5 Keys to Investing Success

What you need to know to be a better investor, with simple steps to help you reach your goals.

In partnership with

Investor Protection Trust

Investor Education in Your Community

Investor Protection Institute

By the Editors of
Kiplinger's Personal Finance

About the Investor Protection Trust

The Investor Protection Trust (IPT) is a nonprofit organization devoted to investor education. More than half of all Americans are now invested in the securities markets, making investor education and protection vitally important. Since 1993 the Investor Protection Trust has worked with the States and at the national level to provide the independent, objective investor education needed by all Americans to make informed investment decisions. For additional information on the IPT, visit www.investorprotection.org.

About the Investor Protection Institute

The Investor Protection Institute (IPI) is a non-profit organization that promotes investor protection by conducting and supporting research and education programs. For additional information, visit www.protectinvestors.org.

More resources and tools

A variety of noncommercial investor-education and -protection materials, including booklets, videos and curricula, are available and can be downloaded for educational purposes at www.investorprotection.org.

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Kiplinger's PERSONAL FINANCE

Start by making investing a (good!) habit

The breathtaking, roller-coaster performance of the stock market that accompanied the bursting of the housing and credit bubbles was a stark reminder of a fundamental truth about investing: It involves risks. Still, investing continues to offer the best means to achieve your long-term financial goals. To be a successful investor means learning to limit risks, not avoid them completely. Among investors who suffered most from the market meltdown that began in 2007 are those who bailed out and then missed the remarkable rally that saw stock prices rise by more than 50% within a few months in 2009.

As you work to create an investing plan that suits you, know that you can accumulate substantial sums of money by applying the following five keys to investment success. Note that these are keys, not secrets. In truth, there are no investment secrets. This booklet presents a bird's-eye view of the well-known methods employed by successful investors.

Key #1: Make Investing a Habit

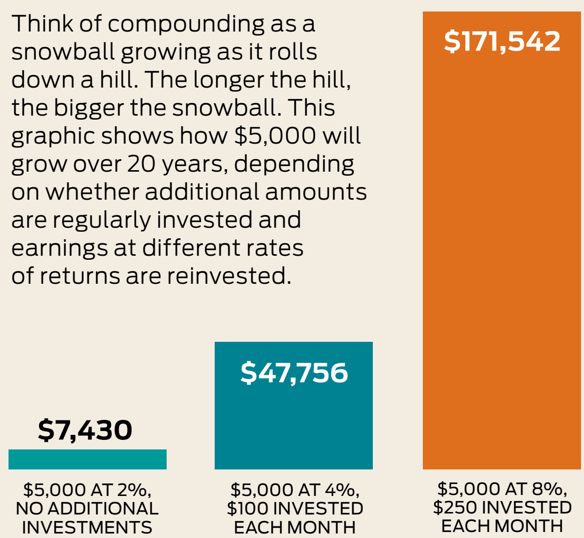
The best chance to acquire measurable wealth lies in developing the habit of adding to your investments regularly and putting the money where it can do the most for you. The rewards can be considerable. Suppose you put $5,000 in a savings account where it earns a nice, safe, 2% rate of interest, compounded annually. Twenty years later, you'll have $7,430.

Meanwhile, your brother-in-law puts $5,000 in one-year certificates of deposit (CDs) at the same bank, with instructions to roll over the proceeds into a new CD every 12 months. In addition, every month he buys a $100 CD and issues the same instructions. Over 20 years he earns an average of 3.44% annually. His nest egg: more than $44,000.

That's a lot better, but it's not going to finance a worry-free retirement. Suppose your goal is to have a nest egg of $250,000. You've got 20 years to get there and $5,000 to start. You're willing to investigate investment alternatives that should boost your return above what you'd earn in a bank account.

THE MAGIC OF COMPOUNDING

Think of compounding as a snowball growing as it rolls down a hill. The longer the hill, the bigger the snowball. This graphic shows how $5,000 will grow over 20 years, depending on whether additional amounts are regularly invested and earnings at different rates of returns are reinvested.



Exciting goals help you stay on track

What's a reasonable return to plan on, and how much more will you have to invest along the way?

Since 1926, the stocks of large companies have produced an average annual return of about 10%. (Remember, that includes such lows as the Great Depression, the stock slide that followed the September 11 terrorist attacks and the financial crisis of 2008.) If we assume a long-term annual return of 8%, you'll need to add $382 a month to the initial $5,000 to reach your quarter-of-a-million-dollar goal in 20 years. If you can earn 10% annually, $279 a month will do the trick.

These examples are simplified, of course, because they don't take taxes or broker commissions into account. But our point is simple, too: Making investing a habit is a key to making investing a success.

Key #2: Set Exciting Goals

Investment goal-setting is an intensely personal affair. But if you set generalized goals, such as "financial security" or "a comfortable retirement," you're going to have trouble measuring progress along the way. You may even struggle to maintain interest in the project. Vaguely defined investment goals can lead to half-hearted efforts to achieve them.

Better to set goals you can grab onto, goals that excite you. Instead of "financial security," why not "$500,000 net worth by age 60"? Instead of "a comfortable retirement," why not "a portfolio that will yield $2,000 a month to supplement my Social Security"? Now those are real goals that you can put a price tag on as an incentive to stick to your plan.

Setting investment goals is a lot like reading a map: Before you can get to where you want to go, you have to figure out where you are. That's the purpose of the personal balance sheet on page 4. You may have to do a little guesstimating about the value of your furniture, jewelry and so forth, but don't spend a lot of time trying to be precise about those numbers. It's the financial portion of your balance sheet that should concern you the most: money in savings accounts, stocks, bonds, mutual funds, ETFs and real estate, for example, plus what you have in a 401(k) or other company retirement plan and your IRAs.

What you learn about where your money is will influence your goal-setting just as the amount of time you have to achieve your goals will influence the kinds of investments you consider.

> There are no investment secrets. This booklet presents a bird's-eye view of the well-known methods used by successful investors.

Short-term goals. Suppose that a vacation in Europe is one of your goals and that you would like to go next summer. Such a short time horizon suggests that the stock market wouldn't be a good place to invest the money you're setting aside for the trip. The market is subject to wide swings, and you wouldn't want to be forced to sell stocks in a downswing just because the time had come to buy your airline tickets. Don't put any money into the stock market that you know you will need in the next three to five years. Low-risk vehicles, such as certificates of deposit that mature about the time you'll need the cash or a money-market fund, may be a better choice.

Medium-term goals. Maybe you'd like to buy a house or move to a larger one within three or four years. With more time, you have more flexibility. Safety is still important, but you are in a better position to ride out bad times in the financial markets and take on a little more risk. For medium-term goals, consider longer-term CDs that pay more interest. You could even consider mutual funds that invest in stocks that pay good dividends but don't tend to fluctuate much in price. That could give you higher income, a chance to ride along if the market zooms, and reasonable protection against a steep drop in stock prices.

Long-term goals. A comfortable retirement is probably the most common financial goal. A college education for the kids is another common goal. For long-term goals such as these, you can afford to take more risk. Consider a wide range of possibilities: stocks, corporate and government bonds, and long-term CDs for diversification. Also take maximum advantage of tax-sheltered plans, such as individual retirement accounts and 529 college-savings plans. Traditional IRA earnings accumulate tax-deferred, and contributions may be tax-deductible; contributions to Roth IRAs are never deductible, but all withdrawals in retirement can be tax-free. Company-sponsored 401(k) plans offer similar tax advantages and often include a real sweetener: matching contributions that will help you reach your goal.

Your goals are likely to change, so it's important to reassess them and your investment strategy annually. The kinds of investments appropriate while you are accumulating a retirement nest egg could be inappropriate after you retire. Luckily, there are plenty

WHERE YOU STAND NOW: YOUR PERSONAL BALANCE SHEET

Use this worksheet to calculate your current assets, liabilities and net worth. When you know where your current net worth is coming from, you can see where your financial position is strong and where it is weak. This worksheet, along with the investment-mix worksheet on page 7, lays the necessary groundwork for setting your investment goals and making plans to reach them.

ASSETS

Cash in savings accounts	$________
Cash in checking accounts	$________
Cash on hand	$________
Certificates of deposit	$________
Money-market funds	$________
U.S. savings bonds	$________
Market value of home	$________
Market value of other real estate	$________
Cash value of life insurance	$________
Surrender value of annuities	$________
Vested equity in pension plans	$________
Vested equity in profit sharing	$________
401(k) or 403(b) plans	$________
Individual retirement accounts	$________
Keogh plans	$________
Stocks	$________
Bonds	$________
Stock mutual funds & ETFs	$________
Bond mutual funds & ETFs	$________
Real estate investment trusts	$________
Other investments	$________
Collectibles	$________
Precious metals	$________
Estimated market value of:	
Household furnishings	$________
Automobiles and trucks	$________
Boats, recreational vehicles	$________
Furs and jewelry	$________
Loans owed to you	$________
Other assets	$________
TOTAL ASSETS	**$________(A)**

LIABILITIES

Balance owed on mortgages	$________
Home-equity credit line debt	$________
Auto loans	$________
Student loans	$________
Other credit lines	$________
Credit-card bills	$________
Other debt	$________
TOTAL LIABILITIES	**$________(B)**

CURRENT NET WORTH
(A minus B) **$________**

of resources—magazines, newspapers, books, the Internet, financial advisers—to help you decide how to modify your portfolio as your circumstances change.

Key #3: Don't Take Unnecessary Risks

Most people would say that risk is the chance you take that you'll lose all or part of the money you put into an investment. That's true as far as it goes. But a more complete definition of risk acknowledges the availability of investments with virtually ironclad guarantees that you will get all your money back plus the interest promised you—for instance, CDs in federally insured banks. Also, with all investments, you run the risk that your return will be less than inflation. So, risk is the chance you take that you will lose money or that your money will lose value.

Build your portfolio on a solid financial base

How can you control your risks? The pyramid is a useful visual image for a sensible risk-reducing strategy. It's built on a broad, solid base of financial security: your home and money in insured savings accounts or CDs. As you move up from the base, the levels get narrower, representing the space in your portfolio available for investments that involve risk. The greater the risk, the higher up the pyramid it goes and the less money you should put into it.

How much should you have in savings? Six months' to a year's worth of living expenses should be your goal. Banks and credit unions are good places to keep this money, but look for opportunities to earn more than these institutions pay on run-of-the-mill deposit accounts—by putting most of it in CDs, for example. Check out what's offered by online banks and money-market mutual funds, too.

Once you've built the base of your pyramid, you're ready to move up and become an investor. One level up is the appropriate place for mutual funds or exchange-traded funds that invest in low-risk, dividend-oriented stocks and top-quality government and corporate bonds. Individual stocks and bonds that you pick yourself are on the same level. Most financial experts would put investment real estate on the next level up. At the very top of the pyramid go investments that few people should try, such as penny or micro-cap stocks, precious metals, commodity futures and most limited partnerships.

THE TRADITIONAL RISK PYRAMID

The higher up the pyramid, the higher your potential reward and the greater your risk of loss—and the smaller the proportion of your investments.

How much risk should you take? Controlling risk means more than being "comfortable" with an investment. Too many investors seem perfectly comfortable with too much risk. The basic thing to remember about risk is that it rises as the potential return increases. The bigger the risk, the bigger the potential payoff. (Don't forget that first *p* word, *potential.*) Or, turned around: The bigger the potential payoff, the bigger the risk of losing money.

Does this mean you should avoid all high-risk investments? No. It means you should confine them

Recognize risks in every kind of investment

to the top of the pyramid. Invest only as much as you can afford to lose because you might in fact lose it. You should learn to recognize the risks involved in every kind of investment.

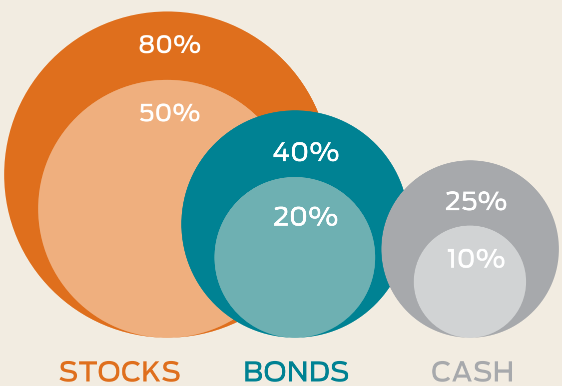
Risks in stocks. A stock could decline because the company isn't well managed or because its revenue declines. Or a well-managed and prosperous company's stock could fall because investors sell millions of shares of stock of all kinds (or stocks of a certain kind). That's what happened when the dot-com and credit bubbles burst. The entire market fell, without bothering to differentiate good stocks from bad.

Risks in bonds. As a general rule, bond prices move up when market interest rates fall and move down when interest rates rise. A bond paying 4% a year is worth more if prevailing rates fall to 3%, for example, and drops in value if newly issued bonds are paying 5%. But individual bond issues can be hurt even if rates in general are falling because a rating service downgrades its opinion of the company's stability. A bond paying a noticeably higher rate than bonds with similar maturity dates is probably paying more to compensate investors for higher risk.

Risks everywhere. Real estate values generally go up and down in sync with supply and demand in local markets, regardless of the health of the national economy. Gold and silver, which are supposed to shine in inflationary times, have usually been decidedly unrewarding in times of tolerable inflation.

What is a prudent risk? It depends on your goals, your age, your income and other resources, and your financial obligations. A young single person who expects his or her pay to rise steadily over the years and who has few family responsibilities can afford to take more chances than, say, a couple approaching retirement age. The young person has time to recover from market reversals; the older couple may not.

HOW TO DIVERSIFY



Think in terms of ranges rather than fixed percentages when deciding how to divvy up your investments. A diverse portfolio allows you to manage risk and adjust according to the market and your time horizon.

REBALANCE YOUR INVESTMENTS

Complete this worksheet at least once a year so you'll know how your investment mix is changing. Then take action to bring it back into line with a mix that matches your goals and your risk tolerance.

	MARKET VALUE	PERCENT OF TOTAL
CASH		
Savings accounts & CDs	$__________	_____%
Money-market funds	$__________	_____%
Treasury bills	$__________	_____%
TOTAL CASH	$__________	_____%
STOCKS		
Individual shares	$__________	_____%
Mutual funds & ETFs	$__________	_____%
TOTAL STOCKS	$__________	_____%
BONDS		
Individual bonds	$__________	_____%
Mutual funds & ETFs	$__________	_____%
TOTAL BONDS	$__________	_____%
Rental real estate	$__________	_____%
Limited partnerships	$__________	_____%
Precious metals	$__________	_____%
Collectibles	$__________	_____%
Other investments	$__________	_____%
TOTAL INVESTMENTS	**$__________**	**_____%**

Key #4: Keep Time on Your Side

A penny saved is a penny earned—or so the adage goes. In fact, a penny saved may be more or less than a penny earned, depending on when it is earned and how it is saved. The reason is rooted in a concept called the *time value of money* and its close cousin, *opportunity cost*.

Which would you rather have, $10,000 today or $10,000 a year from today? Of course, you'd take the money now. Not only is a bird in the hand worth two in the bush, but $10,000 will be worth less a year from now due to the effects of inflation. And delaying would cost you a year's worth of earnings.

Failing to understand how the time value of money works can cause you to think that you're doing something smart when you may not be. For instance, you may have heard praises sung for the 15-year mortgage. Because you pay it off sooner than a 30-year loan, you pay less interest and save thousands of dollars. But the homeowner with the 15-year mortgage parts with the money sooner. Here's where opportunity cost—the cost of doing one thing and not another—comes into play.

What else might you do with the money you'd spend on the higher monthly payments on the 15-year mortgage? If you could invest it at a higher rate of return than the mortgage rate, you'd actually come out ahead. Of course, the reward of not paying interest is guaranteed, while what you could earn on alternative investments is not. You need to weigh the potential risk and reward of both strategies.

Key #5: Diversify

Simply put, diversifying means not putting all your investment eggs in one basket. No investment performs well all the time; when one thing is down, another thing tends to be up. By spreading your investments around, you're likely to increase your

Rebalancing lets you sell high and buy low

STATE SECURITIES REGULATORS

State Securities Regulators have protected investors from fraud for nearly 100 years. Securities markets are global, but securities are sold locally by professionals who are licensed in every state where they conduct business. State Securities Regulators work within your state government to protect investors and help maintain the integrity of the securities industry.

Your State Securities Regulator can:

- Verify that a broker-dealer or investment adviser is properly licensed;
- Provide information about prior run-ins with regulators that led to disciplinary or enforcement actions; serious complaints that may have been lodged against them; their educational background and previous work history;
- Provide a Web site, telephone number or address where you can file a complaint; and
- Provide noncommercial investor-education and -protection materials.

For contact information for your State Securities Regulator, visit the North American Securities Administrators Association (NASAA) Web site at www.nasaa.org and click on "Contact Your Regulator."

overall return and reduce your risk at the same time.

Some investors diversify by selecting a number of investments and dividing their money equally among them. Once a year, they adjust the mix to maintain the dollar balance, taking the gains from the winners and spreading them among the losers. Although it might sound crazy to sell some of the best performing investments to invest in the laggards, think of it as selling high and buying low.

But diversifying doesn't mean buying equal chunks of everything. It's more realistic to think in terms of ranges. For example, perhaps stocks should make up 50% to 80% of your portfolio, bonds 20% to 40% and cash 10% to 25%. A core portfolio is intended not as a hard-and-fast formula but as guidance for constantly changing investment markets. Your mix should also take into account your age, income and investment goals.

Another thing about the core portfolio: *Stocks* doesn't necessarily mean individual shares. Nor does *bonds* mean individual issues. Mutual funds or exchange-traded funds are often the best way to own stocks and bonds.

Wrap Up. As noted earlier, these keys are not secrets. Nor are they guarantees. But if you pay attention to them as you make investment decisions, you're more likely to achieve your goals. ■

GLOSSARY

Bond. An interest-bearing security that obligates the issuer to pay a specified amount of interest for a specified time (usually several years) and then repay the bondholder the face amount of the bond.

Capital gain (or loss). The difference between the price at which you buy an investment and the price at which you sell it.

Certificate of deposit. Usually called a CD, a certificate of deposit is a short- to medium-term instrument (one month to five years) issued by a bank or savings and loan to pay interest at a rate higher than that paid by a regular savings account.

Compound interest. This is really interest paid on interest. When interest is earned on an investment and added to the original amount of the investment, future interest payments are calculated on the new, higher total.

Diversification. The method of balancing risk by investing in a variety of securities.

Dividends. Shares of company earnings that are paid out to stockholders.

Exchange-traded funds (ETFs). Mutual funds that trade like stocks on the exchanges. An ETF's portfolio represents a slice of the market—an index, a subsector of an index or a particular industry.

401(k) plan. An employer-sponsored retirement plan that permits employees to divert part of their pay tax-free into the plan. Money invested in the 401(k) may be matched by the employer, and earnings accumulate tax-deferred until they're withdrawn.

Home equity. The difference between the market value of a home and the outstanding balance on the mortgage and any home-equity line of credit.

Individual retirement account (IRA). A tax-favored retirement plan. Contributions to a traditional IRA may be tax deductible, depending on your income and whether you are covered by a retirement plan at work. Earnings grow tax-deferred, and withdrawals are taxable. Contributions to a Roth IRA are never deductible, but earnings accumulate tax-free and withdrawals are tax-free in retirement.

Money-market fund. A mutual fund that invests in short-term corporate and government debt and passes the interest payments on to shareholders.

Mutual fund. A professionally managed portfolio of stocks and bonds or other investments divided up into shares.

Opportunity cost. The cost of passing up one investment in favor of another.

Portfolio. The collection of all of your investments.

Prospectus. The document that describes a securities offering or the operations of a mutual fund, a limited partnership or other investment.

Risk tolerance. Risk tolerance is the degree to which you are willing to risk losing some (or all) of your original investment in exchange for a chance to earn a higher rate of return. In general, the greater the potential gain from an investment, the greater the risk that you might lose money.

Stock. A share of stock represents ownership in the company that issues it. The price of the stock goes up and down, depending on how the company performs and how investors think the company will perform in the future.

Time value of money. The concept that money today is worth more than the same amount in the future, when inflation has reduced its value.

Total return. An investment-performance measure that combines two components: any change in the price of the shares and any dividends or other distributions paid to shareholders over the period being measured. With mutual funds, total-return figures assume that dividends and capital-gains distributions are reinvested in the fund.

WHERE TO FIND MORE FREE INFORMATION ABOUT INVESTING

The following booklets from the Editors of *Kiplinger's Personal Finance* magazine and the Investor Protection Trust are available at your library and offices of State Securities Regulators.

Five Keys to Investing Success
Make investing a habit
Set exciting goals
Don't take unnecessary risks
Keep time on your side
Diversify

The Basics for Investing in Stocks
What is a stock?
Types of stocks and their relative risks
How to buy stocks
Stock terms you need to know, such as price-earnings ratio (P/E), book value, dividend yield and dollar-cost averaging
Selling your stocks and determining earnings
Mistakes even seasoned investors sometimes make—and how to avoid them

A Primer for Investing in Bonds
What is a bond?
How bonds work
Types of bonds and their relative safety
Why bonds can be an important part of your investment portfolio
Yield and how it relates to bond prices
Bond ratings and how they can help you reduce risk

Mutual Funds: Maybe All You'll Ever Need
What is a mutual fund?
Advantages of investing in mutual funds
Cost of investing in mutual funds
Find the right mutual funds for you
What to look for in a mutual fund prospectus
Types of mutual funds and relative risk
Determining your earnings

Getting Help With Your Investments
Choosing a broker
Full-service, discount and online brokers
Opening a brokerage account
Problems with your broker
Financial advisers and how to choose one
Investment clubs

Maximize Your Retirement Investments
Three fundamental truths about retirement investing
Stocks, bonds and mutual funds to consider
Determining your portfolio mix, depending on your time horizon and risk tolerance
Retirement investment vehicles

Where to Invest Your College Money
Creating a college fund portfolio based on your time horizon
College investment vehicles
State-sponsored college savings plans

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