatility aspect significantly compared to a 1 year time frame.
4. Inflation: This is a critical factor if you are investing for income as many retirees do. You must account for the potential ravages of inflation when you invest. If you invest in a $10,000 bond that will pay you 7% per year in today's dollars($700), and inflation averages 5% per year, then in real terms you are clearing $200 for year one. It gets less and less in real terms over the years, so this investment will deteriorate over time. So the longer you are investing, the more you should consider the inflation factor in choosing the type of investment, and the types of fixed yields.
5. Your Tax Bracket: With today's 2000 federal tax rates as high as 39.6%, this is a very important factor since it affects the actual yield you will make. The higher your bracket, the less you make and the more the government makes. So it can have a crucial role in how long it will take you to reach your goals. Also, it is one of the key factors in deciding whether to use tax-free investments or taxable investments. As a general rule of thumb, the lower your overall tax bracket is, the less

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attractive tax free investments(such as municipal bonds) are. Also, the more volatile your tax bracket will be over the investment timeframe, the harder it is to decide on the proper mix of taxable vs. tax-free selections.

6. Temperament: It doesn't do any good to put your money in investments that will drive you crazy. The overall plan must be coordinated with your overall personality. If you are ultra conservative, you may not wish to invest in aggressive issues even if they are good. It may eventually eat you alive from an anxiety standpoint. You should always invest within an appropriate comfort level from both a quantitative and a QUALITATIVE standpoint. After all, life is more than just investing, isn't it?

Step Four: Use Appropriate Investing Techniques

There are 12 tried-and-true techniques that can literally mean the difference between average success and stellar performance when it comes to investing.

DIVERSIFICATION: Study after study indicates that 90% of the potential total return on investments comes from the broad allocation of assets, and only 10% comes from the individual selections over the long run! This is the Modern Portfolio Theory set forth by the Nobel Prize winner, Professor Markowitz. In layperson's terms, it means it's more important to decide how to place your money within various asset classes, rather than which individual investment to pick. Buying IBM stock is secondary to deciding how much money to put into stocks vs. bonds in general.

Why is this? Because, at various times one type of investment will outperform another type. If you look at some historical examples, you can understand more clearly.

From 1975 to 1980 Gold took off like a rocket, going from $195/ounce to $800/ounce, while stocks languished. From 1980 to 1987, real estate was the "wonder" investment, and gold hit the skids. From 1987 through 1999 stocks have had a great run, while real estate cooled considerably. So, unless you got very lucky in picking the right single asset group over this span, and knew when to sell it as well, you would have done much better by diversifying among all these groups so one could pick up the slack for the other.

In effect, diversification increases your chance for returns while reducing the volatility. Here's an example: Choice One: You can invest in a $10,000 bond paying 10% per year for 25 years. OR, Choice Two: You can put the money in 10 other diversified investments at $1,000 apiece, each with the potential to make 25% per year, or to lose everything over the same 25 year period. Now, assume 9 out of the 10 investments go completely bankrupt, and only 1 makes the grade.

Which was the better choice? The $10,000 bond would have returned $108,000 to you. But, the one successful $1,000 investment would have returned $265,000 to you! That's an example of what diversification can do in real terms.

So, you should mix your investments among a number of asset groups, including Equities(Stocks), Fixed Instruments(Bonds, CD's), Cash Equivalents(Bank accounts, Money market accounts), and Inflation Hedges(Real Estate, Precious metals, and the use of Bond "Ladders"). Further diversification is recommended within these groups. Buy stocks in small, medium, and large companies, buy stocks in different industries and sectors, and have a group of thesenot just one stock in your portfolio. Some

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financial experts believe that if you are a moderate risk taker, and you can't afford to buy at least 11 different individual stocks as your Equity portion, then opt for mutual funds instead.

For the Fixed Instruments, buy various maturities ranging from 2 years up to 30 years to hedge your risk against interest rate changes. Also, buy different types of these investments: US Treasuries, GNMA's, Corporate Bonds, Savings Bonds, and Floating Rate Funds to name a few. Again, unless you have a significant portfolio where you can buy individual issues, consider using bond funds to further diversify among issues and maturities.

What percentage of your money should you put into each group? That depends on many factors we have already mentioned, such as your risk tolerance, your time horizon, and so forth. You must carefully make this decision. Some time-honored tips: The longer you have to invest, the higher the percentage should be in Equities; the more conservative you are, the less should be in equities. But, even the most conservative should have some equity investments for long-term planning according to the experts.

USE DOLLAR COST AVERAGING: This is a long term technique in which you buy into an investment periodically instead of in a lump sum. You buy equal amounts over stated periods(such as monthly). If the investment performs according to historical statistics, this will lower your purchase price. Why? Because investments don't tend to increase in value in a straight line; rather, they go down sometimes, and up others. In fact, statistics show that an average stock can change in value up to 50% in a given year. A $10 stock can decline to $8 or rise to $12. So, by purchasing periodically, you buy on the downside as well as the upside, thus lowering your average cost per share. Naturally, this assumes the investment will eventually increase in value over your time horizon.

ENJOY THE MAGIC OF COMPOUNDING: Investments that allow you to reinvest the income automatically are "compounding" themselves. You are getting interest on your interest. As a guide to see how powerful this is, use the so-called "Rule of 72" to calculate its effect. Divide an investment's expected yearly rate of return into the number "72" to see how fast it will double in value. Thus, an investment returning 6% compounded will double in 12 years. A 12% yield compounded will double your investment in just 6 years!

INVEST FOR THE LONG TERM: When it comes to the equity portion of your investment mix, think long termat least 3 years. If you can't maintain your equity position for at least that long, then don't do it(unless you are an aggressive player). The longer you hold equities, the more you reduce the volatility risk, a major factor.

DON'T TRY TO TIME THE MARKET: If you are investing for the long run, then don't worry about short-term fluctuations, and short term machinations of the market. People who try to time the market lose 70% of the time. Why? For the average investor(even the above-average investor!), the market is always 2 steps ahead in information, performance, and projections. An average investor waits "until the market gets better" to invest, thus insuring that he will be buying "at the top," or at the highest price. Besides, who knows when or where the "top" or "bottom" of a market will occur? A savvy investor who believes in the investments made for the long run understands this, and will buy steadily in good and bad markets. Leave market timing to the so-called "experts!"

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KEEP EMOTIONS OUT OF THIS: Take a tip from the professionals. Look at the entire exercise from a quantitative, cold-calculating approach. This allows you to invest for the long haul, use dollar-cost averaging effectively, and avoid getting caught trying to time the market, to name a few.

REDUCE TRADING COSTS: If you are doing your own selections, consider using discount brokerage services, or non-commissioned funds and financial advisors. Trading costs can put a big dent in your profits, especially if you can't follow the previously mentioned techniques. Everything else being equal, a "buy and hold" strategy for equities may be betterand cheaperthan trading and timing.

LADDER YOUR FIXED INSTRUMENTS: When you buy interest yielding issues such as Bonds, or CD's, it is important to mix up the maturity dates to avoid interest rate and inflation risks. Don't put all your fixed instrument investments into a singular maturity date schedule. Keep in mind that most fixed instruments will change in value after you buy them when the interest rates change in the market. If you buy a bond with a 20 year maturity date today, and interest rates increase 1% next week, the value of your bond declines by 9%(or vice versa).

So unless you are omnipotent and know what interest rates will be doing over the next 30 years or so, play it safe and stagger your maturity dates. This is called "Laddering." That way, you don't get "locked in." If you need to cash in, you can cash in a shorter term bond, or one that is maturing, and avoid loss of capital if interest rates have moved against you. Use maturity dates ranging from 2 years, 5 years, 10 years, 20 years, and 30 years. Also use floating rate bond funds for safety.

USE MUTUAL FUNDS FOR SMALL PORTFOLIO: If you don't have enough money to set up a balanced portfolio of individual stocks and bonds, consider using mutual funds. There are thousands available in all areasequities, bonds, international, precious metals, you name it. Pay attention to the fund's track record, both short-term and long-term. Research how it has done in various types of markets, i.e. "bull vs. bear" markets. Finally, evaluate the costs of using two general types of funds: "Load" vs. "No-load," that is, a commission-charging vs. non-commission fund.

BONDS VS STOCKS: A BENCHMARK: When do bonds make a better investment than stocks? As we mentioned, your overall investment strategy should have both. However, keep in mind an important historical average. According to research company Ibbotson Associates, over the past 65 years the S&P 500 stocks have risen an average of 10% a year. So, from a long-term perspective, if you can make more than that on bonds(in after tax dollars), have a higher percentage in bonds. If not, have a higher percentage in stocks.

THE SECRET TO MARKET PERFORMANCE: Remember this: Investment markets are fueled by emotions in the short term, and value in the long term. Even the biggest of players follow this axiom. That means you should use the short term emotional angle to buy in at the lower end and hold it for the value. It also means if you are going to try to "play the market" you are at the mercy of these emotions(the market's and yours), and it can be quite a roller coaster.

BALANCE & RE-EVALUATE YOUR INVESTMENT PLAN: Once you have set up your plan, coordinating the investments with your financial goals and situation, don't go to sleep. You should balance the mix of equities and bonds periodically. If the mix percentage changes from your original plan because of the change in valuation of the investments, adjust these investments accordingly by either selling or adding to the mix to bring the percentages back in line. This technique forces you to sell at the

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top and buy at the bottom, to increase your chance of success. As a rule of thumb, once you do this periodic check(for most people it is once a year), if the ratios have changed by 10% or more, you should make the necessary moves to restore the balance.

Also, you should re-evaluate your personal financial situation to see if things have changed. Has your overall monetary situation improved dramatically due to job change, inheritance, etc? How about your investment philosophy? Or other value systems? If so, maybe you should re-structure your financial goals accordingly. We all change over time. Make sure you are periodically re-balancing to increase your overall success rate.

Conclusions

As you can see, saving and investing can be done in a step by step procedure. There are no "hidden secrets." But successful investing does depend on putting in the time, either by yourself if you are going to handle your own money or a financial advisor who will be doing it for you. If a fundamental, diversified, long-term approach is used, with periodic balancing to take into account your changing financial situation, and if the 12 time-honored investment tactics & techniques that we discussed are used, you will be well on your way to becoming a very successful investor.

P.S. Enclosed you will find some guidesheets to provide you with insights in 3 important areas:

1. Questions To Ask Financial Advisors;

2. Investment Options Available; and,

3. The 9 Most Common Errors An Investor Makes.

Here's hoping you find them helpful...

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Questions To Ask Financial Advisors

If you are considering using a professional to help you with your investing, make sure the person you select fits into your overall game plan. To help you in this selection process, here are 11 issues to discuss:

1. Investment philosophy.
2. Services to be provided and types of investment options available.
3. Past investment performances: 1 year, 5 years, 10 years.
4. Will advisor have discretionary powers over the account?
5. Can anyone other than yourself remove funds from the account?
6. Licenses, educational background, overall experience, references.
7. Will your account be typical or will it be bigger or smaller than an average account managed by the advisor?
8. How will financial advisor be compensated? Commissions vs. fees or a combination of both?
9. Get copy of fee structure and Parts I and II of Form ADV.
10. Is advisor or advisor's firm affiliated with any of them investments that are recommended?
11. What would happen to your account if the advisor left, or you wanted another advisor?

Keep in mind that you will be working with this person over a relatively long period of time. It should be a person with whom you feel comfortable and confident. This is a high priority issue, so do your homework first. Spend at least as much time in selecting a financial advisor as you do in buying a new car. While this analogy may seem ridiculous, statistics show that it isn't the case! So stand out from the crowd and give yourself a chance to be a successful investor. After all, this is your future and your family's future at stake.

Investment Options Available

Since most successful investors use a diversified approach where the portfolio consists of a mixture of bonds, stocks, and cash equivalents, you should have a knowledge of what investment options exist within these areas, and the pluses and minuses of each as well. Whether you will be buying individual issues within these groups, or using mutual funds instead depends on your temperament, and budget. In either case, the general categories of mutual funds respond the same way as do individual issues.

Stocks & Stock Funds

Statistics have shown that, over the long run, the best investment performers have been equities, or stocks. Stocks can be further divided into three main categories: Large Cap, Mid Cap, and Small Cap, the difference being how much capitalization exists. A Small Cap stock means a company with capitalization of less than $500 million. A Mid Cap is one with more than $500 million, but less than 2 Billion; and a Large Cap has in excess of $2 Billion in market value of its outstanding stock. These differences affect such investment concerns as volatility, potential for growth, and base of ownership, to name a few.

There are numerous ways stocks can be further defined. You can buy preferred vs. common. There are growth-oriented stocks, there are value-oriented stocks. How about high dividend stocks, or low dividend

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stocks. You can also buy so-called "Blue Chip" issues. Each has its own purpose, advantage and disadvantage according to the goals you have set.

Instead of buying individual stocks, you can buy into a stock mutual fund. These funds hold a number of different stocks so there is more diversity. The theory here is that an investor can reduce risk and/or increase diversity by using a fund instead of buying individual stocks. In fact, most financial advisors would agree that an individual should never rely on just buying one stock issue. To reduce risk, a portfolio should have a number of stocks. Hence, the possible advantage of a mutual fund.

Funds have other advantages in that investors can also buy in smaller amounts, have the returns reinvested(or compounded), and supposedly rely on the fund to manage the market changes. Funds cost money in that there is a commission to buy in or out if the fund is a "Load(commission based)" fund, and there is a yearly management fee(both load and no-load funds charge this). Another disadvantage is that funds must follow their charter as to how much stock to own at any given time, which may not always be the right amount in certain market conditions. This is called being "Fully Invested."

Fixed Instruments & Funds

Fixed instruments, commonly referred to as Bonds, are basically an obligation issued by a borrower who agrees to pay back the full amount plus interest at a set future "due date." These bonds can range in due date(maturity) from very shortless than one yearto very longup to 30-40 years. As a general statement, bonds are used more by the average investor for creating income than for creating appreciation.

Bonds are also rated according to the ability of the issuer to pay them back; this is called their "credit quality." It is very important to understand that the rate of return a bond pays relates to credit quality. Thus, everything else being equal in the analysis, the higher the rate of return promised, the lower its credit quality. Investors must pay attention to this axiom and integrate it with their risk tolerances and overall goals.

A bond may fluctuate in value until it reaches its maturity date, since its value relates to changes in interest rates after purchase. Thus, if you buy a bond today paying 7% interest, and interest rates rise, the value of your bond will decline. Why would anyone want to buy yours at full price when they can get a new one paying a higher interest rate. So you would have to "discount" the bond, and sell it at a lower price than you paid for it to get someone interested. This is a point of which many people are unaware, and it can cause trouble(and loss of investment money). The only way you can guarantee the face value of this type of bond is to hold it to maturity. However, there are "floating rate" bonds around which tend to hedge this risk. With these investments, the principal tends to stay constant, but the yield changes with interest rates.

Thus, when you consider buying bonds, the maturity date is as important a consideration as is the yield. In fact, the longer the maturity date, the more the bond price will vary before maturity as interest rates change. Bonds are categorized according to the purpose and the issuer. The main categories are:
US Government Obligation Bonds: Backed by the U.S., these are issues such as US Treasuries, and Savings Bonds.
US Backed Bonds: These are issues backed by various US Government agencies such as GNMA, FNMA, Sallie Mae. Most of them are based on an agency guaranteeing value of mortgages.

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Corporate Bonds: These corporate obligations are rated according to credit worthiness, with AAA the highest, declining according to the alphabet. BBB is more risky, etc.
Municipal Obligations: These are bonds issued by municipalities such as states, cities, revenue authorities. Like corporate bonds, they are rated according to risk. Unlike corporates, many municipal bonds can have tax exempt status, meaning you pay no income tax on the interest received. But not all municipal bonds are alike in either taxability or risk.

Similar to stocks, there are numerous Bond Funds which have pooled together a number of different issues, to diversify your risk. These funds usually categorize themselves according to the type of bonds they buyMunicipal bond fund, GNMA Bond Fund, Corporate bond fund, and so forth.

Cash Equivalents & Funds

These are very short term investments that tend to be readily converted into cash with less volatility and loss of principal. Short term CD's from banks, savings accounts, money market accounts, and short-term US Treasuries are the main examples.

The advantage to these cash equivalents is that your principal can stay relatively constant, and you can cash in immediately even if interest rates have moved against you quickly compared to longer term fixed instruments. Naturally, the trade off is that the yield on these investments tends to be substantially lower than bonds with longer maturities. As we have seen with every type of investment, there is a price for everything, and everything has its price!

The 9 Most Common Errors An Investor Makes

Without a doubt, a good investor has the ability to minimize risk and maximize returnanother way of saying reduce errors. If you can avoid the following errors, you are well on your way to reaching the upper percentile of successful investors. **DON'T MAKE THESE ERRORS**:

1. Putting all your eggs in one basket. Not diversifying properly.
2. Investing without a quantifiable goal, and without understanding your individual investment persona.
3. Not considering the effects your tax bracket will have on the investments especially with these 2000 rates.
4. Waiting for the market to get better before investing. Trying to "time" the market - (30% succeed and 70% fail!).
5. Failing to use equities, especially for long-term investing.
6. Relying on hot tips and emotions.
7. Over use of short-term trading vs "buy and hold" strategy.
8. Paying too much in commissions, or fees for investment transactions.
9. Not balancing the investment mix periodically.

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