Investing and Saving for Retirement

A SIMPLE GUIDE TO A COMPLEX SUBJECT

SEAN SEALES

Retirement

A Simple Guide to a Complex Subject

by

Sean Seales

Copyright © 2015 Sean Seales. Electronically published in the USA.

This work is licensed to you at no cost under a Creative Commons License, which is described in full at http://creativecommons.org/licenses/by-nc-nd/3.0/

This license allows you to download this book, download portions of its contents, and share the contents with others for non-commercial purposes at no charge to recipients, provided that you cite this book as the original source and do not add to or revise its contents while doing so.

Some text and graphics were obtained from government sources and remain in the public domain.

This book is intended only as an introduction to the subject of investing and saving for retirement and not as financial advice. The author has no affiliation with the organizations mentioned in this book, but may own funds used as examples.

Feel free to write the author to provide your comments or suggestions at seanseales (at) outlook (dot) com.

Preface

This book is intended for those who need a very basic introduction to investing and saving for retirement. It's an intro to “financial literacy” in the area of investments, and is not intended to provide you with definitive advice, or delve deeply into the theories of finance. This book is intended to provide clear and concise information about this subject matter to normal people who want to retire one day. Being an introductory primer, this book focuses on investment funds, including actively managed mutual funds and exchange traded funds that track a stock index. It also emphasizes selecting a high quality and well diversified investment portfolio, i.e. not “putting all of your eggs in one basket.”

This book is short, by design, so that you don't feel like the financial firehose was just turned on you. Hopefully, you can quickly get moving in a positive direction to make some important decisions more quickly than with a 300 page book. Sometimes these subjects can be confusing and intimidating, but this can be avoided through learning some of the basics of investing that the investment companies won't necessarily offer up front.

The book focuses in on some key information that you can use to quickly begin deciding how you will plan to

retire. The most vital information that you can use to get started is presented first. Later chapters provide additional information that you may find more useful if you want to do your own investment research. Where indicated, portions of this book are reprinted from government sources providing some good information regarding investing.

While not specifically stated in each chapter, if you are seeking to make an investment decision in the near future and have questions about what to do, it's usually a good idea to seek out the advice of a professional. This may be Certified Financial Planner, Registered Investment Advisor, attorney, or accountant knowledgable of these topics. Other types of investment professionals who're paid based on their sales can also provide useful information, but are not usually required to point out better alternatives to what they're offering you.

This book is provided free of charge for personal, non-profit or educational use, and is not permitted to be sold for any purpose by other parties. Feel free to redistribute information in this book to your friends and relatives, and please consider making a $5 donation or more to one of the charities listed below:

- American Red Cross
- Catholic Charities
- UNHCR (UN Refugees)
- UNICEF

Contents

Chapter 1 – Saving Money for a Rainy Day
Chapter 2 – Simple and Quick Ways to Invest
Chapter 3 – Seeking Professional Advice
Chapter 4 – Making Investment Choices
Chapter 5 – Example Portfolios
Chapter 6 – Conclusions
Online Resources

1

Saving Money for a Rainy Day

One of the first things you should consider before you invest is "What would I do if I lost my current source of income?" How would you survive for the first six to 12 months of unemployment or the loss of your current income source? Unless you have a good answer for that, then you should consider the amount of savings you currently have in the bank. When it comes to emergency funds, it's best to have a source of money that is readily available and not subject to market downswings. Usually this means having money in a cash account. Some stock brokerages provide cash accounts, and some are even accessibly through ATM cards. While this may be changing, most people are more comfortable doing their banking in person with a bank down the street. Some other benefits to this is having a local place to go when you need a loan or when things go wrong with your account. Another important consideration is the ability of your spouse or other dependents to access money in the account in the event of an emergency.

However, if you're comfortable with technology and remote customer service, some online banks offer significantly better interest rates for savings accounts. As of

this writing, there were online savings accounts offering 1.25%, with few fees. If may make sense for you to have a local checking account linked to a higher interest online savings account, keeping at least enough money in checking to pay near term bills.

If you've provided for your dependents to have access to a second ATM card and your PIN in an emergency, then they would probably be able to access these funds in the short term. However, you may also want to discuss with the bank how you can put their names on the account to ensure they have access, or consult an attorney regarding estate planning.

Your emergency fund in your bank or credit union should be enough to take care of yourself and your dependents for at least six months, although some would suggest having as much as twelve months. In addition to that, it would be a good idea to have enough cash to cover your monthly bills.

Some institutions have better reputations or fee schedules than others. While this book will not attempt to tell you which ones are best, here are some sources of information to help you select one:

- Bankrate
- Forbes, America's Best and Worst Banks
- US News, 10 Best Banks
- Wallethub's credit union search tool

High banking and ATM fees can sometimes eat up your savings or checking account balance, which is why some people prefer online banks and credit unions to traditional

banks. Take note of the bank's key terms of service, such as any restrictions as to how and when your money is available, or unusually high fees. Comparison shopping and reviewing online reviews is usually also a good idea.

Sometimes banks offer short-term bonuses of $50 to $500, depending on the amount you plan to transfer into a new account. There are usually rules regarding how long you must keep the money in the account, and sometimes the interest rates are fairly low. However, there are often ways to take advantages of these bonuses and come out ahead.

Similar to bank accounts, many credit cards are offered with points or cash bonuses for establishing a new account. While their relative benefits may fluctuate, the one common item to remember is that you should plan to pay them off every month, or begin incurring high interest rates and fees. Some card companies do offer temporary 0% interest periods of up to a year on balance transfer, which would make sense for someone having a balance. Paying off high interest debt before making any investments is a smart idea. You will be hard pressed to find a better return on investment through putting money into the stock market.

2

Simple and Quick Ways to Invest

This chapter is intended for those who don't want to spend a lot of time worrying about where to put their money for retirement. Assuming you've got an emergency fund established at the bank or credit union, there are many easy and quick options for retirement savings. We will review a few affordable “all-in-one” choices for retirement investing, and later the book will discuss some other investment options.

By “all-in-one,” I am referring to mutual funds having target dates: the year you plan to start drawing money to pay for your life in retirement. These funds split your lump sum into multiple types of investments, which are contained within the fund. You put money into this one target date fund, and they automatically diversify, or split up this this money, based on the risk level that your target date would normally call for.

Diversification is a topic that will be covered later in the book, in case you'd like to know more about what these funds are doing. For now, just remember that it's spreading the risk, on the premise that different parts of the market don't usually all go up or down at once, but generally go up

in the long-term as a whole. It also involves dividing your money between lower risk and higher risk investments, depending on your individual needs.

Each year, the mix of investments is changed so that its less risky than in prior years. When the fund reaches the "target date," or the year you need to start spending the money, then its underlying investments are put into stocks or bonds intended to generate income. If you're already retired and need income from your investments, then you would probably select a Retirement Income fund, rather than a target date fund.

Each mutual fund company has a different method for doing this, which means these types of funds may react somewhat differently to market events. The fund companies may have different philosophies regarding the best way to split up this money. Here is an example of how a family of target date funds might divide your money differently, depending on the year you select:

2040 fund:

- 19% in US Treasury bonds, 6% in corporate bonds, 38% in large company stocks, 16% in medium sized company stocks, and 21% in international stocks.

2030 fund:

- 29% in US Treasury bonds, 6% in corporate bonds, 34% in large company stocks, 12% in medium sized company stocks, and 19% in international stocks.

2020 fund:

- 44% in US Treasury bonds, 5% in corporate bonds,

27% in large company stocks, 8% in medium sized company stocks, and 15% in international stocks.

Retirement income fund (drawing money from it now):

- 74% in US Treasury bonds, 6% in corporate bonds, 12% in large company stocks, 3% in medium sized company stocks, and 5% in international stocks.

As you can see, the percentage going to very low risk investments, the US Treasury bonds, increases dramatically as you get closer to your target date. As the years go by, the 2030 fund will look a lot more like the 2020 fund, and then automatically turn into the Retirement Income fund. This all occurs without you having to move money between funds, which is a primary benefit of the target date funds. Having the low risk Retirement Income portfolio means you hopefully wouldn't lose too much principal to stay retired if the stock market goes down. By that time, the bulk of your money will be in low risk investments, just hoping to keep up with inflation rather than grow much more.

Some companies may also charge additional fees, having a higher than normal annual management fee or fees you're charged upon purchasing or selling shares. You will generally want to avoid these funds unless you've identified a compelling reason to invest in them. On the other hand, firms charging almost nothing are usually investing in stock index-based investments, rather than fund management staff screening and selling stocks on a continuous basis. Your investments would be on “automatic pilot” for the most part. Most active management fund managers have great difficulty beating the stock indices, but there are some standouts that you should consider before going for the one with the lowest management fee. Later in the book, I will

describe how to research this.

In selecting a fund company, you will need to decide whether to use an investment firm that is only online, one that also has a branch office near your home, or a fund for which there is a stock brokerage that will buy and sell you shares at a reasonable cost. Some mutual fund companies, such as Fidelity and Schwab, have hundreds of offices across the country in case you'd rather not use their website to invest. I would personally avoid using a fund or brokerage requiring a transaction fee in order to purchase or sell shares in a fund. This can make a major dent in your investments over a long period of time. They are already earning their pay through the annual management fee, which should hopefully be less than 1% on domestic stock funds or below 1.5% for international funds. Some would say this is too high, but I'd also take into consideration how well the fund is doing relative to its peers and to the stock index it tracks. If its fee is 0.3% more than a low-cost fund, but consistently beating the cheaper fund by 3% high return each year, then I'm not as worried about the management fee.

Once you decide the year of your retirement, or “the target date,” how do you figure out what the best target date fund is for you? Some of the top names in the target date mutual fund business are American Funds, Fidelity, T. Rowe Price, and Vanguard. As with banks, the internet has lots of information available to help you decide which fund is right for you. Here is a comparison of the “target date 2030” funds from these four companies:

- American Funds

  - 2030 Target Date Retirement (REETX)
  - Minimum investment: $250 ($25 for IRAs)
  - Annual fee: $46 for every $10,000 invested
  - This fund was less than 10 years old as of 2015.
  - A $10,000 investment made in 2010 was worth about $16,000 in 2015.
  - Its underlying investments are actively managed, rather than being tied to stock indices.
- Fidelity
  - Freedom Index 2030 (FXIFX)
  - Minimum investment: $2,500
  - Annual fee: $16 for every $10,000
  - This fund was less than 10 years old as of 2015.
  - A $10,000 investment made in 2010 was worth about $16,000 in 2015.
  - Its underlying investments are tied to stock indices.
- T. Rowe Price
  - Retirement 2030 (TRRCX)
  - Minimum investment: $2,500
  - Annual fee: $73 for every $10,000 invested
  - A $10,000 investment made in 2005 was worth

about $20,000 in 2015.

- A $10,000 investment made in 2010 was worth about $18,000 in 2015.
- Its underlying investments are actively managed, rather than being tied to stock indices.

- Vanguard
  - Target Retirement 2030 (VTHRX)
  - Minimum investment: $1,000
  - Annual fee: $17 for every $10,000 invested
  - This fund was less than 10 years old as of 2015.
  - A $10,000 investment made in 2010 was worth about $17,000 in 2015.
  - Its underlying investments are tied to stock indices.

Beyond the differences shown above, they each differ in regards to the types and amounts of investments make over their lifetimes and other important areas. People who're concerned about their portfolio being too risky may want to consider the amount being put into stocks versus government bonds and high grade corporate bonds. You can compare them using any of the free stock information websites discussed later in chapter 4 and by reviewing their prospectus. Another option is to diversify your investments between two, three, or four funds having the same target date, rather than putting everything with one fund company. There are differing opinions on the use of target date funds, but they can provide a diversified, simple and relatively low

cost way of investing for retirement.

If your employer has established a 401k plan or other tax-deferred retirement plan offering access to target date funds, then you should review the fees associated with these funds, and the benefits of investing in them. Sometimes it makes sense to invest in your employer's plan if they offer to match your contribution. In other cases, the fees can be much more costly than what's available from a different mutual fund company. These 401k plans usually offer a higher amount of tax deferred savings than what's available from Individual Retirement Accounts (also called “Arrangements”) at a mutual fund company, which is one of their main benefits.

The rules for contributing to workplace employment plans and IRAs can be complex if your income exceeds certain thresholds. You may want to consult the Internal Revenue Service's website or your tax professional before contributing to both. Generally speaking, you may contribute up to $18,000 in tax deferred income to your employer's 401k plan. This money goes in without taxes being taken out, but you pay income taxes on any withdrawals after you retire.

On top of this $18,000, most people earning less than $118,000 per year may also contribute $5,000 in post-tax income to a Roth IRA. This type of IRA allows for the tax-free growth of this money after you pay taxes on the principal.

You may also contribute as much as you can afford to taxable accounts, where the invested amount is post-tax dollars and you also pay taxes on dividends, capital gains, and other earnings. Funds can sometimes generate capital

gains in a taxable account, even if you haven't sold any shares of the fund, but most capital gains taxes will be due after you've sold shares at a profit.

If you're investing in target date funds for the long-term, with the goal of living off this money in retirement, then “Dollar cost averaging” is a good idea. This means putting in regular amounts every month, depending on what you can afford and also depending on your retirement plans. There are many online investment calculators that can give you an idea of how much money you'll need to save in the future to help meet your retirement objectives, such as:

- Vanguard's Retirement Nest Egg Calculator
- Bankrate's Retirement Planner

Generally speaking, if your financial situation allows, you should save or invest at least 10% of your income starting at a fairly early age. If you're getting a late start, then you may want to consider investing a larger percentage of your income. If you have a complex financial situation, then other considerations may need to be made, such as the amounts and types of insurance you have. A Certified Financial Planner or Registered Investment Advisor could provide independent advice to assist you with making your decisions. Another good resource is a financial literacy website created for the public by the American Institute of Certified Professional Accountants: http://www.feedthepig.org.

3

Seeking Professional Advice

If you want to do more than pick target date funds, then you have the option of either doing your own research or else finding someone qualified to help you make investments. This chapter is about the second option. Several types of investment professionals exist, and many of them are more of a salesperson than an advisor, although the job titles on their business card may not make that obvious. You should ask them if they are acting as your fiduciary—normally a Certified Financial Planner or Registered Investment Advisor—or if they're acting as representatives of the investment firm they work for. Other professionals who can possibly assist with making financial decisions, or at least point you in the right direction, include your accountant or tax attorney.

There are many types of people called “investment advisors.” If the investment advisor you're speaking to is an investment company representative trying to sell you something, then their primary motivation is to get you to invest, rather than explore a complete range of other options. That's not to say that you will necessarily get horrible advice or that they will put you into a bad investment.

Salespeople in the financial industry are required to be licensed and are also required to provide you with accurate information about the investments they're marketing. They must ensure that the investments are “suitable” for you, but this is a lesser standard than what's required of Certified Financial Planners and Registered Investment Advisors acing as your fiduciary. CFPs and RIAs are required to act on your behalf rather than primarily working on behalf of an investment firm. They also provide information about other issues that you may have concerns about, such as debt and estate planning, which may lead you to make a decision other than to invest money in the stock market.

The Securities and Exchange Commission provides the following information regarding the various types of financial industry professionals that you may meet:

Q: What is an investment adviser?

A: An investment adviser is an individual or a firm that is in the business of giving advice about securities to clients. For instance, individuals or firms that receive compensation for giving advice on investing in stocks, bonds, mutual funds, or exchange traded funds are investment advisers. Some investment advisers manage portfolios of securities.

Q: What is the difference between an investment adviser and a financial planner?

A: Most financial planners are investment advisers, but not all investment advisers are financial planners. Some financial planners assess every aspect of your financial life—including saving, investments, insurance, taxes, retirement, and estate planning—and help you develop a detailed strategy or financial plan for meeting all your

financial goals.

Others call themselves financial planners, but they may only be able to recommend that you invest in a narrow range of products, and sometimes products that aren't securities.

Before you hire any financial professional, you should know exactly what services you need, what services the professional can deliver, any limitations on what they can recommend, what services you're paying for, how much those services cost, and how the adviser or planner gets paid.

Q: What questions should I ask when choosing an investment adviser or financial planner?

A: Here are some of the questions you should always ask when hiring any financial professional:

- What experience do you have, especially with people in my circumstances?
- Where did you go to school? What is your recent employment history?
- What licenses do you hold? Are you registered with the SEC, a state, or the Financial Industry Regulatory Authority (FINRA)?
- What products and services do you offer?
- Can you only recommend a limited number of products or services to me? If so, why?
- How are you paid for your services? What is your usual hourly rate, flat fee, or commission?
- Have you ever been disciplined by any government regulator for unethical or improper conduct or been

sued by a client who was not happy with the work you did?

- For registered investment advisers, will you send me a copy of both parts of your Form ADV?

Be sure to meet potential advisers "face to face" to make sure you get along. And remember: there are many types of individuals who can help you develop a personal financial plan and manage your hard–earned money. The most important thing is that you know your financial goals, have a plan in place, and check out the professional you chose with your securities regulator.

Q: How do investment advisers get paid?

A: Before you hire any financial professional—whether it's a stockbroker, a financial planner, or an investment adviser—you should always find out and make sure you understand how that person gets paid. Investment advisers generally are paid in any of the following ways:

- A percentage of the value of the assets they manage for you;
- An hourly fee for the time they spend working for you;
- A fixed fee;
- A commission on the securities they sell (if the adviser is also a broker-dealer); or
- Some combination of the above.

Each compensation method has potential benefits and possible drawbacks, depending on your individual needs. Ask the investment advisers you interview to explain the differences to you before you do business with them, and

get several opinions before making your decision. Also ask if the fee is negotiable.

Q: Do investment advisers have to register with the SEC?

A: Depending on their size, investment advisers have to register with either the SEC or the state securities agency where they have their principal place of business.

Q: How do I find out whether an investment adviser ever had problems with a government regulator or has a disciplinary history?

A: Most investment advisers must fill out a form called "Form ADV." They must file their Form ADVs with either the SEC or the state securities agency in the state where they have their principal place of business, depending on the amount of assets they manage.

You can get copies of Form ADV by accessing the Investment Adviser Public Disclosure (IAPD) website at http://www.adviserinfo.sec.gov/.

You can also get copies of Form ADV from the investment adviser, your state securities regulator or the SEC, depending on the size of the adviser. You can find out how to get in touch with your state securities regulator through the North American Securities Administrators Association, Inc.'s (NASAA) website or by calling (202) 737-0900. Ask your state securities regulator whether they've had any complaints about the adviser, and ask them to check the CRD (Central Registration Depository).

If the SEC registers the investment adviser, you can get a copy of the Form ADV by accessing How to Request Public Documents. In addition, at the SEC's headquarters, you can visit our Public Reference Room from 10:00 a.m. to

3:00 p.m. to obtain copies of SEC records and documents.

Q: What should I do if the financial professional claims that he or she is "certified"?

A: If the professional you're considering claims to be a CFP® certificant, you should also visit the website of the Certified Financial Planner Board of Standards, Inc. (CFB Board) to see if the professional is, in fact, certified as a CFP® professional and whether the professional's certification has been suspended or revoked by the CFP Board. You can also call the CFP Board at (888) 237-6275 to obtain other disciplinary information about the professional.

Q: Are investment advisers required to have credentials?

A: While some investment advisers and financial planners have credentials – such as CFP® certification or CFA (chartered financial analyst) -- no state or federal law requires these credentials. Many states require advisers to pass a proficiency exam or meet other requirements.

Investment advisers and financial planners may come from many different educational and professional backgrounds. Before you hire a financial professional, be sure to ask about their background. If they have a credential, ask them what it means and what they had to do to earn it.

Also, find out what organization issued the credential, and then contact the organization to verify whether the professional you're considering did, in fact, earn the credential and whether the professional remains in good standing with the organization.

4

Making Investment Choices

Selecting your own mutual funds or exchange traded funds can be as simple or complex as you'd like it to be. As Chapter 2 showed, it can be a very simple matter of picking an all-in-one mutual fund, which is set up to provide you with income beginning in your retirement target date. If you'd like to have more say over the investments your money will go to, then you can do your own research to inform your decision.

The first concept you should become familiar with is the investment portfolio. Chapter 2 provided an example of portfolios that target date 2020, 2030, 2040, and Retirement Income funds might have. These portfolios include what the investment firms have determined is an optimal mix of investments during the years leading up to the target date, and eventually into retirement.

You can also create your own retirement portfolio using a mix of investments that you've determined is closer to meeting your objectives. There are many views regarding what constitutes the best portfolio, and the target date funds represent only a few of those. Retirement portfolios may be created out of an assortment of actively managed mutual

funds or indexed-based exchange traded funds. These funds are composed of individual stocks and bonds, among many other alternatives beyond the scope of this book.

One other thing to remember is to always set up your fund or brokerage account so that all money earned is reinvested. This will substantially add to your investments over a long period of time, similar to how compounded interest can make credit card balances go up more quickly. Once you're retired, you can draw money out as needed, while keeping the reinvestment options turned on.

You may decide that you don't favor the very low risk and low return of US Treasury bonds as much as the target date funds do, and think taking on a little more risk is a good idea to achieve your objectives. There are many sources of information that could help you decide what your portfolio should be. Once you have a chance to look at several different options, their expected returns on investment, and potential downward swing, then you will have a better idea of what you like best. At the very least, you should be better prepared for a discussion with an investment professional.

Here are a few sites that provide portfolio models that you could use as a basis for select funds for your investments and rebalance your portfolio over time:

- Schwab ETF Portfolio Builder
- Vanguard Mutual Fund recommendation
- Bogleheads' Asset Allocation info webpage

There are some very complex portfolio models involving a dozen or more investments. On the other hand, as the Boglehead website listed above will tell you, there

are also very simple portfolio models composed of only three index-based funds. Anyone who's new to investing would probably be better off investing in a target date fund or a simple portfolio model such as those offered at the sites listed above.

For those needing a steady source of money, its possible to find undervalued stocks paying steady dividends of 5% or more, which can be important for those wanting to avoid the ups and downs of the stock market. Just keep in mind that dividend payments can also have their own ups and downs, and aren't guaranteed either. Another option is to invest in bond funds that pay regular interest. The main caveat with these types of investments is that the share prices of dividend paying stocks and bond mutual funds may drop as interest rates go up. Some bond funds, such as the Bulletshares funds, repay the principal amount invested in a future year, as well as regular interest payments. This assumes that none of the funds in the portfolio default.

If you have some extra time on your hands, then I suggest watching an Open Yale video that's accessible for free, and which was taught by a Nobel Prize winner in Economics, Dr. Robert Shiller. The other lectures of the course are also well worth watching.

ECON 252: Financial Markets (2011) Lecture 4 - Portfolio Diversification and Supporting Financial Institutions

Once you've decided upon a portfolio model, there are many websites that review mutual and exchange trade funds, provide ratings and a lot of data to consider. A few popular sites having this type of information are:

- Morningstar

- The Street
- US News
- Zacks

Some of the data on these sites is accessible for free, and other data is not. My personal view is that it's worth having the best information you can get while you're making investment decisions. Making poor investment decisions can cost you much more than subscription fees ever will. This may only require signing up for a month or two each year, rather than paying for an annual subscription. Sites such as Morningstar offer advice that is independent of the firms marketing investments, and delve deeply into the underlying management of mutual funds and companies they rate.

To get a more complete picture of a fund when considering whether to buy or sell funds, you can compare their ratings at different sites. Among the ratings to watch for on these sites are:

- Morningstar gold, silver or bronze analyst ratings for mutual funds, which provide an indicator of how well they think these funds are being managed. Receiving any of these ratings is generally a positive sign, because many even don't receive a rating. This rating is a view of the future of these funds, rather than just past performance.

- Morningstar's star ratings, which show how the funds have performed in the past. The highest star rating is 5 stars. Usually you will want to stick with funds rated 3 stars or more, unless you have a reason

to believe their performance is due to improve.

- The Street rates funds using a letter grade system similar to that used in school systems. A+ is the highest rating. Anything above a B+ is considered a Buy rating. C-, C and C+ are Hold ratings. Letters D+ through F are all Sell Ratings.

- US News ranks the top mutual funds in order of preference within various categories.

- Zacks fund ratings of (1) Strong Buy or (2) Buy, which are preferable to ratings of Hold, Sell or Strong Sell.

The performance of ETFs depends less on their management, and more on the performance of stock indices they represent. If you're wanting to invest in the top 500 companies in America, then you don't need an active manager to do that for you, and would be fine with an S&P 500 ETF. It's tough to "beat the market" (or the stock index) when the companies you invest in have lots of professionals watching them and analyzing everything they do. On the other hand, if you'd like to diversify to small company stocks in developing nations, then knowing you have well qualified active fund managers digging into their details is probably good idea. This doesn't eliminate all risk by any means, but neither does bucking your seatbelt and eating healthy every day. Some actively managed funds regularly beat the stock indices that they track. Many of the online research sites show how funds perform relative to the stock index they're tracking.

For the most part, the jury still remains out on whether to buy mutual funds or exchange traded funds, and each option has advocates and detractors. My view is that there's no “one-size fits all” answer to this question. If you're investing for retirement, then it's likely you will be making many recurring investments and withdrawals. Having a mutual fund can help you avoid transaction costs from buying and selling, assuming it's a no-load fund, however you may pay more in annual fees than with an exchange traded fund. Some fund companies, such as Vanguard, keep their actively managed mutual fund management fees fairly low.

Some online brokerages, such as Fidelity, Schwab and Vanguard, do not charge transaction fees for purchasing or selling ETF's in their fund families, or for certain others they're affiliated with. This type of option makes the ownership of many index-based ETF's very inexpensive. Some actively managed funds regularly outperform those ETF's by much more than the additional annual management fee those mutual funds charge. ETF advocates claim often this is not the norm, however it occurs frequently enough that you should pay close attention to fund performance data, and how each investment option compares to other similar investments. You should always consider the relative fees in comparison with the fund's performance and the performance of the index it tracks. Regardless of the type of fund you invest in, always read the fund prospectus to understand it before buying any shares. Also review the reports these funds produce each year, which provide updates on how they're doing and discuss major changes.

The Securities and Exchange Commission provides the following information:

Beginners' Guide to Asset Allocation, Diversification, and Rebalancing

Even if you are new to investing, you may already know some of the most fundamental principles of sound investing. How did you learn them? Through ordinary, real-life experiences that have nothing to do with the stock market.

For example, have you ever noticed that street vendors often sell seemingly unrelated products – such as umbrellas and sunglasses? Initially, that may seem odd. After all, when would a person buy both items at the same time? Probably never – and that's the point. Street vendors know that when it's raining, it's easier to sell umbrellas but harder to sell sunglasses. And when it's sunny, the reverse is true. By selling both items- in other words, by diversifying the product line - the vendor can reduce the risk of losing money on any given day. If that makes sense, you've got a great start on understanding asset allocation and diversification. This publication will cover those topics more fully and will also discuss the importance of rebalancing from time to time. Let's begin by looking at asset allocation.

Asset Allocation 101

Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks, bonds, and cash. The process of determining which mix of assets to hold in your portfolio is a very personal one. The asset allocation that works best for you at any given point in your life will depend largely on your time horizon and your

ability to tolerate risk.

- Time Horizon – Your time horizon is the expected number of months, years, or decades you will be investing to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable taking on a riskier, or more volatile, investment because he or she can wait out slow economic cycles and the inevitable ups and downs of our markets. By contrast, an investor saving up for a teenager's college education would likely take on less risk because he or she has a shorter time horizon.
- Risk Tolerance – Risk tolerance is your ability and willingness to lose some or all of your original investment in exchange for greater potential returns. An aggressive investor, or one with a high-risk tolerance, is more likely to risk losing money in order to get better results. A conservative investor, or one with a low-risk tolerance, tends to favor investments that will preserve his or her original investment. In the words of the famous saying, conservative investors keep a "bird in the hand," while aggressive investors seek "two in the bush."

Risk versus Reward

When it comes to investing, risk and reward are inextricably entwined. You've probably heard the phrase "no pain, no gain" - those words come close to summing up the relationship between risk and reward. Don't let anyone tell you otherwise: All investments involve some degree of risk. If you intend to purchases securities – such as stocks, bonds, or mutual funds - it's important that you understand before

you invest that you could lose some or all of your money.

The reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you are likely to make more money by carefully investing in asset categories with greater risk, like stocks or bonds, rather than restricting your investments to assets with less risk, like cash equivalents. On the other hand, investing solely in cash investments may be appropriate for short-term financial goals.

Investment Choices

You should know that a vast array of investment products exists – including stocks and stock mutual funds, corporate and municipal bonds, bond mutual funds, lifecycle funds, exchange-traded funds, money market funds, and U.S. Treasury securities. For many financial goals, investing in a mix of stocks, bonds, and cash can be a good strategy. Let's take a closer look at the characteristics of the three major asset categories.

- Stocks – Stocks have historically had the greatest risk and highest returns among the three major asset categories. As an asset category, stocks are a portfolio's "heavy hitter," offering the greatest potential for growth. Stocks hit home runs, but also strike out. The volatility of stocks makes them a very risky investment in the short term. Large company stocks as a group, for example, have lost money on average about one out of every three years. And sometimes the losses have been quite dramatic. But investors that have been willing to ride out the volatile returns of stocks over long periods of time generally have been rewarded with strong positive

returns.

- Bonds – Bonds are generally less volatile than stocks but offer more modest returns. As a result, an investor approaching a financial goal might increase his or her bond holdings relative to his or her stock holdings because the reduced risk of holding more bonds would be attractive to the investor despite their lower potential for growth. You should keep in mind that certain categories of bonds offer high returns similar to stocks. But these bonds, known as high-yield or junk bonds, also carry higher risk.
- Cash and cash equivalents – such as savings deposits, certificates of deposit, treasury bills, money market deposit accounts, and money market funds – are the safest investments, but offer the lowest return of the three major asset categories. The chances of losing money on an investment in this asset category are generally extremely low. The federal government guarantees many investments in cash equivalents. Investment losses in non-guaranteed cash equivalents do occur, but infrequently. The principal concern for investors investing in cash equivalents is inflation risk. This is the risk that inflation will outpace and erode investment returns over time.

Stocks, bonds, and cash are the most common asset categories. These are the asset categories you would likely choose from when investing in a retirement savings program or a college savings plan. But other asset categories – including real estate, precious metals and other commodities, and private equity - also exist, and some

investors may include these asset categories within a portfolio. Investments in these asset categories typically have category-specific risks. Before you make any investment, you should understand the risks of the investment and make sure the risks are appropriate for you.

Why Asset Allocation Is So Important

By including asset categories with investment returns that move up and down under different market conditions within a portfolio, an investor can protect against significant losses. Historically, the returns of the three major asset categories have not moved up and down at the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns. By investing in more than one asset category, you'll reduce the risk that you'll lose money and your portfolio's overall investment returns will have a smoother ride. If one asset category's investment return falls, you'll be in a position to counteract your losses in that asset category with better investment returns in another asset category.

The Magic of Diversification.

The practice of spreading money among different investments to reduce risk is known as diversification. By picking the right group of investments, you may be able to limit your losses and reduce the fluctuations of investment returns without sacrificing too much potential gain. In addition, asset allocation is important because it has major impact on whether you will meet your financial goal. If you don't include enough risk in your portfolio, your investments may not earn a large enough return to meet your goal. For example, if you are saving for a long-term goal, such as retirement or college, most financial experts

agree that you will likely need to include at least some stock or stock mutual funds in your portfolio. On the other hand, if you include too much risk in your portfolio, the money for your goal may not be there when you need it. A portfolio heavily weighted in stock or stock mutual funds, for instance, would be inappropriate for a short-term goal, such as saving for a family's summer vacation.

How to Get Started

Determining the appropriate asset allocation model for a financial goal is a complicated task. Basically, you're trying to pick a mix of assets that has the highest probability of meeting your goal at a level of risk you can live with. As you get closer to meeting your goal, you'll need to be able to adjust the mix of assets.

If you understand your time horizon and risk tolerance – and have some investing experience – you may feel comfortable creating your own asset allocation model. "How to" books on investing often discuss general "rules of thumb," and various online resources can help you with your decision.

In the end, you'll be making a very personal choice. There is no single asset allocation model that is right for every financial goal. You'll need to use the one that is right for you.

Some financial experts believe that determining your asset allocation is the most important decision that you'll make with respect to your investments – that it's even more important than the individual investments you buy. With that in mind, you may want to consider asking a financial professional to help you determine your initial asset

allocation and suggest adjustments for the future. But before you hire anyone to help you with these enormously important decisions, be sure to do a thorough check of his or her credentials and disciplinary history.

The Connection Between Asset Allocation and Diversification

Diversification is a strategy that can be neatly summed up by the timeless adage "Don't put all your eggs in one basket." The strategy involves spreading your money among various investments in the hope that if one investment loses money, the other investments will more than make up for those losses.

Many investors use asset allocation as a way to diversify their investments among asset categories. But other investors deliberately do not. For example, investing entirely in stock, in the case of a twenty-five year-old investing for retirement, or investing entirely in cash equivalents, in the case of a family saving for the down payment on a house, might be reasonable asset allocation strategies under certain circumstances. But neither strategy attempts to reduce risk by holding different types of asset categories. So choosing an asset allocation model won't necessarily diversify your portfolio. Whether your portfolio is diversified will depend on how you spread the money in your portfolio among different types of investments.

Diversification 101

A diversified portfolio should be diversified at two levels: between asset categories and within asset categories. So in addition to allocating your investments among stocks, bonds, cash equivalents, and possibly other asset categories, you'll

also need to spread out your investments within each asset category. The key is to identify investments in segments of each asset category that may perform differently under different market conditions.

One of way of diversifying your investments within an asset category is to identify and invest in a wide range of companies and industry sectors. But the stock portion of your investment portfolio won't be diversified, for example, if you only invest in only four or five individual stocks. You'll need at least a dozen carefully selected individual stocks to be truly diversified.

Because achieving diversification can be so challenging, some investors may find it easier to diversify within each asset category through the ownership of mutual funds rather than through individual investments from each asset category. A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, and other financial instruments. Mutual funds make it easy for investors to own a small portion of many investments. A total stock market index fund, for example, owns stock in thousands of companies. That's a lot of diversification for one investment!

Be aware, however, that a mutual fund investment doesn't necessarily provide instant diversification, especially if the fund focuses on only one particular industry sector. If you invest in narrowly focused mutual funds, you may need to invest in more than one mutual fund to get the diversification you seek. Within asset categories, that may mean considering, for instance, large company stock funds as well as some small company and international stock funds. Between asset categories, that may mean considering

stock funds, bond funds, and money market funds. Of course, as you add more investments to your portfolio, you'll likely pay additional fees and expenses, which will, in turn, lower your investment returns. So you'll need to consider these costs when deciding the best way to diversify your portfolio.

Changing Your Asset Allocation

The most common reason for changing your asset allocation is a change in your time horizon. In other words, as you get closer to your investment goal, you'll likely need to change your asset allocation. For example, most people investing for retirement hold less stock and more bonds and cash equivalents as they get closer to retirement age. You may also need to change your asset allocation if there is a change in your risk tolerance, financial situation, or the financial goal itself.

But savvy investors typically do not change their asset allocation based on the relative performance of asset categories – for example, increasing the proportion of stocks in one's portfolio when the stock market is hot. Instead, that's when they "rebalance" their portfolios.

Rebalancing 101

Rebalancing is bringing your portfolio back to your original asset allocation mix. This is necessary because over time some of your investments may become out of alignment with your investment goals. You'll find that some of your investments will grow faster than others. By rebalancing, you'll ensure that your portfolio does not overemphasize one or more asset categories, and you'll return your portfolio to a comfortable level of risk.

For example, let's say you determined that stock investments should represent 60% of your portfolio. But after a recent stock market increase, stock investments represent 80% of your portfolio. You'll need to either sell some of your stock investments or purchase investments from an under-weighted asset category in order to reestablish your original asset allocation mix.

When you rebalance, you'll also need to review the investments within each asset allocation category. If any of these investments are out of alignment with your investment goals, you'll need to make changes to bring them back to their original allocation within the asset category.

There are basically three different ways you can rebalance your portfolio:

- You can sell off investments from over-weighted asset categories and use the proceeds to purchase investments for under-weighted asset categories.
- You can purchase new investments for under-weighted asset categories.

If you are making continuous contributions to the portfolio, you can alter your contributions so that more investments go to under-weighted asset categories until your portfolio is back into balance.

Before you rebalance your portfolio, you should consider whether the method of rebalancing you decide to use will trigger transaction fees or tax consequences. Your financial professional or tax adviser can help you identify ways that you can minimize these potential costs.

Stick with Your Plan: Buy Low, Sell High – Shifting money away from an asset category when it is doing well in favor

an asset category that is doing poorly may not be easy, but it can be a wise move. By cutting back on the current "winners" and adding more of the current so-called "losers," rebalancing forces you to buy low and sell high.

When to Consider Rebalancing

You can rebalance your portfolio based either on the calendar or on your investments. Many financial experts recommend that investors rebalance their portfolios on a regular time interval, such as every six or twelve months. The advantage of this method is that the calendar is a reminder of when you should consider rebalancing.

Others recommend rebalancing only when the relative weight of an asset class increases or decreases more than a certain percentage that you've identified in advance. The advantage of this method is that your investments tell you when to rebalance. In either case, rebalancing tends to work best when done on a relatively infrequent basis.

You can find out more about your risk tolerance by completing free online questionnaires available on numerous websites maintained by investment publications, mutual fund companies, and other financial professionals. Some of the websites will even estimate asset allocations based on responses to the questionnaires. While the suggested asset allocations may be a useful starting point for determining an appropriate allocation for a particular goal, investors should keep in mind that the results may be biased towards financial products or services sold by companies or individuals maintaining the websites.

Once you've started investing, you'll typically have access to online resources that can help you manage your portfolio.

The websites of many mutual fund companies, for example, give customers the ability to run a "portfolio analysis" of their investments. The results of a portfolio analysis can help you analyze your asset allocation, determine whether your investments are diversified, and decide whether you need to rebalance your portfolio.

5

Example Portfolios

Now that you've become familiar with the basics of investing, you may be wondering how to go about doing this yourself. This will greatly depend on your goals and tolerance for market downturns, but some ideas are shown below. While the example mutual funds are from Vanguard, you could use similar low-cost, no-load mutual funds from other companies. To save on annual fees, you could even use ETFs at a brokerage charging no transaction fees within their fund family, such as at Fidelity, Schwab, or Vanguard. Some portfolio models I've seen advertised call for up to a dozen investments, however this would probably be too complex for someone who's just getting started in investing. I don't see the benefit of putting 3% in real estate and 2% in emerging market bond funds, unless you've already got a large sum to diversify.

Portfolios of Major Stock Index Funds:

- Young and middle aged: growth portfolio with moderate volatility
    - 40%: Total US Stock Market (VTSMX)
    - 30%: Total International Stock Market (VGTSX)

    - 20%: Total US Bond Market (VBMFX)
    - 10%: Total International Bond Market (VTIBX)
    - Other suggestions: The "Total International" funds normally have a lot of exposure to Europe and Japan. Should you wish to diversify more into Asia outside of Japan, then you might consider an actively managed fund, due to the unstable nature of Asian markets. To help you sort through the thousands of funds out there, mutual funds rated "Gold," "Silver," or "Bronze" by Morningstar are highly regarded by their analysts. You can see this rating when searching for funds on the Morningstar website.
- Young and middle aged: aggressive growth portfolio with high volatility
    - 60%: Total US Stock Market (VTSMX)
    - 40%: Total International Stock Market (VGTSX)
    - Other suggestions: Instead of the Total US Stock Market, you could also invest in an S&P 500 fund (such as VFINX) if you think large companies will do better than medium and small companies in market downturns. You could also further divide your international stock investments to include more emerging market stocks, such as Asia ex-Japan funds. A high-volatility portfolio is more suited to people who don't get nervous when the market takes a nosedive. When you attempt to trade stocks on

their highs and lows, you are speculating on prices, which is something you should only do after making this a serious hobby (at the least). Even professional fund managers, with all of their tools, education, training, experience and support staff, have a hard time timing the market well enough to beat the major stock indices in relatively accurately priced markets like the USA.

- Approaching retirement in 5-10 years: A moderate growth and volatility portfolio.
    - 25%: Total US Stock Market (VTSMX)
    - 15%: Total International Stock Market (VGTSX)
    - 40%: Total US Bond Market (VBMFX)
    - 20%: Total International Bond Market (VTIBX)
    - This portfolio shifts a lot of your money to bonds to help reduce the amount of volatility, while still allowing for growth. You can look at recent history to see how long stock market downturns last to decide if this is conservative enough. For example, the S&P 500 peaked in October 2007 before declining in value for over 5 years. It didn't achieve this level again until March 2013, but it's made major gains by 2015.
    - It's anyone's guess how long the next market downturn will last. One way to hedge against this threat is buying dividend or interest-producing funds, giving up some of the growth

potential in exchange for earnings. Do keep in mind that dividends are only paid out at the discretion of a company's board, and are not guaranteed, especially if their business declines. There are dividend-producing ETFs and mutual funds, as well as individual major companies producing consistent dividends for many years.

  - When you get within a decade of retirement it's probably time to check in with a professional investment advisor, such as a Certified Financial Planner, to see if your portfolio will support your objectives.

- Approaching retirement in 1-4 years: A conservative, low volatility portfolio.
  - 15%: Total US Stock Market (VTSMX)
  - 10%: Total International Stock Market (VGTSX)
  - 60%: Total US Bond Market (VBMFX)
  - 25%: Total International Bond Market (VTIBX)
  - This further reduces the amount of volatility by taking more money out of stocks and putting it into bonds. Some may see this as being too risky and want to go ahead with a Retirement Income portfolio a few years ahead of time. On the other hand, being too conservative may prevent you from growing your portfolio to where it needs to be to generate income in the long-term. I would stay in regular contact with your Certified Financial Planner or investment

advisor at this point to avoid making any major mistakes.

- Retirement income portfolio: Low volatility, income generator
  - 20%: Total US Stock Market (VTSMX)
  - 10%: Total International Stock Market (VGTSX)
  - 40%: Total US Bond Market (VBMFX)
  - 10%: Total International Bond Market (VTIBX)
  - 20%: US Short Term Inflation Protected Bonds (VTIPX)
  - This portfolio shifts your money heavily into corporate and US government bonds. Another way to further ensure that there is no loss of principal is to invest in funds that repay your principal at maturity, such as Bulletshares. Your portfolio should be aiming for about 5% to 6% annual total return, so that you can begin making withdrawals of about 4% to 5% to supplement your income. As mentioned earlier, get in contact with a well qualified and independent investment advisor to ensure you're on the right track to retire.
    - National Association of Personal Financial Advisors – Find an Advisor
    - Certified Financial Planner – Find a CFP
    - Wallethub's Financial Advisor Search

6

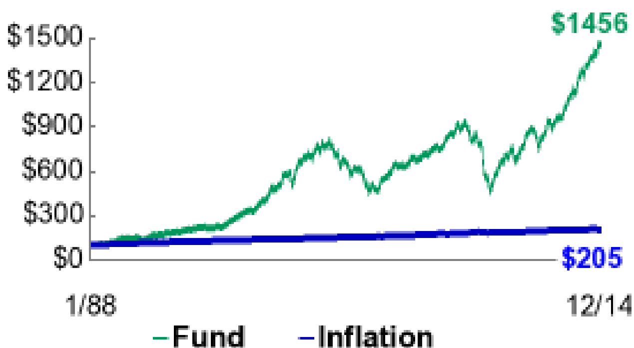
Conclusions

Investing for retirement can get very complex, especially if you start getting the idea that you can do better than the major markets indices or target date funds, however it doesn't need to be. The main thing to remember is that not investing at all, and keeping everything in cash, gives you no chance to grow your money. Your money could actually lose value due to inflation if you aren't at least earning interest to keep up. target date funds provide a diversified portfolio, which you can easily further diversify by having multiple target date funds of the same year. There are many resources, such as the Bogleheads.com website, that you can use to learn more about investing, especially if you believe that target date is not the best option for you.

I personally avoid: (1) small, less liquid mutual funds and exchange traded funds, (2) those having a sales load, (3) those having management fees of more than 1% on domestic stock funds or 1.5% for foreign stock funds, and (4) any funds that are not positively reviewed by a legitimate and independent source of investment information. Even the top rated funds have down years due to market swings, so this doesn't eliminate all risk. Before

putting money into a fund, you should also see what's going on with the stocks and bonds it owns using these sites. Putting a large lump sum into a fund right before it crashes may require many years to recover from (dollar cost averaging, or gradually investing small amounts, is a lot safer). Bear markets can crash just about any portfolio full of stocks in the near term by 30% or more, even if it has high quality companies, so keep this in mind as you get closer to needing to withdraw your money for living expenses. Retirement Income funds holding low risk US Treasuries are more appropriate for people retiring in a couple years than having a majority in stock funds, unless they're producing consistently reliable dividends.

Those whose retirements are still many years away are likely better off ignoring stock market swings and continuing to invest as usual. For example, someone who began putting $300 per month into an S&P 500 fund in 1999 would have grown their $58,000 investment to about $116,000 by 2015. Had they sold their stock in 2009 as the market crashed, they would not have been as fortunate. The chart below shows that even $100 invested in an S&P 500 fund in 1988 would have grown to almost $1500 by 2015.



As long as nothing has fundamentally changed about a fund's underlying investments, or their future potential, then downturns aren't necessarily a reason to sell a fund. If you've invested money into a narrow sector of companies now in trouble, or into a particular foreign market that's piled up too much debt, then there may be more reason to rethink your investment. Broad based stock funds, such as those tracking the S&P 500, seem to bounce back eventually. Sometimes its best to ignore what they're saying on TV about the markets, rather than attempt to “Time the market”, buy low and sell high. To quote billionaire investor Warren Buffett:

"The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd."

Online Resources

Chapter 1

- Bankrate's Bank Search
- Forbes, America's Best and Worst Banks
- US News, 10 Best Banks
- Wallethub's credit union search tool

Chapter 2

- Internal Revenue Service's IRA information website
- AICPA's Feed the Pig Website
- Vanguard's Retirement Nest Egg Calculator
- Bankrate's Retirement Planner

Chapter 3

- Security and Exchange Commission information on selecting investment advisors

Chapter 4

- Schwab ETF Portfolio Builder
- Vanguard Mutual Fund recommendation

- Bogleheads' Asset Allocation info webpage
- Yale course video on Portfolio Diversification
- Morningstar
- The Street
- US News
- Zacks
- Securities and Exchange Commission – Beginner's Guide to Asset Allocation

Chapter 5

- Morningstar information on analyst ratings for funds
- National Association of Personal Financial Advisors – Find an Advisor
- Certified Financial Planner – Find a CFP
- Wallethub's Financial Advisor Search
- 401k and IRA Distribution Calculator
- Compound Interest Calculator
- Mutual Fund Analyzer
- 529 Expense Analyzer
- Ballpark E$timate
- Social Security Retirement Estimator