How to Get Wall Street's Hands Off Your Wallet

Investment Principles to Build & Preserve Wealth

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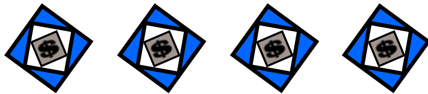
Malkiel, and others. The data are there for anyone to evaluate but it takes a little effort. Don't expect the brokerage and mutual fund firms to highlight these data for you – there is way too much money at stake, and they don't want the facts to be well understood.



I hope this book has made you a more knowledgeable consumer of financial products and I hope you maintain a healthy dose of skepticism when you hear "hot tips" and "good advice" from the so-called "experts." If you cast aside conventional wisdom, you will be well rewarded.

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Introduction

> *I would rather sit on a pumpkin and have it all to myself than be crowded on a velvet cushion.*
> - Henry David Thoreau

Believing something that is contrary to conventional wisdom can be difficult. Sitting with everyone else on what appears to be a velvet cushion feels comfortable – it makes you feel good to know that many others are in the same position as you. However, oftentimes things are not as they appear, and a velvet cushion can be infested with insects or be so crowded that it becomes uncomfortable. This book will address many of the misconceptions related to investing – misconceptions perpetuated by Wall Street brokerage firms, mutual funds, financial magazines, popular media, aggressive salesmen, and human nature. I am writing from experience as I worked on Wall Street (Alex Brown & Sons, Deutsche Bank and Wachovia Securities) for over ten years. It was through these work experiences that I learned about the industry, witnessed how it works and gained conviction that what I'm about to tell you is absolutely correct. There is no substitute for first-hand experience. When it comes to investing, I can assure you that oftentimes sitting on a pumpkin *is* in fact much better than being crowded on a velvet cushion.

I am not going to say that all brokers and investment

Summary

> *Do not hire a man who does your work for money, but him who does it for the love of it.*
> - Henry David Thoreau

So, would you rather help your broker prepare for her retirement or help yourself prepare for yours? Don't drive yourself crazy following stocks and trying to time the market.

Understand your investment goals, minimize your costs, be disciplined and keep it as simple as possible. If you don't have the time or inclination to manage your portfolio, hire a fee-only (no commissions) Registered Investment Advisor and keep your costs at 1% of assets or less. There is a lot of value in having a diversified portfolio, rebalancing when necessary and taking the emotion out of investing – so if you need to pay a trustworthy advisor a modest fee to help you, that's fine.

There are a lot of people out there trying to sell you financial services, magazines, newspapers and all sorts of unnecessary things. Their goal is to make you believe that investing is so complicated that you must pay someone a lot of money in order to do it properly. That is conventional wisdom and it couldn't be further from the truth. As you become more educated in the investment arena, you will become convinced of this. Don't simply take my word for it. Read some of the recommended books and articles. Review the studies published by Fama, French, Bogle,

professionals are bad people who are trying to make as much money as possible off of you (although some are). Rather, I will make the case that the average financial intermediary (broker, fund manager, advisor) destroys value and the average investor necessarily does worse than they otherwise could by investing in a low-cost, simplified, indexed portfolio. While giving your money to active mutual fund managers and brokers isn't the worst thing in the world, it is absolutely not the best thing in the world either. Was your portfolio performance "good" or "bad" last year? Do you know what the relevant benchmark comparison is and do you know that you can probably find passively-managed funds (think "index funds" or a fund that actually holds stocks for the long-term) that cost less and will deliver better performance over your investment horizon?

This book will provide you with a simple alternative to the high cost, complex world of brokerage firms and mutual funds. I will not pretend to have the ability to predict the future and I will not pretend to have a great secret that will allow you to retire in ten years. But I will unravel some of the misconceptions about investing. The conventional wisdom is that investing is very complicated and some people have the ability to consistently outsmart everyone else. The truth is that investing should be simple and inexpensive and it is impossible to consistently know in advance what the markets will do.

Why do brokerage firms want to make investing seem so complicated? To justify their outrageous fees. Why do financial magazines and newspapers want to make investing seem so

complicated? To get you to buy their thoughts. Why do financial experts on TV try to make investing sound so complicated? So they can keep getting paid to try to predict the future and because many of them don't really know what they're talking about. Why don't brokers and mutual funds clearly state their performance versus a relevant benchmark on every client statement and why do they bury their fees in footnotes and prospectuses? Because most of them are not worth the fees you're paying them and they want to hide this from you. The truth is that the market is pretty darn efficient and it's almost impossible for one human brain to consistently outsmart the hundreds-of-millions of other human brains that participate in the market.

Where does this lead us? To a simplified, low-cost investing strategy that ignores the nonsense coming out of Wall Street and the financial press. Why does this matter to you? It will allow you to accumulate more wealth and enjoy the future quality of life that you deserve. If you follow the investment principles in this book, your portfolio will do better than at least 80% of your neighbors' portfolios because you will minimize your fees, develop a well-diversified portfolio, rebalance your portfolio when necessary, and take human emotion out of the process. This style of investing is not sexy and it will not make you sound cool at a cocktail party, but it is the proper way to build and manage wealth and it's a lot easier than you would imagine. The hard part is believing in the philosophy and being disciplined enough to adhere to the strategy during every phase of the market cycle.

Chapter 10: Other Reading Lists

> *Wall Street's favorite scam is pretending luck is skill.*
>
> \- Ron Ross, PhD,
>
> "The Unbeatable Market"

Larry Swedroe – Principal at an investment advisory firm – author of "The Successful Investor Today," "The Only Guide to a Winning Investment Strategy You'll Ever Need" and other worthwhile books.

Bill Schulteis – investment advisor – author of "The Coffeehouse Investor"

Gordon Murray & Dan Goldie – authors of "The Investment Answer"

James Surowiecki – staff writer at *The New Yorker* – author of "The Wisdom of Crowds"

There are also a few websites that dispense good investment advice. I recommend visiting:

- *www.indexfunds.com*,
- *www.dfaus.com*,
- www.investopedia.com, and
- *www.vanguard.com, and look for articles by John Bogle*.

Taking an hour to read this book could make an enormous difference in your current and future quality of life. You will learn to control what you can control (costs, asset allocation, diversification, and tax efficiency) and ignore what you cannot control (market fluctuations). Remember to keep an open mind and always challenge conventional wisdom. Just because something sounds simple and new doesn't mean that it's wrong.

YOU work hard for your money so make sure your money is working hard for YOU.

A lot of problems arise when people think they know something when they actually do not. When it comes to investing, it is critical to understand that neither you nor anyone else knows in advance what the markets are going to do. *If* you could predict the future and make all sorts of money from this power, would you share it

Chapter 1: Facts Worth Understanding

with lots of other people? Of course not! You would keep it a secret and keep making lots of money for yourself. Many investment professionals will pretend that they have the ability to predict the future and "time the market," but you would be better off going to the state fair and paying $2 for advice from a fortune teller – at least *that* bad advice will only cost you $2 instead of $2,000 or $15,000. If something (or some money manager) sounds too good to be true, then it (he/she) probably is. There's no easy way to make money and build wealth – if there were then everybody would do it. A basic understanding of some facts, coupled with the discipline to adhere to a strategy, is all you need to succeed. Having the discipline, however, is easier said than done. In the end, you are responsible for your own financial well-being, so equip yourself with some knowledge and start working towards financial freedom – there is no better time to start than today.

> *To know that we know what we know, and that we do not know what we do not know, that is true knowledge.*
> - Confucius

Here are some facts to consider:

- *Costs matter* – they reduce the value of your portfolio. Only pay a fee if you get something of value in return. Don't pay a fee for someone to destroy value. Your goal is to get exposure to the proper asset classes at the lowest possible cost.

industry who want *you* to *help them* achieve *their retirement goals* and they charge fees accordingly. Look out for yourself and take responsibility for your own financial well-being. If you need help along the way, find a trusted advisor who charges reasonable fees.

There is so much noise in the marketplace that it is oftentimes difficult to identify which "experts" are knowledgeable and which ones are simply trying to sell you something. In my opinion, most of the financial media is either uninformed or they have ulterior motives like trying to sell you a magazine or trying to increase ratings so they can get more advertising dollars. You can ignore 95% of the nonsense that is distributed through the media. Listed below are a few authors who know what they're talking about and they dispense good advice. In no particular order:

John Bogle – founder of Vanguard – author of "The Relentless Rules of Humble Arithmetic" along with numerous other publications. Visit the Vanguard website.

Burton Malkiel – Princeton University professor – author of "A Random Walk Down Wall Street"

David Swenson – Chief Investment Officer at Yale – author of "Unconventional Success" and other worthwhile books.

companies will give you all sorts of loans to feed your spending habits – then they'll charge you 15% interest and it will take a long time to pay off that loan. Be a well-informed consumer. You don't need a huge house, you don't need to spend most of your annual disposable income on a vehicle to get you from point A to point B, and you don't need to spend your life buying things at the mall. Again, the choice is yours.
If you aren't able to save any money for one reason or the other and you have other people depending on you for their well-being, do everyone a favor and buy some cheap term life insurance. It might cost $150-$300 per year for a healthy, young person to get valuable coverage in case something happens to them. That's a small price to pay for your family's financial security. As you accumulate more assets and build that nest egg perhaps you can stop paying the term insurance premiums, but it's a good idea to have some coverage. I would recommend term insurance over whole life insurance or annuities because term insurance is a lot cheaper and it's true insurance coverage. The other products tend to be a blend of life insurance and investment vehicles and the fees tend to be very high. Save money in a retirement or brokerage account and buy term life insurance – that will cover most people reasonably well.

Finally, financial products and services can be very, very important tools to help you achieve your personal goals. Always try to learn more about the products and services you are consuming and don't pay a fee for something unless you're getting something of value in return. There are a lot of people in the financial services

- *It is impossible to know in advance which stocks or fund managers will outperform in the future* – past performance means nothing about the future and there are reams of studies, data, and books to support this assertion. Don't mistake luck for skill. If 8,000 people flipped coins ten times in a row, a few of them would flip all heads; this is *luck*, not skill! Wall Street would have you believe that they are very talented coin-flippers (stock pickers) and, therefore, you should pay them a high fee to flip coins (pick stocks) on your behalf.

- *Your risk profile should drive the investment process* – it's easy to understand returns, but it's somewhat more complicated (and important) to understand how much risk you could or should take. Your risk profile should drive how you allocate your portfolio across various asset classes.

- *Asset allocation determines results* – most people spend all of their time and money trying to pick the correct individual stocks. The truth is that asset allocation – your mix of large-cap stocks, small-cap stocks, international stocks, bonds, real estate, etc. – is responsible for 95% of your returns, and individual security selection is essentially a waste of time and a huge waste of money because of the high commissions. Asset classes tend to move as a group (for example, most large-cap stocks declined from 2001 to 2003 while most bonds appreciated) so it is best to simply

buy the asset class at the lowest possible cost via passively-managed index funds.

- *Diversification is crucial* – you should only take a risk if it is reasonable to assume you'll get compensated for taking it. Diversifying allows you to mitigate risks that don't provide a commensurate return. You can actually maintain your expected return while lowering your risk (volatility) through proper diversification.
- *Rebalancing matters* – it forces you to sell high (temporary winners) and buy low (temporary losers) and it helps take the human emotion out of the investment process.

When you combine high fees with the active managers' inability to consistently beat the market, another simple fact emerges: *simply capturing the returns of stock and bond market averages will give you better performance than the average investor*. How can this be? Because the average investor pays high fees, tries to time the market (ineffectively) with active buying and selling of securities and pays more in taxes as a result (if they manage to generate any positive returns).

From 1986 to 2006 the S&P 500 enjoyed an approximate annual return of 13% while the Lehman Brothers Bond Index returned almost 8% and the international equity markets returned about 10%. What's wrong with these returns? Nothing! So why not simply take what the market gives you and do so at minimal

Chapter 9: Highlighting the Obvious

have nobody to blame but yourself when you realize you can't afford a house or you can't afford to retire. Take responsibility for your actions and be prudent. You can probably enjoy life now while saving enough money for a nice retirement (although kids make this more difficult!) – those choices are not mutually exclusive. Just prioritize things and understand what makes you happy and what doesn't. Tons of new clothes or a new electronic gadget probably won't bring you true happiness. Remember that $1,000 today could be worth $10,000 or more in retirement. The choice is yours.

> When asked what he considered to be mankind's greatest invention, he replied: *"Compound interest!"* - Albert Einstein. He also called compounding the 8th wonder of the world.

Also understand how financial intermediaries get paid. We've already discussed how brokers get paid, but apply the same logic to mortgage bankers, credit card companies and even car salesmen. They all look out for their own best interest, not yours. So of course the mortgage banker will tell you to buy a bigger house and take on more debt – that's how they make money. Of course a car salesman will try to get you to buy a $25,000 car instead of a $10,000 car that is perfectly adequate – that's how they make money. Of course credit card

11% per year, but let's be really conservative and take 3% inflation into account (inflation erodes the value of your dollar – it hurts your purchasing power and that's why you need a little more money each year to maintain your quality of life). So if your investment dollar will double every ten years and you are 30 years old today, look at what happens over time:

Year 0 - $1
Year 10 - $2 (doubles)
Year 20 - $4 (another double)
Year 30 - $8 (another double)
Year 40 - you're now 70 years old and retired. That initial dollar is now worth $16. Go buy yourself dinner.

This is the power of compounding. It's a beautiful thing. But it can't work for you unless you save those dollars. Between compounding the existing dollars and adding new dollars, your account will have solid, consistent growth if it's properly invested.

In order to save more for your future, you need to spend less today. As highlighted in a brilliant *Saturday Night Live* skit in late 2005, "don't buy stuff that you can't afford." Don't buy stuff, build credit card debt and then figure out a way to pay for it. You'll end up paying thousands of dollars in financing charges each year and you'll never be able to save for a house, your child's education or your retirement. Save money first and then spend a little if necessary. Remember, you can either spend the money now or invest it and have a bunch of money at retirement. The choice is yours. If you choose to spend all of your money now, you will

cost? You can build wealth and plan for a nice retirement by simply taking what the stock and bond markets give you. Don't make it more difficult and risky than it needs to be and don't pay 2-3% fees and commissions in a futile attempt to do better than the market indices – you'll end up about 2-3% below the market averages while your brokerage firm or mutual fund company ends up about 2-3% wealthier.

Think of matching the indices as playing par golf. Wouldn't you be happy to simply play par golf instead of hacking up one course after another? Well, most investors pay a lot of money in a futile effort to outperform the market (play golf like Tiger Woods) but they end up hacking apart their portfolio. Be happy playing par golf and be happy taking what various market indices will give you via a low-cost, passively-managed fund. When it comes to investing remember that:

- Less is more (less trading, less cost, less activity), and
- The tortoise will beat the hare at least 90% of the time.

If you want to make things complicated and hurt the performance of your portfolio, then pay high fees, try to time the market, churn your portfolio, and pay the government more than you need to with capital gains taxes. If you want to accumulate wealth and focus on improving your quality of life, then minimize fees, take what the market segments give you, don't churn your portfolio, and minimize your tax bill by accumulating long-term capital gains. This chapter will discuss how:

- Costs matter,

Chapter 2: Sources of Portfolio Underperformance

- Market timing is futile, and
- Taxes matter (in taxable accounts).

> *Gross return in the financial markets, minus the costs of financial intermediation, equals the net return actually delivered to investors.*
> - John Bogle,
> "The Relentless Rules of Humble Arithmetic"

If you care about building wealth, then costs matter – advisory fees, annual management expenses, front-end loads, back-end loads, custodial fees, and commissions all detract from the value of your portfolio. Numerous studies have shown that only about 20% of all active portfolio managers will outperform their respective benchmarks over any 20- or 30-year time period (a reasonable investment horizon for many people). Even though it is impossible to know in advance which managers will be successful, the average investor continues to pay approximately 1.5% of their assets to these active managers and brokers in the hope that they will be one of the few lucky ones. While some fees are necessary for good advice and low-cost investment vehicles, it is important that you only pay a fee if you get something of value in return. The problem is that most people don't know how to evaluate the investment services and advice that they're receiving and not all

There are a few simple things to remember before you can even start to accumulate wealth. First and foremost, you have to save. The decision-making process is very simple: you can either earn one dollar and take home 75 cents today (after paying taxes) or you can invest that full dollar in a tax-deferred retirement plan and let it grow to $4 or $8 or $16 by the time you retire. It's that simple. You can spend 75 cents today or have a lot more than that during retirement. Of course you need to spend some money today in order to enjoy life, but as long as you plan on retiring some day, you had better start saving or else you'll live out in the streets. Social Security won't pay all of your bills.

Think through the math for a few moments. If your portfolio generates a 7% annual return (a fairly conservative assumption, ignoring inflation), then your money should double every ten to eleven years. If you don't believe me, pull out a calculator and prove it to yourself. A more aggressive portfolio might grow by

In addition to expanding the investment options, you can aggregate retirement accounts from previous employers and lump them into one Rollover IRA. This makes it much easier to manage your wealth. Oftentimes it is a good idea to simplify your investment portfolio so you can do a better job of monitoring and measuring the allocations. There is no need to make things unnecessarily complex. Of course you now know how to properly manage all of your accounts so you can build a well-diversified portfolio and lower your costs.

investment professionals keep their clients' best interests in mind. Poor advice and perpetual underperformance destroy value and, therefore, aren't worth a penny. So make sure you're comparing the performance of your portfolio to relevant benchmark indices (for example S&P 500, Russell 2000, International EAFE Index, Lehman Brothers Bond Index or a combination of these indices depending upon how your money is invested).

Active management is conducted by human beings. Human beings generally have a bad habit of letting emotions dictate their investment strategy. For example, people usually decide to increase their exposure to stocks *after* the markets have been strong, and they pull money out of the market *after* the market has been weak. This sort of emotional market timing will ensure that investors meaningfully underperform the indices over time. Again, it is impossible for anyone to know in advance what the various market segments will do going forward. So take the time to understand your risk profile (more on this in Chapter 3), develop an appropriate asset allocation model for your portfolio (more on this in Chapters 7 & 10), and *stick to it*! Trying to time the market is a waste of time and, for most investors, a huge waste of money. John Bogle, founder of Vanguard and author of "The Relentless Rules of Humble Arithmetic," estimates that the average investor loses approximately 3.7% in annual performance because of poor market timing. Emotions – fear and greed – can decimate your portfolio and dramatically lower your current and future quality of life. Stay humble and level-headed; remember that if you or your broker comes up with some great way to time the market and make some easy money, there's a good chance about 5 million

other people have already thought of the same thing.

Unless you enjoy giving the government your hard-earned money, you need to be diligent about minimizing short-term capital gains (retirement accounts are tax deferred so gains are not taxed along the way). Short-term capital gains tax rates are generally meaningfully higher than long-term (12 months or longer) tax rates. So being more tax efficient with your investing could save you an additional 1-2% annually. Because active portfolio managers tend to buy and sell stocks on a regular basis (weekly, daily, hourly or by the minute), a relatively high percentage of their capital gains will be short term in character and, therefore, these gains will be taxed at the higher rate. While passively-managed index funds will also recognize gains over time (stocks typically get added to and subtracted from the index), a much higher percentage of these gains are long term in character and are taxed at the lower rate.

So what do these sources of portfolio erosion leave for the average investor? Not much given the risks taken:

Average Return of the S&P 500:	10% (real return, less inflation)
Less Excessive Costs	(1.5-2.0%)
Less Market Timing Penalty	(2.0% - at least)
Less Tax Inefficiency	(1.5-2.0%)
Net Real Return to the Investor	**4.5%**

If investors *minimized* costs, were more *tax efficient* and did *not try to time the market*, their return profile would be much improved:

save for education expenses. Each state approves a few service providers (Vanguard and T. Rowe Price for example) and you can find applications online. The "direct 529" option that you manage (online) yourself has much lower fees than the plans sold through brokerage firms – brokers will help you open a 529 but it'll cost you a lot in annual fees. In some states a portion of these contributions are deductible from your state taxes – a great benefit. As long as you ultimately use the funds in the 529 for education (tuition, books, etc.) then you don't have to pay any taxes on the capital gains. Therefore, this is a very efficient way to save if you know that you, your spouse or your children will be buying educational services in the future. Vanguard offers model portfolios similar to the examples outlined in this book, and your portfolio can automatically get more conservative as your child gets older and reaches college age. The fees on the Vanguard plans are generally very low as long as you open a direct 529 and avoid brokerage firms.

Rollover IRA – You can establish a Rollover IRA when you leave a job and move the retirement account out of the employer's plan. For example, if you worked at GE and participated in the 401-k plan, you could move your account to Charles Schwab & Company and open a Rollover IRA when you left GE. As long as you're still with the employer, you must keep the account in their plan. However, once you leave you may want to invest in other funds aside from the options your employer provided. So you could "roll over" your 401-k balance into a Rollover IRA and then you would have the option to invest that money in an almost unlimited number of options.

Chapter 8: Means to an End - Action Steps

> *Things may come to those who wait…but only the things left by those who hustle.*
> - Abraham Lincoln

contributions on your behalf – a great benefit for your company to offer. In order to receive the company contribution sometimes you need to participate up to a certain level – so ask your human resources director for information about your retirement plan. It's important to note that your investment selections will be limited to those chosen by the plan sponsor (your employer). You should be able to build a well-diversified portfolio with those options, but it is highly likely that the options will be costly. When you enroll in these plans ask what the annual operating expenses are for the available funds – the fees are oftentimes up in the stratosphere at 2% or more. If you give away 2% each year, it'll be that much more difficult to achieve your retirement goals. Don't be afraid to ask your employer to provide more low-cost index funds. The employer has the fiduciary duty to offer the best plan possible, so hold them accountable. The service provider (Fidelity for example) will try to fill the plan with high cost funds so they can make a lot of money, so it's up to you to look out for yourself.

College 529 Savings Program – If you or your kids plan to attend college in the future, then the "529" plans are a great way to save. Each state offers a 529 plan that provides a tax-efficient way to

Average Return of the S&P 500:	10% (real return, less inflation)
Less Modest Costs	(1.0%)
Less Market Timing Penalty	0%
Less Modest Taxes	(1.0%)
Net Real Return to the Investor	**8.0%**

So how big of a deal can 3.5% be over your investment horizon? HUGE! A $100,000 investment held for 20 years that earns 4.5% per year will be worth $241,000. On the other hand, a $100,000 investment held for 20 years that earns 8.0% per year will be worth $466,000 – a difference of $225,000. This difference can either go into your portfolio or it can go to the government, brokers and mutual fund companies. It's clear that minimizing costs and adhering to a disciplined asset allocation model can significantly impact your future quality of life. Remember, it is highly likely that you will waste your money by trying to beat and time the market. Stay humble – you have no good reason to believe you'll be one of the few lucky ones to consistently outperform the market.

In conclusion, it is critical to control those factors that you can control – costs, asset allocation and tax efficiency – and to not spend much time or money on things you cannot control – market fluctuations. While brokerage firms and mutual fund companies pretend that they can pick the right stocks and outperform the market benchmarks, 80% of the funds underperform over time. If you want a fortune teller, go to the Atlantic City boardwalk because they can't be found at money management firms.

To quote John Bogle again, investing "is a zero-sum game before costs and a loser's game after costs." Don't give away your money to a broker or mutual fund company.

Different people will have different perceptions of risk depending upon their investment goals and priorities. Not all returns are created equally and returns should generally be a function of the level of risk you choose to take. Your ultimate goal should be to maximize your return given the level of risk you take. So make sure you understand how much risk or volatility you can comfortably take and then diversify your portfolio among several asset classes such that you maximize your return. By properly diversifying your portfolio you can actually lower your risk while capturing the same return that you might get by owning just a few stocks, for example. Who said there was no such thing as a free lunch? Capturing the same return while reducing the risk sounds pretty good to me; and so does capturing a higher return for the same level of risk. Diversifying can give you this free lunch – so eat it up and go back for seconds.

While an advisor should be able to help you think about risk, it's really up to each individual to define it for themselves. Someone who wants to retire at age 50 might view risk differently than someone who wants to work forever. Some people might want to

Chapter 7: Maintaining Discipline and Conviction

> *Market timing is a wicked idea. Don't try it – ever.*
> - Charles D. Ellis, "The Loser's Game"

treatment (for after-tax money) so you will have to pay capital gains taxes when you realize gains in these accounts. Watch out for hidden costs like annual account maintenance fees, custodial fees or other silly fees some firms like to charge. I would recommend Charles Schwab or Vanguard for a regular brokerage account.

Roth IRA (Individual Retirement Account) – These accounts allow people to save money for retirement and benefit from favorable tax treatment. You put after-tax money in these accounts but there are no taxes paid on the gains. However, there are limits as to how much you can contribute each year and there are also income thresholds that limit participation.

401-k and SIMPLE IRA – These are types of retirement accounts that your employer may offer as a benefit. You would contribute gross dollars out of your paycheck before paying any taxes – a nice feature. You would not pay tax on the contributions or the gains until you retire and start taking out the money. Remember that you will probably be in a lower tax bracket (making less money) in retirement so it's usually smart to defer taxes until a later date. Also, most employers choose to make some

stray from the process and get overwhelmed by emotions, you will suffer the same mediocre returns as most of your neighbors. Dare to be a bit different and don't follow the herd – it'll be tough and it might seem counterintuitive at times but you'll be rewarded.

In Chapter 6 we briefly discussed some basic ways to save and build a financial portfolio. This chapter will outline some popular ways to save and invest. This list is not meant to be comprehensive, but I think you'll find enough options to get started. As is usually the case, the government has made saving for retirement fairly complicated with their alphabet-soup variety of accounts. Many of these accounts are named after sections of the convoluted tax code.

Savings account – Money that you'll need over the next few years can be kept in a traditional savings account at a bank. Make sure you're getting paid interest for keeping your money there. You may want to evaluate online savings accounts as they may pay slightly higher rates (less costly for the bank to maintain you as a customer). Also, think about putting your money in a 6-month or 12-month Certificate of Deposit ("CD"), if you can lock it up for that amount of time, as you'll get a slightly higher interest rate.

Brokerage account – A regular brokerage account can be opened at numerous firms like Merrill Lynch, Morgan Stanley, E-Trade, Charles Schwab, Fidelity, Ameritrade, or a local service provider. Regular brokerage accounts don't have favorable tax

Chapter 3: Understanding Risk

leave $500,000 for their heirs and don't want the risk of failing to achieve this goal. Someone else might be getting ready to make a down payment on their first house and they don't want the risk of taking on too much debt. Risk means different things to different people. It is oftentimes associated with the volatility (ups and downs) that you can stomach in your portfolio, but it can be more complicated than that.

> *It's easy to dream about what you would do with ten million dollars, but it's a lot more important to think about what you will do if you can't buy food, can't retire and have to work for the rest of your life. The devil is in the downside scenario.*
>
> \- Scott Reinhardt

Most people don't *want* to take any risk. It doesn't sound very appealing. But the financial markets will pay you to take certain types of risk, so there is an upside if you go about investing properly. If you don't take any risk in your portfolio, then you will earn low returns and may not have enough money to ever retire – not being able to retire is also a risk. So you need to be smart and take calculated risks that will reward you over time. Putting all of your money in one stock may or may not reward you over time – but that's a risk that I personally would not want to take. If you have enough money to retire, then you may not want to take the

risks associated with putting all your funds in the stock market – perhaps you should put a majority of your account in government bonds and cash. On the other hand, if you only have enough money for 5 years of comfortable retirement, then putting all your funds in government bonds and cash would expose you to the risk of running out of money before you die. In that situation you might want to keep a majority of your portfolio in equity markets while you continue to work so your wealth can keep growing.

Here's an easy-to-remember reference point for you:

> *The S&P 500 broad equity market index has generated positive results over any eight year period since 1926.*

So if you have eight years or longer before you need the money, then it is reasonable to put a meaningful portion of your money in equities. Having recently lived through the 2000-2002 and 2008-2009 periods, we all know that markets can go down meaningfully over the short term. So if your time horizon is less than eight years (or so), you should probably invest a lot of your portfolio in less volatile bonds. Remember that you can, in fact, lose money in a bond fund if interest rates rise meaningfully – but it is reasonable to assume that high quality government bonds will be less volatile than a diversified equity portfolio over time. So the shorter your investment horizon, the less money you should have in the volatile equity markets. If you have the time to survive the ups and downs of the stock market, then you will probably be rewarded for taking that risk.

These are all issues to help you figure out what risk means to you.

high) and add to the losers (buy low). Just as important, this process will help take the emotion out of investing. Your target allocations will determine when to rebalance – fear and greed will have no place in your portfolio. If you start to feel really smart or you just received a hot tip from a friend, remember that you cannot consistently outsmart the other 300 million (or so) investors in the world. Stay humble and don't get overly confident. The tortoise will beat the hare by the time your retirement arrives.

By now you should be a finely-tuned investment robot, immune from feeling emotion or being swayed from ridiculous hot tips. Actually, there will undoubtedly be times when stock market weakness will make you sick to your stomach and you will be tempted to put all your money in cash. There will also be times when you make a lot of money in the stock market so you'll be tempted to move your bond allocation into stocks as well. You may even have a good friend or relative who is absolutely convinced they have some undiscovered investment idea that will make you quick, easy money. Do not be swayed by your emotions or advice from anyone! During those times of weakness, maintain the conviction that your investment process is a strong one, built on reason and investment principles and not dictated by greed or fear. If you understand why you've structured your portfolio as you have, then it will be easier to maintain conviction during tough times. Be disciplined and you'll be rewarded. If you

cost index funds should do the trick.

Now that you have some ideas on how to structure a good portfolio, you need to understand how to maintain it. Planting flowers is easy but they need a little TLC to grow. Every three to six months you should look at your portfolio to see if the percent allocations have changed; if so, it's time to rebalance your portfolio. For example, if you owned the aggressive portfolio listed above, after a few months of market action the portfolio might look something like this:

Asset class	Initial allocation	Current allocation
Domestic large company stocks	40%	45% (too high)
Domestic small company stocks	15%	10% (too low)
International large company stocks	15%	20% (too high)
Bonds	30%	25% (too low)

In this case you would want to:

1. sell 5% of your domestic large company position;
2. sell 5% of your international company position; and
3. use the funds to buy an additional 5% of the domestic small company fund and buy an additional 5% of the bond fund.

This rebalancing will take you back to your initial target asset allocations. This process will force you to trim the winners (sell

There are trade-offs that every individual needs to consider when it comes to investing, but it's critical that you don't spend all of your time dreaming about limitless upside in your portfolio. If huge gains come your way, that's great, but volatility works in both directions, and you want to make sure you're not taking undue risk and exposing yourself to dire consequences.

Once you understand your risk profile, then you can begin to understand how your portfolio should be spread amongst various asset classes. You should spend your time and money understanding your risk tolerance and asset allocation, not researching individual stocks or the next hot idea. Investors who can tolerate risk (volatility) in the capital markets should have an aggressive asset allocation (majority in stocks), while investors who do not want to take much risk should have a moderate or conservative asset allocation (majority in bonds and cash). Chapter 6 outlines some specific asset allocation models that might be appropriate for you.

Have you ever asked a broker how much you paid in total fees for the year, including commissions, sales loads, annual management expenses, custodial fees, 12b-1 marketing fees, wrap fees, etc.? If not, good luck trying to get an answer! For most investors, there are more layers in their portfolio's fee structure than in a good taco dip. Would you ever lay down your credit card if you had no idea what that new television costs? Would you ever sign for a new car without ever asking what the price was? Of course not. But most people have no idea how much they are paying for financial services. It's OK to ask because, after all, it's your money. But maybe you're just a kind soul who wants your broker or mutual fund manager to take more of your money. If not, look out for yourself and start keeping an eye on expenses because they all add up.

Brokers generally get paid commissions based upon the activity they generate in your account and the money they make for their firm. They can also get paid ongoing fees for selling you specific products like mutual funds, annuities, unit trusts, etc. So they definitely have a financial incentive to get you to buy certain products – sometimes those products might be good for you and sometimes those products might not be so good. All of the time those products are good for your broker or else they wouldn't get sold to you. But you shouldn't blame a broker for trying to make money – they're human just like everyone else. It's up to you, the buyer of financial services, to know what you're buying and how

and volatile than bonds. There is no magic involved in the asset allocation process (we can crunch historical numbers, but that doesn't guarantee anything about the future), but you want to make sure you have different asset classes that don't all go up and down together. If you owned a small company index fund and a technology fund, those two investments would probably go up at the same time and down at the same time – therefore, you would not be properly diversified. Domestic stocks, bonds and international stocks can zig and zag at different times and that will help reduce the volatility in your account. There is no way to know in advance if the target allocations I've listed above will be perfect (probably not), but they are reasonable and will provide a low-cost, well-diversified portfolio. Said another way, there are thousands of portfolios that are worse than those I've listed above.
Regarding the specific investments needed to achieve exposure to each asset class, there are lots of options but few low-cost options. Various asset classes include: domestic large company stocks, domestic small company stocks, international stocks, government bonds, high yield bonds, real estate, commodities (oil, gold, wheat, etc.), and others. I would keep it simple and stick with the basic asset classes I've outlined on the previous pages. Regarding the specific investments, I recommend using index funds from either Charles Schwab or Vanguard because they have low fees and enough options to build a proper portfolio. Relative to other financial service firms, Schwab and Vanguard are generally proponents of this style of
investing. Remember, keep your costs below 1.0% annually and don't make your portfolio unnecessarily complex – four or five low-

want to spread your money across four or five asset classes, with the percent allocated to each asset class being determined by your risk profile.

For example, an aggressive portfolio for long-term investors could look like this:

Aggressive Portfolio

40% domestic large company stocks – Schwab S&P 500 Fund
15% domestic small company stocks – Schwab Small-Cap Index Fund
15% international large company stocks – Schwab International Index Fund
30% high quality bonds – Schwab Total Bond Market Fund

This portfolio would have 70% invested in stocks so it could be quite volatile at times. The different stock funds might zig and zag at different times, while the bond fund would add a source of stability that will help smooth returns a bit.
On the other hand, a conservative portfolio for someone who might need access to the money within the next five years might look like this:

Conservative Portfolio

20% money market fund or cash – savings account or Schwab Money Market Fund
50% high quality bonds – Schwab Total Bond Market Fund
20% domestic large company stocks – Schwab S&P 500 Fund
5% domestic small company stocks – Schwab Small-Cap Index Fund
5% international large company stocks – Schwab International Index Fund

This conservative portfolio should demonstrate less volatility than the aggressive portfolio because stocks are generally more risky

Chapter 4: How Brokerage Firms Make Money

much you're paying. Buyer beware.

It's amazing how difficult it is for a man to understand something if he's paid a small fortune not to understand it.
- Upton Sinclair

Most brokers are paid for simply generating activity in your account – hence the recommendations for the hot stock of the month or hot tip of the week. It doesn't matter if your portfolio value increases or not. They want activity. If your account value increases that's great, if not the broker still gets paid. This isn't to say brokers will necessarily lie, cheat and steal to get your money. What it means is that the broker's incentives are not directly aligned with yours. The broker wants activity – which generates fees and may have tax consequences. You want results – which are best achieved by minimizing activity in order to minimize fees and avoid short-term capital gains. Your broker has incentives and so do you – make sure you look out for your wallet, not your broker's.

Some brokerage firms are moving to an asset-based fee in order to better align their goals with those of the client. There are also Registered Investment Advisors who charge a fee based on assets under management. If you work with someone under this arrangement, make sure your advisory fees are 1.0% (100 "basis

points") or less because you don't want the performance of your portfolio to get eroded by fees. With this asset-based fee arrangement (no commissions paid for simply generating activity), the advisor and the client have the same incentive – to maximize the return given the level of risk taken. The only way the advisor could make more money under this arrangement is by having your portfolio increase in value (1% fee applied to a larger account size) – this is exactly what you want too. Make sure you know how your broker or advisor gets paid and make sure the incentives are aligned with yours. If not, you're asking for trouble and will probably pay a lot of money for lackluster results.

Individuals can be their own worst enemy when it comes to investing – greed and fear are very powerful emotions that can be difficult to overcome. Add these emotions to the fact that

Chapter 6: What To Do – A Simple Strategy to Build and Maintain Wealth

year-end profit-sharing contribution. This is free money so make sure you take it. Alternatively, you can open an account (Schwab and Vanguard have good low-cost options) and build a portfolio using after-tax money that you don't need for living expenses. Ideally, you would save in a retirement account and in a regular account.

> *There is no evidence managers beat the market; if there was, someone would find it.*
> - Rex Sinquefeld, CIO of Dimensional Fund Advisors and creator of the first index fund in 1973

We discussed risk in Chapter 3. It's critical that you spend time thinking about it. Understand when you might want access to the money, what would happen if you temporarily or permanently lost money in the market, and how well you can stomach volatility in your portfolio. The more risk averse you are, the more money you should put in money market and government bond funds (less volatile and lower returns over time). The more risk you decide to take, the more money you should have in domestic stocks, international stocks and small company stocks (more volatile but better returns over time). Regardless of what you decide, you'll

industries by owning a broad-based portfolio of market index funds. Now it's time to discuss what you SHOULD do to build and maintain wealth. Contrary to popular belief, successful investing should not be complicated or costly.

Here are some things you should do to build wealth and successfully manage your portfolio: save money, understand how much risk you want to take, develop an asset allocation model based upon the level of risk you decide to take, keep your investments simple and low cost, rebalance a couple times per year to get back to your initial allocation weightings, and be disciplined enough to follow your strategy.

First things first. In order to build a portfolio either you or your employer needs to contribute to an account. Social Security does not provide you with a personal portfolio with your name on it and there can be no assurance that Social Security will give you more than a few hundred dollars per month when you retire. The first thing you should do is learn about the retirement plan (401-k, SIMPLE IRA, etc.) that your employer offers. Your contributions into these plans are on a pre-tax basis, which means you don't pay any taxes on the money until you take the money out upon retirement. So instead of earning $500 and paying $100 to the government in taxes, you could put all $500 into your retirement account and keep the government's hands off your money (for now). There are limits to how much you can contribute annually, but the limits are fairly high ($10,000 to $17,000 for most people). Also, many employers choose to help their employees save for retirement by "matching" a portion of contributions or by making a

successful investing can at times seem counterintuitive and you have a recipe for portfolio disaster.

In order to understand how following the herd (emotions) can hurt your portfolio, think about these next two questions for a few seconds. If everyone has already sold (very weak stock market) then who is left to sell? Nobody – so it's time to buy! If everyone has just gotten done buying stocks (very strong stock market) then who is left to buy? Nobody – so it's time to sell! If you simply try to react to what the market has already done, then you will find yourself selling at the interim market bottom and buying at the interim market top; selling low and buying high is no way to make money. Everyone was buying technology stocks in 1999 and early 2000, right? But as soon as that last buyer was done, the bottom fell out of the market. Human emotion and investor psychology is what makes the investing world go 'round; it is very difficult to gauge, impossible to predict and oftentimes chews people up and spits them out (after taking their money). So don't let human nature get the best of you. Stay humble and remember that you cannot outsmart everyone else. Adhere to your target asset allocations and rebalance your portfolio by selling recent winners and buying recent losers – this will help ensure that you don't run with the herd…and get trampled.

Another way that fear and greed can ruin your portfolio is through buying the latest and greatest stock or mutual fund. Every year the *Wall Street Journal* and every financial magazine will publish a list of the best performing stocks and funds for the past year. Then people get excited and buy those securities for their own

Chapter 5: Human Nature

portfolios; once the buying frenzy is complete and the last buyer has bought, then there is no place for the stock to go but down. Do yourself a favor and don't chase past performance. There have been numerous studies that have shown that past performance does not imply anything about future performance. Even the brokerage industry is pretty good about telling you this. The worst thing to do is sell last year's losers to buy last year's winners. Your portfolio will suffer tremendously if that's what you do.

> *Monkey see, monkey do.*
> - Humans
> *Human see, human do.*
> - Monkeys

Remember, making money isn't that easy and the entire world reads the same newspapers and magazines that you do, so they won't give you any sort of sustainable advantage. In 1999 every magazine was touting the best technology funds. In 2004 and 2005 energy funds had the "smartest" and best managers. Who knows what will be hot in the future, but don't spend a lot of time or money trying to figure it out. You simply need to build a low-cost, well-diversified portfolio and adhere to your asset allocation – let everyone else rub their crystal balls and predict the future. You don't need the "best" funds each year. You just need solid performance from a few different indices year-in and year-out and you will accumulate wealth.

If you are not capable of detaching your emotions from investment decisions (most people cannot do this successfully), then pay a modest fee and have an advisor manage the money for you. Having the guts to maintain your disciplined asset allocation strategy through the ups and downs of the market can be very difficult for anyone, professionals and individuals alike.

OK, so we've discussed many things that you SHOULD NOT do – pay high commissions and fees, churn your portfolio, chase last year's winners, put all your money in one asset class, and let emotions dictate your investment decisions. Also, avoid narrow sector funds (technology, oil, apparel, etc.) because those don't provide proper diversification and you will get exposure to those