

There are two possibilities here: You will pay taxes on the amount, plus a 10 percent penalty for early withdrawal. This approach makes sense for small sums.

The second way is to put the money into a no-risk IRA that can be tapped easily, like a bank money market account. Withdraw funds as you need them. You will owe taxes and a penalty on the money you take. But the moment you find work you can stop the withdrawals, leaving the rest of your IRA intact.

11. If you don't find work and see that your money won't last, it's time to rethink your life from the ground up. Look for cheaper housing: an apartment, or a home far out in the country. Find an area where living costs are lower. Consider jobs at a lower salary.

Reach these decisions *before* you start borrowing from relatives. My reasoning here is tactical, not moral. Your relatives are normally your ace in the hole, the most usual ones to help you finance a new start in life. So try to tap them last, not first.

SPENDING AND YOUR FINANCIAL PLAN

A spending plan is the visible evidence of financial planning at work. Later on, if it seems appropriate, we'll talk about other things, including the making of strategic choices. The spending plan helps you to save the money to get to that place.

TO CLOSE THIS SECTION LET'S TALK OF CHOICES THAT CAN COST PLENTY

1. Future value of interest saved in an avoided car purchase.
2. Minor Lifestyle choices that can cost plenty.

FUTURE VALUE OF INTEREST SAVED IN AN AVOIDED CAR PURCHASE

12%, COMPOUNDED QUARTERLY, FOR THE YEARS INDICATED

Narrative and Assumptions

This scenario, while addressed specifically to younger people, is applicable to everyone.

Many young people, in the 20 - 30 year age bracket, will choose to buy a car that is more than they can easily afford, and they will pay for the car over a four year period, possibly a five year period.

My encouragement would be to "buy down" to whatever they can pay cash for: then save the money to pay cash for their future automobile purchases. Early in life, one might have to buy a \$2,500 - \$3,500 vehicle in order to pay cash, but I believe the results that can be shown will demonstrate the merits of the suggestion.

The interest expense thus saved, on just one vehicle, invested and left alone will provide significant savings for the later years. We have attempted to be conservative in our assumptions, which are as follows: (let's look at the slides, a table + a graph).

1. the vehicle-purchase avoided cost was \$15,000.
2. the interest rate charged was 12% (APR).

3. the interest dollars saved, over a 4 year period, were \$3,960.
4. the interest rate used to compute the future value of the savings was 12%. That rate is considered conservative because growth stocks over a long period of time for a young person have shown those kinds of earnings.
5. no attempt was made to quantify the savings on insurance required on a new \$15,000 vehicle v. say, a used vehicle that cost \$3,500, and to include that savings in the computation.
6. the growth of the interest savings only, at 12% compounded quarterly, is as follows:

| | |
|---------------------|----------------------|
| 1 year - \$4,457 | 20 years - \$42,138 |
| 5 years - \$7,152 | 25 years - \$76,106 |
| 10 years - \$12,918 | 30 years - \$137,456 |
| 15 years - \$23,331 | 35 years - \$248,260 |

Minor Lifestyle Choices Can Cost Plenty

The other side of the "sources of income" equation is "spending of income." The difference between a small Mercedes and a Honda is about \$2.5 million dollars....give or take a million. It is as important for people to think about how they spend their money as how they invest it.

Some say that we reach our goals by deciding how we live, not how we invest. I believe that both are true. But to illustrate this point and to elaborate more on the effects of compounding, I want to continue this discussion!

Peace of mind isn't a function of how much you make, it is a matter of how much you spend.

Our most important decisions, aren't our investment decisions, they are our "lifestyle" decisions -- what we do with the money we earn.

Going back to a Honda v. a small Mercedes. The difference between a luxury car and a car that is just "nice" -- is about \$2.5 million dollars.

How, you ask.

You can buy a small Mercedes now for about \$28,000 - \$30,000. You can also buy a number of cars that most people would consider luxury cars in the \$23,000 - \$26,000 range.

But you also can spend \$10,000 less and have a satisfactory car. Most people will say that, "yes, you can spend the lesser amount" and they'll hope they can find a way to pay off the car loan and have no payments.

But life really isn't like that. Unless you do make a financial plan and have the discipline to follow it, you'll have a lifetime of car payments. Cars get old and wear out. They are wasting assets. And you'll need a car for the rest of your life.

Invest the difference on a lesser car loan and it will accumulate to a large sum by the time you are 65. It won't quite be a million dollars, but if you then take a series of monthly payments for the rest of your life, it will total more than \$2.6 million dollars or more. You don't believe me do you?

If you are skeptical, here are the economics worked out on my computer:

**SLIDE--INTEREST SAVED IN AN AVOIDED CAR PURCHASE
 FUTURE VALUE OF INTEREST SAVED IN A CAR PURCHASE
 12 PERCENT, COMPOUNDED QUARTERLY, FOR THE YEARS INDICATED**

1. The vehicle-purchase avoided cost was \$15,000.
2. The interest rate charged was 12 percent (APR).
3. The interest dollars saved over a 4 year period, were \$3,960.
4. The growth of the *interest savings only*, at 12 percent compounded quarterly, is as follows:

| | | | | | |
|----------|------|--------|----------|------|---------|
| 1 year | - \$ | 4,457 | 20 years | - \$ | 42,138 |
| 5 years | - \$ | 7,152 | 25 years | - \$ | 76,106 |
| 10 years | - \$ | 12,918 | 30 years | - \$ | 137,456 |
| 15 years | - \$ | 23,331 | 35 years | - \$ | 248,260 |

1. Financing say, \$25,000 for 4 years will cost you \$634 a month. It will cost you \$253 a month less for the \$15,000 car.
2. If you save the difference for 35 years -- from age 30 to 65 say, and it earns an average of 10% it will accumulate to \$960,548, a respectable sum.
3. If you get 25 years of monthly payments from that sum -- so that the money is exhausted when you have reached the age of 90 -- you'll collect \$8,728.43 per month. The total amount you'll collect will be more than \$2.5 million -- \$2,618,529

If this seems magical, it isn't. It is the result of compound interest over a long period of time. If, for instance, you only save the difference from age 40 to 65 the result is more modest -- you'll accumulate \$335,689 by age 65 which will provide a 25 year income of \$3,050.41 a month or a total of \$915,122.49.

As I said earlier, the decision is worth \$2.5 million...give or take a million.

Most people have some area of their life where they want to spend more money. Some want a big house, some want a fancy car, some like to spend money on clothes, others want to spend money on travel and vacations.

Where you spend the money is a lifestyle choice. You can spend extra money on one area of your life, maybe two....but you can't do it on everything. There isn't enough money. So you have to make choices.

This approach is loaded with possibilities for thinking about your personal finances. If, for instance, there is a choice between one car and another that will have a dramatic impact on your retirement income, a similar process can be applied to choices between different areas of expenditure.

The after-tax cost of supporting a \$10,000 increase in the value of the home you buy, for instance, is about \$1,000 a year or about \$83 a month. The same amount of after-tax income, however, will buy you about \$3,300 more car (assuming that you finance it for 4 years at 10 percent and cannot deduct any of the interest expense.)

Now suppose a couple finds a house they like that is \$10,000 more than they can comfortably afford. Using "lifestyle choices", they can see these things as interchangeable: (let's look at the slide--Perx15-2).

1. \$10,000 of house
2. \$3,300 of car
3. \$1,000 of annual vacation
4. \$1,000 of meals out, entertainment, etc.
5. \$11,013 per year of retirement income, without ever touching the principal. (\$83/per month, 25 years at 10%, = \$110,126.)

Some of you, no doubt, will not see these as choices. A lot of what we do seems to be absolutely necessary. We can't be satisfied with a car that costs less than this, a house that costs less than that, or a vacation here rather than there, etc.

But that is an illusion. There are people "going broke" at all levels of income. While it is easy to do so on say, \$20,000 a year, this country is full of people who will happily tell you how they can't make ends meet on \$50,000... or \$100,000...or \$250,000. (Let me tell you about a boss I had at Tenneco, etc.)

Our spending, most usually represents our choices, not our necessities. For all but a handful of people, these choices are hard ones because facing them involves giving up one of our most treasured fantasies....the idea that spending some amount of money will buy happiness.

It won't. It will only buy our choices....an amount of house, an amount of car, or something else, or some contribution to financial security. It's that simple...or that difficult.

Before I leave this area, I want to ask you a question? I want you to consider it seriously.

Let's suppose you had a windfall from some source, perhaps an inheritance, of \$20,000. Now, you have a choice to make. Are you going to invest that money? Or are you going to spend it; or some of it.

Let's say you took half of it and bought a different car as opposed to investing it. Do you have any idea what that choice would have cost over a 20 year period?

At 12%, compounded monthly, that \$10,000 would be worth \$108,925.53 at the end of 20 years. Would you trade \$109,000 in 20 years for a wasting asset, a car now?

I'll make it a little more graphic! At 12%, compounded quarterly, that \$10,000 one-time payment, at the end of thirty years would be worth \$347,109.87; at the end of 40 years it would be worth \$1,132,285.52. Taxes on dividend and capital gains have not been considered. If you managed to get it into an IRA or a Keogh plan for the self-employed, there wouldn't be any taxes until began to take it out.

BREAK

Could we consider taking a break? In the next section we're going to talk about investing this money that you are now going to save. What we'll talk about then are things that are very simple...simple enough for all of us to follow.

INVESTING

There is no secret to investing that cuts a path directly to the profits that you are looking for. The secret is simplicity. The more elementary your investment style, the more confident you can be of making money in the long run.

This insight isn't easy for investors to accept. Wall Street has goods that are colorful and varied. The more intricate an investment package, the greater the aura of success.

In fact, it's stuffed with risks you're unaware of. This glittering merchandise almost always profits the vendors more than you.

You don't need it! You can rack up a superb lifetime investment record with just two or three good stock-owning mutual funds, maybe a bond fund, and some Treasury securities.

That's all you really need to know. Investing is easy, if you buy the simple things and buy them well.

DEVELOPING A PLAN

Should you buy this mutual fund or that one? How do you choose between stocks and bonds? Which risks make sense and which don't?

There are logical answers to these questions, but only if you start with a good, long-term investment plan. Once you've drawn that plan, you will see the kinds of investment you ought to be making. Just as crucial, you'll know which investments to avoid.

Your plan will not make you rich tomorrow, and never have that goal. You're going to use your common sense to map a strategy for building wealth.

You can only get poor quickly; getting rich is slow! Thoughtful investors buy the kinds of investments that will yield the combination of safety, income, and growth they need. At the end of the road, they will look and see that they did well.

FIRST PRINCIPLES OF INVESTING

Before you draw up your own plan, you need to know what has worked in the past. These are the lessons that history teaches:

1. **For building capital long term, buy stocks.** You are taking hardly any risk. Over 10-year periods, stocks have always outperformed bonds and have left simple bank accounts in the dust.
2. **Buy stock-owning mutual funds, not stocks themselves.** Good mutual funds give you full-time, professional money management, which you normally cannot do yourself.

The managers diversify your investments and balance your risks. Picking stocks individually is a fascinating game, but for the dedicated hobbyist only.

3. **Diversify.** Although stocks win the race in the long-term, you and I live in the short-term. That means we need buffers---investments that give our capital some protection in a year when the economy falls apart and stocks decline.

So think "portfolio"---your portfolio being every investment, savings account, and retirement account you own. Stocks for growth; money market mutual funds for ready savings; bonds and dividend-paying stock for steady compounding of interest; your home as an inflation hedge.

4. **Keep it simple.** Plain vanilla stocks and bonds will do the job. All the other stuff---options on futures, commodities, limited partnerships---usually leave you wiser but poorer.

5. **Have the courage to hold your mutual funds for the long term.** Successful investors check the charts showing long-term stock market action (up, down, up, up) and believe them.

When the occasional downturn occurs, they roll into a fetal position until the market comes back.

6. **Ignore market timing.** Market timers try to sell when the stock market nears its peak and buy again when stocks bottom out. As if they knew. This game isn't worth much, because they are so often wrong.

On a percentage basis, stocks rise much more often than they fall. So the odds are on the side of the people who stay invested all the time.

(Your protection against temporary declines is diversification; having some of your money invested somewhere else.)

7. **Invest regularly.** Put a fixed sum of money into mutual funds at regular intervals---maybe once a month. Don't worry about "bad" markets. They are good buys for long-term investors, because stock prices are so low.

8. **Reinvest your dividends.** If I do no more than make you appreciate dividends, this section will have done its job. An investor who put \$100 into the Standard & Poor's 500-stock average on the first day of 1928, and held it until December 31, 1993, ---and spent all the dividends---would have earned \$2,642.

If that investor reinvested all dividends, he would have had \$51,074. Compounding interest and dividends is the investment world's strongest, surest force. (ACHYPO).

9. **Stick to your investment strategy.** One year you'll make money. One year you'll lose money. But time is always on your side. Don't let impulse investing or sudden market changes shake you out of your long-term plan.

10. **Have patience, patience, patience, patience, and more patience.** The urge for quick returns hurls you into lunatic investments---the financial equivalent of lottery tickets, with just about the same odds. A successful investor hitches a ride on private industry's long-term growth.

HOW RISKY ARE STOCKS, REALLY?

Having made such a strong pitch for buying stocks, I can hear the echoes coming back---"Yeah, but what about the '87 Crash? What about the '89 Crashette? What about all the other times that stocks have fallen?"

Well, what about it? Those drops are temporary. No one knows what stocks will do tomorrow, but the evidence is clear as to how they'll perform over 10, 20, 30, even 50 years. They will almost certainly go up a lot.

Let's look at several tables to illustrate my point.

FIFTY YEARS OF RETURNS (1943 THROUGH 1992)

Average Annual Compound Rates of Return (%)

| | S&P 500 | Small Stocks | L-Term Corp Bonds | L-Term Govt Bonds | Treasury Bills | Inflation (CPI) |
|-------------|------------|-----------------|-------------------------|-------------------------|-------------------|--------------------|
| Last 10 yrs | 16.2% | 11.6% | 13.1% | 12.6% | 6.9% | 3.8% |
| Last 20 yrs | 11.3 | 15.5 | 9.5 | 9.1 | 7.7 | 6.2 |
| Last 30 yrs | 10.9 | 15.1 | 7.3 | 6.8 | 6.7 | 5.3 |
| Last 40 yrs | 11.5 | 14.6 | 6.2 | 5.7 | 5.5 | 4.3 |
| Last 50 yrs | 12.6 | 16.3 | 5.4 | 4.9 | 4.6 | 4.3 |

Growth: What \$1 Invested Would Have Grown To

| | | | | | | |
|-------------|--------|----------|--------|--------|--------|--------|
| Last 10 yrs | \$4.49 | \$3.00 | \$3.42 | \$3.28 | \$1.95 | \$1.45 |
| Last 20 yrs | 8.51 | 17.85 | 6.14 | 5.71 | 4.41 | 3.33 |
| Last 30 yrs | 22.28 | 67.96 | 8.28 | 7.20 | 7.00 | 4.71 |
| Last 40 yrs | 77.80 | 233.02 | 11.09 | 9.18 | 8.51 | 5.39 |
| Last 50 yrs | 377.50 | 1,901.02 | 13.87 | 10.93 | 9.48 | 8.21 |

TIME FRAME AND LOSSES (1926 - 1992)

Percentage of Holding Periods That Resulted in Losses

| Holding Period (Years) | S&P 500 | Small Stocks | Corp Bonds | Govt Bonds | Treasury Bills |
|------------------------------|------------|-----------------|---------------|---------------|-------------------|
| 1 | 30% | 31% | 21% | 25% | 0% |
| 3 | 14 | 22 | 12 | 15 | 0 |
| 5 | 10 | 14 | 5 | 10 | 0 |
| 10 | 3 | 3 | 0 | 2 | 0 |

The table includes all possible holding periods for the time periods indicated over the past 66 years. For instance, the 3-year holding period includes 1926 through 1928, 1927-1929, 1928-1930, etc.

Purchases are made at the beginning of the year and held through the time period indicated.

Another fact that we can see from the tables is this: Over long periods of time, stocks have outperformed inflation by roughly 7 percent to 8 percent annually. That's a far better average real return than you'll get from any other financial investment.

HOW TO LIMIT ALL YOUR RISKS

Some investors stay out of stocks, in order to keep their money "safe." But they don't know what "safety" really means. Bonds and bank accounts carry hazards that you haven't even thought about.

A fixed-income investment can eat up your future just as surely as if you had fed it to the sharks. You have to understand your whole range of risks, in order to make good investment decisions.

Of all risks, the most familiar is *market risk*---the risk of losing money in a bad investment.

Adjust for this by (1) diversifying your investments, so that a single loss (even though temporary) doesn't leave a hole in your wealth, (2) buying only the boring old standbys like diversified mutual funds, and (3) skipping the dizzy new ideas that only a stockbroker could love. If you can't resist "diz," give yourself a small mad-money fund to play with. I'll wager that your boring investments come out ahead.

Everyone also endures *economic risk*---the hit you take when the economy turns down.

Adjust for this risk by staying out of the speculative investments that really get bashed in a recession: junk bonds, new issues, limited partnerships whose units can't be sold.

Some of these investments may soar in good times, but they also expose you to extra-large losses.

Less understood is *inflation risk*---the risk of losing the purchasing power of your capital.

This is the monster that eats up fixed-income investors. After inflation and taxes, a certificate of deposit, a zero-coupon bond, or a Treasury security yield almost nothing.

You might preserve the purchasing power of the cash you deposited, but your money doesn't really grow. After years and years of investing, you come out with a pittance in real terms.

Adjust for inflation risk by:

- (1) not keeping large, permanent sums of money in money market mutual funds and similar short-term investments.
- (2) avoiding an all-bond portfolio, even in retirement.
- (3) putting at least some of your money into stocks for real growth. Here's how well (or how poorly) all the common investments survive inflation.

AVERAGE COMPOUND RETURNS AFTER INFLATION, 1926-1989*

U.S Treasury bills: 0.5%

Long-term government bonds: 1.4%

Intermediate-term government bonds: 1.8%

Common stocks: 7.0%

Small-company stocks: 8.9%

* Inflation for the period, 3.1%. Dividends reinvested but not adjusted for income taxes.

The consistency of long-term common-stock yields over inflation is nothing short of astonishing. So, no matter what's happening to your stocks today, it is reasonable to expect that, 10 or 15 years from now, you'll show a 6 to 7 percent real return over inflation, whatever that may be.

Bond investors face *interest-rate risk*---the risk that interest rates will rise. When that happens, the value of your bonds (or bond mutual funds) falls. Furthermore, the income you're earning may no longer beat inflation and taxes.

Adjust for interest-rate risk by owning short-to medium-term bonds (maturing in maybe 2 to 10 years). When rates rise, these bonds don't fall as much in price as 20- or 30-year bonds do.

Investors in short-term instruments, such as money market mutual funds and one-year certificates of deposit, face *reinvestment risk*. Say, for example, when your instrument matures the interest rates are less than those on the matured instrument. You can avoid some of this risk by "laddering" your fixed-income investments by having maturity dates of say 1 year, 2 years, 3 years, etc.

Then there's *liquidity risk*. A "liquid" investment can be sold immediately, at market price, if you suddenly find that you need the money. An "illiquid" investment can't be sold immediately. Not all of your investments have to be liquid. But enough of them do to assure you quick cash if you ever need it. So what's liquid?

* A money market mutual fund is liquid. You can get your cash at any time. A certificate of deposit is relatively liquid, but not perfectly so. You can always get the money, but it may cost you an early-withdrawal penalty.

* Mutual fund shares are normally liquid. You can sell at any time, at current value. You can sell at current market value. Occasionally, however, a fund's liquidity may be impaired.

If scads of investors all want out at the same time---as has happened during panics in the junk-bond and municipal-bond markets---selling pressure can push down the market price.

The fund also has the right to suspend telephone redemptions or delay mailing your check for up to seven days.

* Individual stocks are liquid, as long as they trade on the major stock exchanges. Small stocks sold over the counter, however, may cost you a lot if you have to sell.

* Gold bullion coins are liquid, anywhere in the world.

* Retirement accounts are superficially liquid, in that you can usually cash them in. I would count them semi-liquid, because of the tax cost and penalties of breaking into them too soon.

- * Small amounts of tax-exempt bonds are often illiquid. No one wants to buy them except at a discount.
- * Real estate is generally illiquid. It can take months to sell, and even then you might have to mark down the property's price.
- * Your own business is illiquid.
- * Units in most limited partnerships are so illiquid that there may be no market for them at all.

Adjust for liquidity risk by balancing illiquid assets with liquid ones. Anytime you buy something, ask: What happens if I want to sell? Can I get my money fast? Can I sell at market price without taking a discount or paying a penalty? If not, how long might I have to wait for my money?

THE RIGHT SHOE FOR THE RIGHT FOOT

As you cannot escape taking some kind of risk, the next thing to ask is whether your current range of risks supports or undermines your purpose. Here's a general guide.

Use safe savings, with no market risk, for:

- A cash reserve equal to three months' take-home pay.
- Accumulating a down payment on a house.
- Protecting college tuition that's due within four years.
- Protecting capital when you've lost your job.
- A parking place for money waiting to be invested elsewhere.
- Preserving any sum that you dare not put at the slightest risk.

Use stocks for:

- Accumulating college tuition while your child is young.
- Building a retirement fund.
- Generating an income out of dividends and capital gains.

Use medium-term bonds for:

- Adding to your income (from interest earnings).
- Adding some price stability to a stock portfolio.
- A deflation hedge.

Use long-term bonds for:

- Speculating on falling interest rates.
- A deflation hedge.

Use investment real estate for:

- Building retirement savings over 10 years or more.
- An inflation hedge.

2. *When you buy isn't nearly as important as what types of assets you buy and how much you own of them. You can be all wrong on your market timing and still do well if you are properly diversified.*
3. "Market timing" (which means buying before the market goes up and selling before the market goes down) is extraordinarily hard to do.

The average investor won't guess right often enough to beat the investor who buys and holds. Most professional investors don't do much better. The Forecaster's Hall of Fame is an empty room.

4. Almost no one---including investment professionals---can "beat the market" over the long term. It's a waste of time to set that kind of standard for yourself.

These findings lead to the conclusion that you shouldn't break your head trying to predict what will happen to stocks, interest rates, or the economy. Don't be stampeded in to the market, or out of it.

Instead, focus on what you're investing for. Split your money among the investments most likely to achieve that goal. And stick with them.

HERE ARE FOUR CLASSIC PORTFOLIOS, RANKED BY MARKET RISK:

- * *Low risk*---40% in stocks: broken into 20% Core Growth stocks, 20% is Growth & Income stocks. 50% in bond funds: broken into 10% in Corporate Bond Funds, 40% in Government Securities. 10% in cash equivalents (such as money market mutual funds).
- * *Medium risk*---55% in stocks: broken into 10% Emerging Growth, 10% into Mid Cap companies, 20% into Core Growth, and 15% into Growth & Income stocks. 40% in Bond Funds: broken into 20% Corporate Bond Funds, 20% into Government Securities. 5% into cash equivalents.
- * *Moderate risk*---70% in stocks: broken into 15% Emerging Growth, 25% into Mid Cap companies, and 30% into Core Growth Stocks. 30% into Bond Funds: broken in to 20% Corporate Bond Funds and 10% into Government Securities.
- * *High risk*---100% stocks: broken into 25% Emerging Growth, 50% into Mid Cap companies, and 25% into Core Growth companies.

Take these examples as baselines. Play them against your personal goals to create your own portfolio mix.

Tip toward lower risks if your earnings are relatively low, you carry huge debts, you're in poor health, you don't know much about investing, you're naturally cautious, or you'll need that money within three or four years.

Tip toward higher risks if your earnings are moderately high, if you have a high net worth, are an experienced investor, are young, or won't need the money for many years.

YOUR REWARD, AT LAST

ASSET ALLOCATION: HOW TO DO IT, WHY IT WORKS

Now it's time to consider pure long-term investing, like parlaying your savings into enough to live on when you retire. Here, other kinds of matching schemes come into play. You are asking the question: What return do I need from my long-term investments? How much risk am I willing to swallow in order to get it. @

That brings us to the concept of "asset allocation." To explain it, let me start with a tale of two investors, as told my Marshall Blume, professor of finance at Wharton School in Philadelphia. Fighter Jock puts \$100 into stocks in August 1929, just before the Great Crash. Measured by the Dow

Jones Industrial Average, it takes him 16 years to get his money back.

Savvy Sal also has \$100, but she puts \$50 into stocks and \$50 into bonds and maintains that 50-50 split. When her bonds are worth more than 50 percent of her capital, she sell some and buys stocks. When her stocks are worth more, she sells some and buys bonds.

She does this every month. (Blume is measuring by the market averages here), always seeking to keep half of her money in each investment. In just 6 years, she recovers her original stake.

Notice what Sal did not do.

She did not sell all her stocks at the bottom and give up the market for every and ever.

She did not try to guess when the market would rise or fall again. She just followed her investment formula.

She did not let herself be swayed by the news of the day. Instead, she invested for the long term.

She did not fail. She beat Fighter Jock, who bought stocks and held them. And she beat the investors who fled the market and put their money in the bank.

Sal practiced asset allocation---which, simply put, means dividing your money among stocks, cash and other kinds of investments and keeping it there.

People don't pay a lot of attention to asset allocation. *But it's the key decision that determines investment success*, not how smart (or dumb) you are at picking stocks or mutual funds.

TIME OUT FOR THEORY

Even if you know that you're supposed to diversify your investments, maybe you don't know why.

A lot of study has established four things:

1. Different types of investments tend to move in difference cycles. Some may go up while others go down. Some go in the same direction, but not at the same time or at the same speed.

Some move by larger percentages than others. Owning different types of investments protects you from big losses and can improve your returns.

Something you own is usually going up (or at least not going down). You are less exposed to risk.

The table we're going to look at in a moment helps you decide how much risk you are willing to tolerate in order to earn a desirable return. The measurements cover 1947-1989, and came from Wesley McCain of Towneley Capital Management.

Here's how to use the table.

Read down the column headed "Your average return." That shows the average long-term return you can expect if you hold the indicated mix of U.S. stocks and long-term bonds.

When you see a return that your wallet says you want---say, 11.8%---read across to the last column. There, you'll see the largest percentage loss that that mix of investments is likely to take in a single year. You'll recover that loss in later years, but you must be prepared to suffer through it.

If that loss looks too scary, read on down the column until you find a one-year loss that seems tolerable. Then look over to the first column to see what mix of stocks and bonds you've chosen and what your average return would be.

If that return looks too low, rethink the size of the one-year loss that you're willing to risk (*remembering that these losses are temporary*).

That's investing, in a nutshell. You are looking for the highest possible return commensurate with the risk you're willing to take.

The middle column, by the way, is strictly for fun. It shows the luck you're likely to have in your best year. But it shouldn't enter into your investment decision. Long-term investors won't earn the single highest return, they will earn the *average* return.

FINDING YOUR CENTER: RISK VERSUS REWARD

| <i>If you own</i> | <i>average return*</i> | <i>largest one-year gain</i> | <i>The single largest one-year loss</i> |
|------------------------------|----------------------------|----------------------------------|---|
| 100% stocks** No bonds*** | 13.5% | 52.6% | -26.5% |
| 90% stocks 10% bonds | 12.7 | 48.1 | -23.4 |
| 80% stocks 20% bonds | 11.8 | 43.5 | -20.3 |
| 70% stocks 30% bonds | 11.0 | 39.0 | -17.2 |
| 60% stocks 40% bonds | 10.1 | 34.4 | -14.1 |
| 50% stocks 50% bonds | 9.3 | 31.6 | -11.1 |
| 40% stocks 60% bonds | 8.4 | 32.8 | -8.0 |

FINDING YOUR CENTER: RISK VERSUS REWARD (continued)

| If you own | average return | largest one-year gain | largest one-year loss |
|-------------------------|-------------------|--------------------------|--------------------------|
| 30% stocks 70% bonds | 7.6 | 34.7 | -6.1 |
| 20% stocks 80% bonds | 6.7 | 36.6 | -5.8 |
| 10% stocks 90% bonds | 5.9 | 38.5 | -5.9 |
| No stocks 100% bonds | 5.0 | 40.4 | -9.2 |

* From 1947 through 1989, compounded annually, dividends reinvested.

** Measured by Standard & Poor's 500

*** Long-term U. S. government bonds.

SOME MORALS

To minimize risk, don't choose an all-bond portfolio. *Combining bonds with some stocks reduces your risk and improves your return. The mixed portfolio has a better average return and, in its worst year, didn't suffer as big a loss. Moral: Bonds are riskier than you think.*

For the greatest growth over the long-term, choose all stocks---at least, for that portion of your money available for long-term investment. *Stocks show the highest risk of loss in a single year but the biggest average gain over time.*

Moral: If you truly mean to leave the money alone for 10, 20, or 30 years, as a younger person might, with a retirement fund, don't bother looking beyond stock-owning mutual funds.

If you want solid growth but with some protection against market drops, choose a mix of stocks and bonds. *Younger people should tip toward higher returns, because they have time for their stocks to recover from any drop.*

For the younger ones, I'd suggest a stock-to-bonds ratio of 90/10 to 70/30. Middle-aged people and even young retiree should look at 60/40 or 50/50 splits.

Much older retirees might move to 30/70 allocations of stocks to bonds, but never to an all-bond portfolio. Stocks cushion you against inflation, which is critical when you don't have a salary to fall back on. Moral: Good investing isn't dumb luck. Success comes to those who use their heads.

HOW TO GET MONEY TO INVEST

It's no mystery.

Save money. We showed you how to do that earlier.

Buy shares in a mutual fund every month.

Month after month after month after month.

After month.

If that doesn't work, inherit.

BE AN AVERAGING INVESTOR

You already know that you ought to invest part of every paycheck. For the good of your soul, for your future, and because I told you to.

But regular monthly investing has an even better rationale. It can make you more money than periodic lump-sum investing, because you follow a system known as dollar-cost averaging. Here's how it works.

Say that you put \$150 into a stock-owning mutual fund every month. When stock prices rise, your \$150 buys fewer shares. When stock prices fall, your \$150 buys more shares. In a see-saw market, dollar-cost averaging lowers your average cost per share. So it builds for higher profit.

Dollar-cost averaging disciplines you to keep on investing when prices are down. And it keeps you from plunging too heavily when prices are high. Reinvesting all dividends automatically is a form of dollar-cost averaging.

There are times when this technique may be second best.

If the market is on a roll, you might have made more money by investing a lump sum all at once.

Dollar-cost averaging is better done with diversified mutual funds than with individual stocks. The broad market always recovers, but certain stocks might not. If you choose a rotten stock, buying more shares on the way down would be throwing good money after bad.

FOR THE NERVOUS

Maybe you quake more easily than others. You know in your heart that stocks are the best investment in the long run, but the thought of owning them scares you stiff.

Obviously, I'd like to change your mind. So try this: Put just a little money into a diversified, stock-owning mutual fund, maybe 20% of your savings. Pick a simple fund, and invest a modest sum every month over the next 12 months. Then forget it. Pretend it isn't there. Take a look 5 years from now and see what you've got.

The result ought to make you feel pretty good, good enough to put even more money in stocks. If I can divert even a small portion of your long-term retirement savings into the stock market, this discussion will have been worthwhile.

But you have to promise to leave that investment alone. If you'll panic and sell the first time stocks drop, forget it. You don't belong in the market just yet.

Keep on learning. The more you learn, the more you'll come to understand that long-term stockholdings aren't as risky as you thought.

MUTUAL FUNDS DEFINED

A mutual fund is a vehicle. It takes in money from many different investors. The fund's manager invests that money in specified types of securities. You'll find stock funds, bond funds, money market funds, gold funds, real-estate funds...literally, something for everyone.

EIGHT REASONS TO ENJOY MUTUAL FUNDS

- 1. You get full-time money management, from the person (or committee) who runs the fund. Believe me, you don't get that from stockbrokers. A broker's job is to sell stuff. They don't have time to worry about the overall shape of your portfolio.*
- 2. You can pick exactly the level of risk you want to take. By contrast, when you buy your own stocks, you generally have no idea how risky your total investment position is.*
- 3. You diversify. You share in the fortunes of a large number of securities rather than owning just a few.*
- 4. You can check a fund's past performance record.*
- 5. You can buy and hold for the long term. There's no need to switch from one stock to another as market conditions change. Your mutual-fund manager does that for you.*
- 6. You don't have to spend a lot of time doing stock research and following market conditions.*
- 7. You avoid all the costly risks of falling into the hands of a bad broker---churning, bad recommendations, high sales commissions, etc.*
- 8. You can automatically reinvest your dividends and capital gains. Steady compounding doubles and redoubles the returns that you would get from stocks alone.*

What About My Neighbor and His Stocks

What about him? Your neighbor who buys stocks would be lucky if he made a killing one time out of 30. Meanwhile, his losers and his mediocrities (which he doesn't mention) accumulate.

Counting losers as well as winners, I'll bet that he doesn't do nearly as well as the average mutual fund...especially if he doesn't reinvest all his dividends and capital gains.

HOW TO RETIRE WITH YOUR TOTAL CAREER EARNINGS

INTACT

IN YOUR RETIREMENT FUND

ILLUSTRATION ASSUMPTIONS:

INITIAL EARNINGS ARE \$24,000 PER YEAR AND INCREASE AT 4% ANNUALLY OVER THE WORKING CAREER.

THE AMOUNT SAVED AND INVESTED ANNUALLY FROM EARNINGS IS 4% OF TOTAL EARNINGS.

THE EARNINGS RATE IS 14% ANNUALLY OVER THE WORKING CAREER.

HOW TO RETIRE WITH YOUR TOTAL CAREER EARNINGS
INTACT IN YOUR RETIREMENT FUND

| YEAR | EARNINGS PER YEAR | ANNUAL AMOUNT SAVED/ INVESTED @4% | EARNINGS RATE | REMAINING TERM IN YEARS | EARNINGS OVER THE TERM OF YEARS |
|------|-------------------------|---|------------------|----------------------------------|--|
| 1 | \$24,000 | \$960 | 0.14 | 44 | \$306,256 |
| 2 | \$24,960 | \$998 | 0.14 | 43 | \$279,391 |
| 3 | \$25,958 | \$1,038 | 0.14 | 42 | \$254,883 |
| 4 | \$26,997 | \$1,080 | 0.14 | 41 | \$232,525 |
| 5 | \$28,077 | \$1,123 | 0.14 | 40 | \$212,128 |
| 6 | \$29,200 | \$1,168 | 0.14 | 39 | \$193,521 |
| 7 | \$30,368 | \$1,215 | 0.14 | 38 | \$176,545 |
| 8 | \$31,582 | \$1,263 | 0.14 | 37 | \$161,059 |
| 9 | \$32,846 | \$1,314 | 0.14 | 36 | \$146,931 |
| 10 | \$34,159 | \$1,366 | 0.14 | 35 | \$134,042 |
| 11 | \$35,526 | \$1,421 | 0.14 | 34 | \$122,284 |
| 12 | \$36,947 | \$1,478 | 0.14 | 33 | \$111,557 |
| 13 | \$38,425 | \$1,537 | 0.14 | 32 | \$101,772 |
| 14 | \$39,962 | \$1,598 | 0.14 | 31 | \$92,844 |
| 15 | \$41,560 | \$1,662 | 0.14 | 30 | \$84,700 |
| 16 | \$43,223 | \$1,729 | 0.14 | 29 | \$77,270 |
| 17 | \$44,952 | \$1,798 | 0.14 | 28 | \$70,492 |
| 18 | \$46,750 | \$1,870 | 0.14 | 27 | \$64,309 |
| 19 | \$48,620 | \$1,945 | 0.14 | 26 | \$58,667 |
| 20 | \$50,564 | \$2,023 | 0.14 | 25 | \$53,521 |
| 21 | \$52,587 | \$2,103 | 0.14 | 24 | \$48,826 |
| 22 | \$54,690 | \$2,188 | 0.14 | 23 | \$44,543 |
| 23 | \$56,878 | \$2,275 | 0.14 | 22 | \$40,636 |
| 24 | \$59,153 | \$2,366 | 0.14 | 21 | \$37,071 |
| 25 | \$61,519 | \$2,461 | 0.14 | 20 | \$33,820 |
| 26 | \$63,980 | \$2,559 | 0.14 | 19 | \$30,853 |
| 27 | \$66,539 | \$2,662 | 0.14 | 18 | \$28,147 |
| 28 | \$69,201 | \$2,768 | 0.14 | 17 | \$25,678 |
| 29 | \$71,969 | \$2,879 | 0.14 | 16 | \$23,425 |
| 30 | \$74,848 | \$2,994 | 0.14 | 15 | \$21,370 |
| 31 | \$77,842 | \$3,114 | 0.14 | 14 | \$19,496 |
| 32 | \$80,955 | \$3,238 | 0.14 | 13 | \$17,786 |
| 33 | \$84,193 | \$3,368 | 0.14 | 12 | \$16,225 |
| 34 | \$87,561 | \$3,502 | 0.14 | 11 | \$14,802 |
| 35 | \$91,064 | \$3,643 | 0.14 | 10 | \$13,504 |
| 36 | \$94,706 | \$3,788 | 0.14 | 9 | \$12,319 |
| 37 | \$98,494 | \$3,940 | 0.14 | 8 | \$11,239 |
| 38 | \$102,434 | \$4,097 | 0.14 | 7 | \$10,253 |
| 39 | \$106,532 | \$4,261 | 0.14 | 6 | \$9,353 |
| 40 | \$110,793 | \$4,432 | 0.14 | 5 | \$8,533 |
| 41 | \$115,224 | \$4,609 | 0.14 | 4 | \$7,784 |
| 42 | \$119,833 | \$4,793 | 0.14 | 3 | \$7,102 |
| 43 | \$124,627 | \$4,985 | 0.14 | 2 | \$6,479 |
| 44 | \$129,612 | \$5,184 | 0.14 | 1 | \$5,910 |
| 45 | \$134,796 | \$5,392 | 0.14 | 0 | \$5,392 |

TOTALS

EARNINGS \$2,904,705

FUNDS INVESTED \$116,188

VALUE OF RETIREMENT ACCOUNT

\$3,435,244

CONCLUSION

Well, we've talked about a number of things today: How to organize our finances so that we could find some money to save.

We talked about investing those amounts that you will save.

We talked some in the beginning about stewardship. A good manager is synonymous with a good steward. The things given today were an effort to make you a better steward...a faithful servant.

A faithful servant is an all-embracing term, let me be a little more specific. When I was working on this, I thought about my motives. These were at least some of them:

- 1. I did want to see you more successful in handling the resources you had.*
- 2. I did not have the goal to make you rich in a purely monetary sense.*
- 3. At some point, I wanted to see (or hear) that you were handling the monies you had in such a way that you were able to have an emergency fund saved and set aside.*
- 4. In that sense, I wanted to see you stop living from pay-check to pay-check.*
- 5. Of those monies you save, above and beyond the reserve fund, I wanted to point out investments...simple investments that were available to you.*
- 6. If the Lord tarries, I wanted to see you go into your retirement years being able to maintain a decent standard of living because you had saved and invested in your working years.*
- 7. Those were my goals in a nut-shell.*

Next, I would like to say that I appreciate my wife very much in every way. For the things we talked about today, particularly saving, I could not have done it without her.

How many dollars she has saved at garage sales, Goodwill, Thrift Town, and Resale Shops in clothing for our family (herself, the children and grandchildren), as well as many friends, is an arresting number.

There are a couple of men who have poked fun at me for buying clothes at resale shops. Let me offer this scenario and it's applicable to all wives, not just mine.

Let's say my wife, by buying prudently, even wisely, has saved me \$1,000 a year over time. Let's also say that for the last 15 years I have invested that money in American Capital Emerging Growth.

And now, 15 years later, at December 31, 1993, I have \$63,813 based on my wife's contribution. As for those guy's who poked fun at me, have you ever heard the phrase, "I cried.....all the way to the bank."

Actually, I didn't do it just like that. What I did do was make other investments including purchases of American Capital Enterprise, and American Capital Emerging Growth.

I wanted to mention my wife for two reasons: I get too many accolades for what I do: she gets too few for what she does.

Wives, you can make that kind of contribution to the family. It may not be as graphic as this, but it will be significant.

Though we've just touched the surface in many cases, I hope that the discussion has been beneficial.

I will entertain some questions of general interest, or clarifying questions. Other questions that are personal or only applicable to you, we can discuss privately.

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