CONFIDENT INVESTING

WHY BLIND TRUST IS A POOR STRATEGY

PAUL WINKLER

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As with all investment information, past performance is no guarantee of future results. There is no way to predict all the future variables that can affect stock and bond market returns. It is my intent that this book be used as a tool to help make the reader a better educated and savvier consumer of investment products and services. The information provided is general in nature and is provided for educational purposes only. It shall not be considered to be a solicitation for the sale of securities or investment products. Every investor's situation is different. This information is not intended to be a replacement for a qualified financial advisor.

—Paul Winkler, The Investor Coach

Acknowledgments

I have so many to thank for their contributions to making this latest work possible. Writing a book that deals with a topic that is so important to so many people is a great responsibility. There is always the reality that something important will be left out and someone will find a typo someplace. In the writing of this work, I have been able to use some of the same material from my first book "Above the Maddening Crowd" and build on its foundation. As with the first work, many people are credited with helping me get this project off the ground - some of the same people and some new faces. I can only hope that I don't leave any out:

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Introduction

My introduction into the financial arena was characterized by a marked lack of anything truly relevant to wise investing. Like countless others in the financial services industry, I entered the world of finance through mutual fund and insurance sales. I will never forget the first time I walked into an insurance company sales office in upstate New York. I had just graduated from college with a degree in economics and a minor in business and felt that my education qualified me for whatever leadership role they might have available. I confidently approached the front desk and told the staff that I was looking for a job in management. My hopes were quickly dashed when the secretary explained that I would have to become a successful salesperson first, and then I might be able to move on to management. *A salesperson first? They never tell you that in school.*

Desperate for my first real job, I agreed to speak to the branch manager about a position in sales. The first interview was cordial enough, as the manager explained how the financial industry worked. He spoke at length about the huge income I could make selling insurance and investment products; quite frankly, the thought of making five times my current salary at my computer repair job was all I needed to take the next step.

Before I could continue the interview process, I had to take a test to see how well suited I was for the position. I arrived at the office early on test day and sat down in a small cubicle to take the test. To my surprise, the exam was filled with questions that seemed to have nothing to do with being a competent financial planner. The questions primarily revolved around how I dealt with rejection and whether I was outgoing or introverted. One question asked how I acted when entering a room of strangers. Did I retreat to a corner and keep to myself, or did I introduce myself to everyone?

It didn't take long to figure out how to play the test. I knew I had to answer every question in a way that showed I wasn't afraid of people. I understood that a career in selling probably meant a life of hearing 'no' more often than 'yes,' and I knew that they were looking for people who wouldn't take rejection personally. Sure enough, when my test results came in, I got a call from an ecstatic sales manager. He told me my test scores were through the roof, and he wanted me to come in as soon as possible for the second interview.

Needless to say, I was hired.

The next step was to pass all of the state exams for the insurance licenses I needed to hold in order to sell the company's products. By the time my first year under new employment came and went, I had passed the state insurance exams to sell life, health, disability, and property and casualty (home and auto) insurance, as well as the exams required to offer mutual funds and variable annuities.

My first year on the job was challenging in many ways. The classes I was required to take primarily focused on how the company's products worked and how to prospect for new business. Every once in a while, someone taught me a useful financial planning technique, but those moments were few and far between. Essentially, the name of the game was "smile and dial." Most of the advice I received from experienced advisors revolved more around prospecting and sales strategies than anything else, and the only advice I ever received about investment portfolio management ended up being completely wrong.

On top of being improperly trained, there was another obstacle in my way—my age. At twenty-five, I found it difficult to get people twice my age to take me seriously. That made the sales process all the more difficult. What could I possibly know that will help them plan their financial futures? My clients were probably thinking that—and I was, too. The problem was that I didn't have the right education to properly guide my potential clients through the financial maze.

I decided that I needed a few designations behind my name before I would be taken seriously. After achieving the first designation, I noticed something that surprised me. The process of gaining clients' trust and hence their business became no easier. The reaction I was hoping for—something like, "You're a Life Underwriter Training Council Fellow®? My wife and I have got to work with you"—didn't exactly come. The answer, I thought once again, was to get more designations. I became a Chartered Life Underwriter®, a Chartered Financial Consultant®, a Registered Financial Consultant®, and so on, add nauseam. While I learned a great deal, my goal of instant credibility was never attained. I was still just a salesperson in the investment and financial planning industry.

Then I thought perhaps the solution was to change broker/dealers. (A broker/dealer is a company that is registered with the Securities and Exchange Commission and is allowed to sell securities to the public or for itself.) I attended broker/dealer conventions looking for answers, and I wandered up and down the aisles listening to all the wholesalers' sales pitches as they feverishly presented their products to salespeople like me. It was an overload of information (but I did get some nice pens and stress balls for all my efforts).

I struggled with many of the concepts that the wholesalers taught at their booths. In my mind, the numbers didn't add up. They used overly optimistic numbers to make their financial products stand out. They always seemed to focus our attention on the mutual funds they managed that had just had stellar performance; yet they virtually ignored the poor performers in their inventory.

Other elements of the industry didn't make sense to me either. For example, there were numerous companies who offered to help manage their clients' portfolios on a fee basis, but their methods of fund management never seemed right. One company in particular puzzled me. They said they would carefully watch the various funds in the portfolio, which they probably did. But when they changed the mix between different asset categories (like from large to small U.S. stocks), the company's fund managers would automatically buy or sell the changed category in another part of the portfolio to make up the difference. To me, that was like hiring a maid to clean your house, and then following behind her throwing things on the floor.

The head of one of the broker/dealers caught my attention one day during a lecture on tax and financial planning. He was one of the most successful men I had ever met (income-wise), so I thought it might be a good idea to listen to him. I listened with great interest as he explained the process of putting together someone's financial picture. The idea was to sell the client an oil and gas limited partnership for the intangible drilling cost deductions (8 percent commission), as well as a low income housing REIT for the tax credits available (8 percent commission), and then combine that with other REITs that kicked off income (another 7 percent commission). The tax deductions or credits could offset the income from the taxable investments. Next, take the cash flow from the limited partnership and buy a variable universal life policy (90 percent commission), borrow the cash value, invest in outside mutual funds (5.75 percent commission), and deduct the interest . . . and on and on. His goal, as he put it, was to confuse the client to the point that they became putty in his hands and bought whatever he recommended.

I questioned this powerful man's tactics and advice at length with an advisor at breakfast, and it was there that the advisor gave me one of the best pieces of advice I had ever received. He recommended that I invest some money in my own education by pursuing investment studies outside the financial product sales side of the industry. He assured me that I would never hear any objective information about investing until I removed myself from the mutual fund and insurance companies who stood to gain if I sold their products. It made perfect sense after several years of nothing making sense—and that advice started me on a journey that continues to this day.

What follows is the culmination of years of study as well as research from academics from such places as the University of Chicago, Yale University, MIT, and Harvard, to name a few. My goal is to make this information understandable to each and every investor, regardless of his or her level of knowledge in investing. I often joke with my clients that I believe my mother passed through Missouri when she was pregnant with me. That's the only way I can explain my desire to have to know why something works rather than just know it works. You have to "show me" or I won't be convinced. In that spirit, I use results from numerous academic studies to explain the philosophies taught in this book.

Call me crazy, but I believe investing should make sense.

There are over 280,000 financial advisors in the U.S., over 385,000 insurance sales agents, the thousands of insurance and brokerage firms they work for, twenty-four- hour a day media streaming from every direction, and countless other do-it- yourselfers and self-titled "experts" who are more than willing to dispense advice on what they think the market is doing.[1] Everybody wants to tell you how to beat the market and find the next best deal or the best undervalued stocks. The media in all its forms is ready with the tips, tricks, and timing that could make you the next millionaire. It really does seem like a circus, a cacophony of sounds and smoke and mirrors.

But there is a way to escape the marketing madness —and that's where educated investors can be. Knowledge and education are powerful forces, and this could be no truer anywhere than in the world of investing. For beginner and expert investors alike, I hope to shed some light on the complex realm of investing through teaching basic principles, dispelling common investment myths, and providing real-world solutions for managing your money.

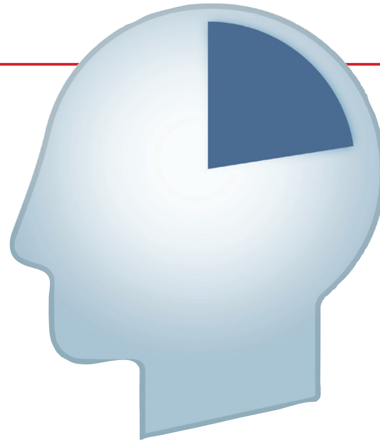
Wall Street and the media would have us believing that there are short cuts and tricks of the trade to make big money, and to make it fast. In the following pages, I'll show you there is no hocus pocus or magic to investing. Instead, we'll discuss researched ideas, as I provide practical tools that you can actually use. There is a way to invest that won't make you nervous every single time the market moves. And you don't have to lose sleep worrying about your retirement. We'll drown out the investment noise as we reveal what history has shown to be a better, sounder, and more proven way to invest.

It has been quite a ride since the first time I walked through the doors at that financial office in upstate New York. I hope that my experiences will be your gain as you discover the hidden world of investing and the truths behind the Wall Street Marketing Machine.

CHAPTER ONE

THE INVESTOR'S DILEMMA

The Investor's Dilemma



Why do investors fail? This is a question that has plagued me for years. On the surface, it seems that investors should be a happy and prosperous lot. The return figures reported by mutual fund companies are almost always in the double-digit range. Who would complain about that? Yet investors become easily disillusioned when it comes to the stock market—and for good reason. According to Dalbar Research in Boston, the average equity investor earned a trivial 3.98 percent return from 1987 to 2016, while large U.S. stocks, as measured by the S&P 500, averaged over ten percent during the same time period. Why then do investors often get such poor results, when the double-digit figures reported by the market at large would seem to indicate that the situation should be otherwise?

The answer lies in a perpetual cycle that investors go through when it comes to making investment decisions. It is a cycle that is often incredibly beneficial to the investment industry in general, but it can be highly detrimental to the individual investor. That cycle is called "The Investor's Dilemma."

What is the Investor's Dilemma?

The Investor's Dilemma is a seven-phase cycle that people go through which ultimately ends in frustration with the investing process. Some of the steps are psychological in nature, while others are related to the actions we take based on "stinking thinking". Even though we all desire a positive outcome regarding our investment experiences, it is this cycle that often prevents the success we so desperately need in order to maintain our standard of living in retirement.

Step One: Fear of the Future

The Investor's Dilemma begins with a fear of the future. Fear is nothing unusual— and it is certainly nothing new. We all have fears and misgivings when it comes to money. Yearly, monthly, weekly, and even daily, we find ourselves concerned with the possibility of market declines that erode investment values, the chance of missing out on big market upsides, the apprehension of paying too much for investment advice and finding out that it was lousy advice, and the likelihood of getting lower returns than we should have gotten. Ultimately, it all boils down to one underlying fear: *People are afraid they will run out of money before they run out of life.*

These fears intensify as retirement nears, because it causes us to reevaluate our previous investment decisions and face the reality that we must make better investment decisions or be faced with working many more years than we initially intended. When we're younger, it is easy to feel bulletproof—we're invincible and relatively unconcerned about the future. After all, we have plenty of time ahead of us to build our investments and save. The thinking is, "If I make a mistake, there is always time to rectify it." With age, though, comes the realization that time is a precious commodity.

Step Two: Prediction of the Future

Since we have this inherent fear of the future, it is only natural that we would desire a prediction of future market events as it relates to our money and investments. We subconsciously wish that someone could tell us—with great certainty—what is likely to happen down the road. We want the answers to questions like: *Where will U.S. markets go? What's going to happen overseas? What is ahead for the economy at large? Who are going to be the great fund managers? Who seems to have a handle on this thing called the "market?"* If we could find the answers to these questions, then we would feel safe, knowing that the future was in good hands; and we, the individual investors, would know our money was secure.

The investment and financial industry is aware of our intrinsic desire to know what lies ahead. They also know that, instinctively, we want to survive, so they will go to great lengths to make us feel like we're getting both the best information and the best investments available. The question then becomes how can the experts—or anyone for that matter—predict the future?

Well, if you were trying to figure out who is going to succeed in college, where would you look? Logically, you would be inclined to look at students who did well in high school. It just makes sense. If you want to figure out who is going to be a star quarterback this year, you would naturally look at who did well last year. This same idea directly applies to predictions about investments. In short, if you want to find out what funds or stocks are likely to do well in the future, you are, understandably, first going to look at what did well in the past.

Step Three: Past Performance

Pick up the latest copy of any financial magazine, and chances are high that you will see dozens of references to past performance showered all over the covers and within the pages. You'll likely see article titles such as *Ten Five-Star Fund Managers, Five Funds You Can Count On,* and *Six Stocks for the Year Ahead.* Even the advertisements make references to funds' Morningstar™ ratings. Morningstar™ gives Five Stars for those funds in the top ten percent of their peer group and Four Stars for the next 22.5 percent, and fund manager and investment companies will use these ratings in their ads. The message is clear—the industry wants you to think you can put your trust in the fund managers and investment gurus who have gotten the job done in the past.

Does it work? If we're talking about getting investors to buy a fund, you bet it does. According to the Wall Street Journal, "funds that earned high star ratings attracted the vast majority of investor dollars." In fact, according to Morningstar, in 2016 four and five star funds garnered $303 billion in inflows compared to $98 billion in inflows to one and two star funds.[2] Clearly, these ratings—which are all based on past performance—attract a lot of attention from the average person looking for a shortcut to making investing decisions.

More importantly, though, does it work for individual investors like us? The answer to that question is a resounding "NO." Focusing on the past encourages investors to concentrate on yesterday's winners, but that is just like driving down the road with your eyes in the rear-view mirror.

So why does the industry do it? Ultimately, it boils down to pure marketing. Investment companies, firms, and portfolio managers want to sell more mutual funds; they know that using past performance figures will attract the majority of the new money being invested, so they use those numbers. It's that simple. Investors think past performance is helpful, so the industry will use that data to sell investments. This is evidenced by the articles in trade magazines, the talking heads on TV, and the sales pitches of investment advisors all around the country.

Step Four: Information Overload

We live in one of the most amazing periods in history, with access to amounts of information that is virtually unprecedented. The Internet has revolutionized most of our business practices—but it is not without its complications. As human beings, hard wired to process information in a certain methodical way, we aren't capable of properly processing all of the data being thrown at us on a daily basis; thus, we are literally drowning in information. It was the great promise that, with the advent of the personal computer and subsequently, the World Wide Web, we would have access to unlimited amounts of information that would surely make our lives easier. *What happened?* Now we have so much information that it is almost paralyzing.

I refer to this modern state of information overload as the Harry Nilsson Syndrome. Remember the lyrics of his old song "Everybody's talkin' at me, but I don't hear a word they're sayin'?" Simply put, it's mass confusion at every turn. One publication says that X, Y, and Z are the best funds. Another magazine has a completely different list of the "must have" funds. The expert broker on TV says they're both wrong. In fact, just try to Google the word "investments," and you'll get over 246 million hits on your computer. There are stock tips galore, investor alerts running rampant, and every kind of advice under the sun on what you should do with your hard earned money.

Like Southwest Airlines says, "Wanna Get Away?"

Step Five: Emotion or Instinct-Based Decisions

As humans, we are continually driven by our instincts and emotions. When we're overloaded with information, our emotions and feelings go into overdrive; and that's when we tend to make bad decisions. This is yet another point that the investment industry—and virtually every other industry—uses against us. In fact, using this detail against us is ingrained in many salespeople as a commonly used sales tactic. There is a universal truth in the sales world that people buy on emotion and justify with logic, and salespeople use this to their advantage by learning how to appeal to the emotions instead of calling on reason and intellect.

Fear. Humans have a handful of strong emotions that often fall prey to salespeople's tactics. One of these emotions is fear. People often think, "I have no idea what to do. I guess I'll just stick my money under the mattress." Maybe they just put all their money into a CD or a guaranteed annuity, believing that it will be safe there. The fear of making a colossal mistake and losing some or all of their money leads them to this general attitude, "It is better to do nothing or search out guarantees at all costs than to throw my money away on a bad investment decision."

Greed. Another strong emotion is greed. Unlike their fearful counterparts, a person driven by greed can become overly confident. "I've got this. Investing is easy." They throw caution to the wind, trying every scheme that seems to hold the promise of making them rich quickly.

Loyalty and Trust. These two emotions often drive our decision-making as well. When we don't know what to do or who to believe—especially in light of how many out there claim to be "experts"—we can be easily influenced by a family member, an old family friend, or fall back onto familiar investments. We find ourselves justifying our investment decisions by saying

- "My dad worked at that company all of his life."
- "My husband loved that company's products."
- "I don't know. I just like that guy."
- "That magazine has a pretty logo."

And on the list goes. When friends and family are involved, it is easy to be swayed by their investment decisions with no thought to the fact that they may have a far more aggressive strategy than you, or that they have been given bad advice themselves.

Emotions play a clear and important role in our decision-making process, but instincts are just as significant. We are inherently driven away from pain and gravitate toward pleasure. We abhor pain—any kind of pain. It is painful to invest in mutual funds that haven't performed well in the past three to five years. It's like betting on a horse that just lost its last five races. Our brains have difficulty processing that kind of thinking. We think, *surely it will lose the next one as well.* Similarly we are driven to buy the funds with strong track records. *This fund has averaged fifteen percent since its inception. It must be a good one.*

Step Six: Breaking the Rules

When reason and rational decision-making is replaced by emotion, following the rules is generally not a primary concern. Consequently, when we invest with our emotions it won't be long before we break the rules of investing. What are these rules? Without even realizing it, you've probably heard them a hundred times. ***In fact, the investment industry has pounded them into our brains; which is ironic, because it is typically the industry players who most often break the very rules they advocate.***

One widespread rule is **Buy Low, Sell High.** This seems obvious, but in reality, it's actually quite hard to do. It is analogous to losing weight. Diet and nutrition experts tell us that all we have to do is "eat less and move more." It sounds simple enough, yet it is often seemingly impossible to carry out. The main reason that the *Buy Low, Sell High* rule is so hard to abide by is that markets and stock prices run in unpredictable cycles.

When friends see me in public, they will often ask, "Hey Paul, what's the market going to do?"

My reply is always the same. "It will go up, then down, up, then down… and not necessarily in that order."

We laugh and then go about our business. Yes, we laugh, but the funny thing is, I'm not kidding. If we buy a fund that has had recent stellar performance, where is it in the cycle? It is up! You can probably guess what follows up. All of the highest returning funds in 1999 had a healthy dose of tech stocks as investments. We all know where that led—down, down, and then down. By focusing us on past performance, as we are encouraged to do, the investment world often causes us to buy high. It is no wonder that we don't get the desired results we seek. Rarely is anything so cut and dry as the rule of Buy Low, Sell High.

Another rule of investing is to **Diversify.** As the saying goes, *don't put all of your eggs in one basket.* The trouble is that when we buy funds based on past performance, we are often getting into funds that contain all of the stocks that have gone up in the past few years. When we do a little research, we often find that our mutual funds often contain many of the same stocks because it is based on performance rather than diversity. In this case, the investor is experiencing what I call "perceived diversification." The stocks may have all been good performers, but no one has taken care to ensure that the stocks span multiple asset classes, which can help safeguard a portfolio against a particular market segment downturn.

Many of us have heard the warning: **Don't try to time the market. You can't possibly figure out the market's future direction.** I agree wholeheartedly with this statement. Time and time again studies show that investors who try to predict the market's direction will get burned. As common knowledge as this fact may be, it is not unusual to find investment managers doing just that. Of course, they don't call it "market timing," but that is exactly what they are attempting to do—play with market timing. It may come in the form of holding large amounts of cash in the fund or waiting for the right "opportunity." The fund manager may also drift into segments of the market in the hope that they've miraculously spotted a trend in the making.

We've also heard that it is wise to **Buy and Hold.** *Once you've invested, it is best to sit tight. And whatever you do, don't try to day-trade.* Yes, that's what we hear from the mutual fund companies and their sales forces, but what is really happening behind the scenes? According to Investopedia, the average "managed stock" fund turnover rate is approximately 130%. That means that they are completely changing what stocks are held in the fund on an annual basis. So, while we the individual investors are buying and *holding*, fund managers are moving our money all over the place.

So why do the "experts" engage in these practices? There are two probable motives. The first is fairly innocent—some fund managers truly believe that they can beat the market. In an TV show I saw several years ago, John Stossel interviewed Princeton professor Burton Malkiel about this issue. Malkiel said it was like "giving up a belief in Santa Claus." I think it's more like giving up a belief in *yourself*. Imagine being a highly educated fund manager. You've studied the stock market for years, and you've studied with the best and brightest in the investment field. Now you're told that you must accept that you have no ability to choose stocks that will do better than the market does all on its own. It is a humbling thought and not an easy pill to swallow for veteran investment gurus.

The other reason is a little less innocent—and it has to do with marketing. Since the majority of money flows to funds with the best short-term performance (and for the record, ten years is short-term in the world of stocks), a fund manager is forced to gamble with the portfolio. It is one of the only ways to have top-shelf performance. In other words, if I want my fund to be in the top-ranked funds—the ones that get all the press—I have to trade stocks and get in and out of the market in hopes of hitting a quick home run without taking a hit. Since most investors are unaware that the success is random, the risk is worth taking if it results in money flowing toward the fund they are managing.

Step Seven: Performance Losses

The final step of the Investor's Dilemma is performance losses. Performance losses come in three varieties. The first type is called a *capital loss*. When we hear stories about investors who lost everything, it was the result of a capital loss. This type of loss is when you invest in an individual stock and the company goes bankrupt. Examples from the news include Toys "R" Us, Radio Shack, Eastman Kodak, General Motors, Chrysler, and Lehman Brothers.

The second type of loss is a *market loss*. Market losses don't just affect certain companies; they affect most companies in a certain area of the market. For example, when the technology bubble burst, nearly all the companies in that area of the market tumbled in value, and investors lost money whether they owned two or two hundred tech stocks.

The final type of loss often goes completely undetected by investors. It is referred to as a *relative loss*. A relative loss can be difficult for average investors to identify because they may not necessarily be losing money. This type of loss is the result of a fund or other investment vehicle that you own delivering returns that are less than the area of the market in which you are investing. For instance, if you are in a large company stock fund and it under performs the Standard and Poor's 500 (the large company stock index more commonly known as the S&P 500), then you have suffered a relative loss. If and when these losses are discovered, investors usually find themselves back at the beginning of the Investor's Dilemma—fear of the future. And so the dilemma continues.

Escaping the Investor's Dilemma

In all of my years spent working with investors, I've only found one tried and true way to help investors escape the frustrating cycle of the Investor's Dilemma.

The solution is education.

I strongly believe that most investors don't want to know every last detail about investing, but they do want a basic foundation in investments and a general knowledge of the market and key terminology. They want to understand enough so they feel confident that they are doing the right things with their money. Confident investors—or in other words, those who are educated—have peace of mind regarding their investment decisions. They don't worry about every slight change in the economy or what the Chairman of the Federal Reserve is going to announce next week, and they're not concerned with every movement of the market. They can leave these concerns behind, because they know four crucial things. Educated investors know

1. What they are doing.
2. Why they are doing it.
3. What their costs are.
4. What to expect.

Throughout this book I will provide the information that will help you become a confident investor. My goal is to provide information to you in an entertaining and stimulating way. Since most people are visual learners, I will be using multiple visual aids to help you "see" how investing works. Because investing is also largely concerned with numbers, I will be using some light mathematics for example purposes. Don't worry—it won't get too complicated.

I will begin by describing some of the basic components of investing. We'll cover fundamental topics such as *What is a stock? What is a bond?* For those of you who've been investing for a while, it will be a nice refresher course of the basics. It's always good to get back to essentials. I will then move to the more advanced aspects of investing. Investing doesn't have to be complicated—in fact, everyone can and *should* understand the basic principles. It is critical for peace of mind.

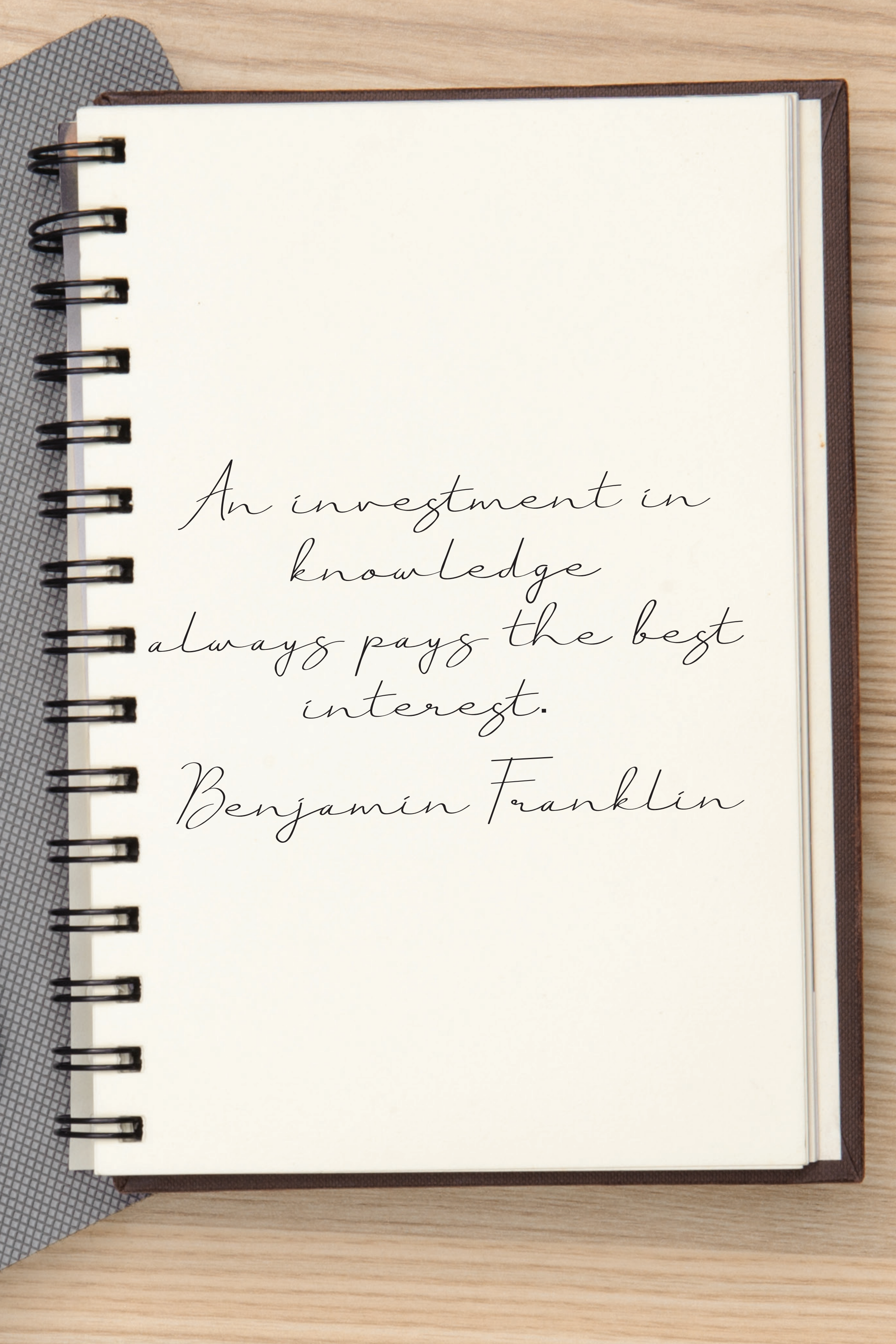
Some say that knowledge is power; it's really *applied knowledge* that holds the key to your financial success. So use the following pages as a road-map to understand and take control of your financial future. For it is not simply the facts and figures in these pages that will lead you to becoming a successful investor. Rather, it is your practical application of them in the real world.

Summary

- The question that plagues the financial world is why do investors fail? The answer lies in a perpetual cycle called the Investor's Dilemma.
- The Investor's Dilemma is a seven-phase cycle that ultimately ends in frustration with the investing process. There are seven phases or steps in the Investor's Dilemma.
- Step One: Fear of the Future. Ultimately, it all boils down to one underlying fear: People are afraid they will run out of money before they run out of life.
- Step Two: Prediction of the Future. We feel that if we could just know where the market is heading, we would feel safe, knowing that the future was in good hands.
- Step Three: Past Performance. Using past performance as an indicator for individual investors simply does not work.
- Step Four: Information Overload. The amount of information available to us today is almost paralyzing in its volume. Investors must be selective as to what they pay attention to.
- Step Five: Emotion or Instinct-Based Decisions. As humans, we are continually driven by our instincts and emotions. The most common emotions that drive our decisions are: fear, greed, loyalty and trust.
- Step Six: Breaking the Rules. When reason and rational decision-making is replaced by emotion, following the rules is generally not a primary concern. The most common rules of investing are: 1) Buy low, sell high 2) Diversify 3) Don't try to time the market 4) Buy and hold.
- Step Seven: Performance Losses. Performance losses come in three varieties. The first type is called a capital loss. The second type of loss is a market loss. The final type of loss is a relative loss.
- The only real and lasting solution to escape the Investor's Dilemma is education.
- Educated investors know what they are doing, why they are doing it, what their costs are, and what to expect.

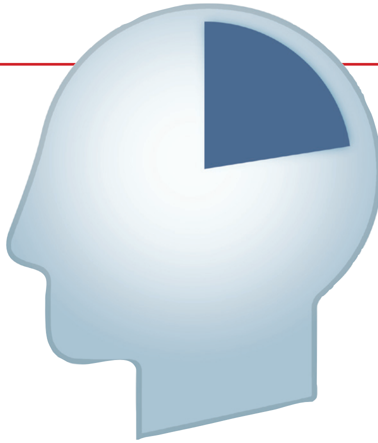
Quick Quiz

1. Why do investors fail?
2. What is the Investor's Dilemma?
3. What are the seven steps of the Investor's Dilemma?
4. What is most investors' biggest underlying fear?
5. With age comes the realization that time is a ________ __________.
6. When investors are trying to determine where to invest their money, what is typically the first (and fatal) mistake they inherently make?
7. Why does the investment industry put such an emphasis on past performance?
8. What fact about humans do salespeople utilize as a sales tactic?
9. When we don't know what to do or who to believe, what or who are we easily influenced by?
10. One common rule of investing is don't put all your eggs in one basket. What is the technical term for this phrase?
11. What is the most common outcome of engaging in market timing?
12. What two motivating factors drive investors to engage in unwise investment practices such as market timing?
13. How do we escape the investor's dilemma?
14. Some say that knowledge is power; it's really _______ __________ that holds the key to your financial success.


An investment in knowledge
always pays the best interest.
Benjamin Franklin

CHAPTER TWO

UNDERSTANDING BONDS



Understanding Bonds

It is said that the great Vince Lombardi, legendary coach for the Green Bay Packers, started every season with a team meeting. Coach Lombardi would hold a football high in the air proclaiming to rookies and veterans alike, "Gentleman, this is a football." In his own unique way, Lombardi was saying that the key to greatness is to be brilliant at the basics, never forgetting where it all begins.

Since this is primarily a book about investing, it seems appropriate to start off by developing an understanding of some of the primary building blocks of an investment portfolio. Too often, we jump into complex topics, but lack an understanding of the foundation. The result is that we tend to draw faulty conclusions and end up making grave mistakes that could cost us our financial futures.

Give Me Money

Some say that it takes money to make money—and for the corporate world, truer words were never spoken. Equipment, infrastructure, distribution, advertising, and every other aspect of business all require money before a single light switch can be flipped. Raising several billion dollars for a company's operations is often no easy task—it's not as simple as going down to the local bank for a loan. Because of this, corporations turn to the public markets for capital, and one way they raise money in this market is through the issuance of bonds.

What is a Bond?

A *bond* is simply a tool that is used when a company, mortgagee, or governmental unit borrows money. Bonds are usually issued in even denominations of $1,000, $5,000 and $10,000, and they typically have a certain period of time before they *mature* (or end). For instance, if an investor buys a $1,000 ten-year bond, he can expect to receive the bond's face value (or $1,000) back ten years from the date the money was first borrowed. During this ten-year period, the borrower makes interest payments to the lender/investor.

In the old days, bonds had coupons attached to them for the interest payments, which were redeemed on a regular basis by the lender/investor. Because of our increasingly paperless way of doing business, this method of paying interest is no longer used, but the term coupon is still used to refer to the interest payment associated with the bond. Most bonds make interest payments every six months, or semi-annually.

Why Invest in Bonds?

Author Mark Twain once said, "I am more concerned about the return ***of*** my money than the return ***on*** my money." My guess is that Mr. Twain was a bond investor, because one of the main reasons we invest in bonds is because of their stability. Many bondholders choose bonds for this very reason, and consequently, they are among the first groups in line to get their money back when the issuer of their bonds runs into financial difficulty. As we'll see later, though, bonds often go up in value when stocks go down. This reduces volatility when stock markets aren't doing well. Unfortunately, many investors get impatient with the lower returns that they usually see associated with bonds and break this cardinal rule.

One type of bond is a *high-yield bond*. By definition, high-yield bonds are those issued by companies in financial distress. When the market goes down and the economy falters, it is these distressed companies that often default on their loans. This can cause both the stock and bond segments of our investments to go down together. This occurred in the stock and high-yield bond market during the economic downturn in late 2007, 2008 and early 2009. Many high- yield bond funds lost 40% or more of their value at the same time stocks declined in value. The mistake that investors often make is that they invest in these so-called high-yield bonds to increase their returns, but anytime we have the potential for greater returns, as is the case with high-yield bonds, we must realize that there is greater risk involved.

Maturity Ranges

There are three typical maturity ranges associated with bonds:

1. ***Short-Term***—Less than five years.
2. ***Intermediate***—Between five and ten years.
3. ***Long-Term***—Over ten years.

The greater the amount of time a bond has until it matures, the greater the potential amount of volatility that can be experienced by the investor. The major cause of fluctuations in bonds is *interest rate risk*.

Interest Rate Risk

I fondly remember one of my favorite childhood activities on the elementary school playground was riding the seesaw. The concept of a seesaw is simple enough; If you find someone nearly equal in weight, each time you push off the ground and go up, your friend will go down—and vice versa. Investing in bonds can be a lot like that old childhood toy. When interest rates climb, bonds prices go down. When interest rates drop, bond prices increase. To understand why this occurs, let's look at a simple example.

Let's say that I've decided to buy a single bond issued by a well-established corporation. This bond matures in five years, has a triple-A rating (more on ratings below), and has a six percent coupon (interest) rate. In year one of our example, I invest the $1,000. For the next five years, I would expect to receive $60 (which is six percent of $1,000) per year, or $30 every six months. Visually, it would look like this:

ABC Corporation 5-Year Bond

Now imagine that one year from the date I made my $1,000 investment, interest rates climbed such that new bonds were paying more to investors than they were just a year ago. For example, let's say our corporation would now have to pay eight percent on the new four-year bonds they are issuing. (Note that this four-year bond will mature at the same time that my five-year bond will mature, because it was issued in year two of my five-year bond.)

Now here is the question, if I want to sell my five-year bond, what must I do to entice someone to buy it from me? The problem I face is that my bond will still only pay $60 per year for the remaining four years, and the new $1,000 bonds are paying $80 per year. The only way to sell my bond is to drop the price. In other words, I must discount the bond so that the investor choosing between my bond and the new, four-year bond will be indifferent between the two alternatives. Investors must get the same yield or return regardless of which bond they choose to buy. Again, visually, it would look like this:

ABC Corporation 5-Year Bond

ABC Corporation 4-Year Bond

The investor in the six percent bond will be just as happy receiving $60 per year because he paid only $934 for the bond, and he will of course receive $1,000 when the bond matures. Thus, it is easy to see how risk rises as a bond's years to maturity increase. The longer an investor holds on to old, lower yielding bonds, the longer he must accept lower interest, and demand greater discounts.

Risks of Bond Investing

Credit Risk. Go down to your local check-cashing location and you will find many people who are credit risks walking in and out of the doors. Check cashing businesses charge high rates for their services, but when people have poor credit that may be their only option, and they usually have to pay more to borrow money. The same is true in the world of capital.

The lowest risk borrower is the federal government. As fiscally irresponsible as the people in our government may sometimes be, we know that they will pay what they owe. How? The government can always raise taxes to cover their debt, or they can print more money (which I suppose is really just another form of fiscal irresponsibility). It is for this reason that the yield on treasury bills—government bonds maturing in less than a year—is often referred to as the *risk-free rate*.

On the other hand, corporations don't have the luxury of printing money, so some can and will default on their loans. A rating system was developed to help investors determine the risk of defaults, and consequently, the appropriate interest rate to charge a company when they borrow. Credit rating agencies assign *ratings* to all bonds when they are issued and monitor developments during their lifetime. For example, Standard & Poor's and Fitch will assign a **AAA** rating to a borrower with outstanding credit, assign a **BBB** to borrowers who are considered "investment grade," and give a **BB** rating or lower when an borrower is high yield or of lower quality. The higher the risk that the borrower may not be able to repay what they owe, the higher the interest rate that they will have to pay for the use of the money.

Call Risk or Prepayment Risk. Some bonds have *call features* associated with them and are most often found in corporate and municipal bonds. This means that the borrower may be able to prepay the principal before the bond matures. To compensate the investor, the issuer often pays a little more interest to make up for the increased risk of having that call feature. As you may recall, interest rate increases are accompanied by bond price declines, and interest rate declines go along with bond price increases. This presents a potential problem for the bond investor. Just when the price of my bond is expected to go up (during an interest rate decline), the borrower goes and repays the loan. This is the very reason why I generally avoid callable bonds in my portfolio.

Inflation Risk. One of the most sinister risks of investing is that of *inflation risk*. Inflation risk is often called the *silent tax*. We never see it, but it is always at work, destroying the purchasing power of our money. Most bonds do a poor job of protecting us against the ravages of inflation because they are denominated in the currency of this country. In other words, when we buy a bond, we agree to a certain interest payment in U.S. dollars. If the dollar is dropping in value, each payment that the borrower makes is with dollars that are worth less than they were before.

I overheard a conversation one day where a business-owner client of mine was describing this concept to his highly conservative son. The son was advising his father that, if it were his decision, he'd just pay off his old mortgage. To the son's surprise, the father told him that his mortgage was only a couple hundred dollars per month.

"That's it?" the son asked.

Dad replied, "You've got to realize, when I took this out, $200 was a lot of money. I'm taking my time repaying, because every day $200 buys less and less."

Historically, it takes about one hundred years for money to double after inflation in treasury bills. The average rate of return for treasuries is only around .5 percent after inflation. If we figure in taxes our money is, in actuality, most likely going backwards.

To help combat this, some bonds have inflation protection built into them. For instance, the government is now issuing "I-bonds" or *Inflation-bonds*. The idea is that they pay a certain level of interest every year on the principal. When inflation figures are announced, the principal value is adjusted to reflect the inflation number. Two of the main issues regarding these bonds are as follows: 1) The potential fluctuations in value that they can experience and 2) The fact that the borrower and the entity determining the amount of the inflation adjustment are one in the same. The government may have an incentive to keep its borrowing costs down by keeping the inflation numbers artificially low. For these reasons, I would use them very sparingly in a portfolio.

Reinvestment Risk. The final type of risk to discuss regarding bonds is *reinvestment risk*. This is the risk that the interest rate at which I can invest my interest payments will be lower that interest rate I'm actually earning on the investment.

If you've been investing long enough, you may remember the good old days when CD's paid sixteen percent, and banks and investment houses gave away toasters if you made a big enough deposit. (Truth be told, those CD rates weren't so great if you consider taxes and the fact that inflation was hovering around the twelve percent range at the time.) As interest rates declined during the 1980s, the interest payments that were reinvested from those CD's had no place to go but down. Once the interest was paid, the borrower had no obligation to pay a high rate on those dollars. Anyone who had calculated their future wealth based on those high rates continuing was more than likely highly disappointed with the end result.

Bonds and Your Portfolio

Determining the amount of bonds to hold in your portfolio is usually a factor of your time horizon, or how long you plan to invest. Generally, the shorter the time horizon, the greater the percentage of the portfolio that should be dedicated to bonds. Bonds can provide a powerful hedge against stock market downturns, but as you've seen, they contain some fairly formidable risks as well. Later in the book, I will discuss the particulars of choosing the type of bonds for your specific investment objectives.

Summary

- Before any investor begins to invest, it is important to first develop an understanding of the primary building blocks of an investment portfolio.
- A bond is a tool that is used when a company, mortgagee, or governmental unit borrows money. Bonds are usually issued in even denominations and have a certain period of time before they mature.
- There are three typical maturity ranges associated with bonds: 1) Short term 2) Intermediate 3) Long term.
- Treasury bills are government bonds maturing in less than a year. The yield on treasury bills is often referred to as the risk-free rate.
- Credit rating agencies assign ratings to all bonds when they are issued and monitor developments during their lifetime. The ratings range from AAA to BB or lower. The higher the risk that the borrower may not be able to repay what they owe, the higher the interest rate that they will have to pay for the use of the money.
- Inflation risk is often called the silent tax. We never see it, but it is always at work, destroying the purchasing power of our money. Most bonds do a poor job of protecting us against the ravages of inflation because they are denominated in the currency of this country.
- Some bonds have inflation protection built into them. For instance, the government is now issuing I-bonds, or Inflation-bonds. The idea is that they pay a certain level of interest every year on the principal. When inflation figures are announced, the principal value is adjusted to reflect the inflation number.
- Determining the amount of bonds to hold in your portfolio is usually a factor of your time horizon, or how long you plan to invest. Generally, the shorter the time horizon, the greater the percentage of the portfolio that should be dedicated to bonds.

Quick Quiz

1. All too often, what is the result when we jump into complex topics but lack an understanding of foundational principles?

2. What is a common way that corporations raise capital?

3. What is a bond?

4. True or False: Many bondholders choose bonds because of their stability; and consequently, they are among the first groups in line to get their money back when the issuer of their bonds runs into financial difficulty.

5. What are the three maturity ranges associated with bonds?

6. True or False: The shorter the amount of time a bond has until it matures, the greater the potential amount of volatility that can be experienced by the investor.

7. It is only one year from the date you made a five-year bond investment, but now you want to sell the bond. Interest rates have gone up in the market. What will you have to do to entice someone to buy it?

8. Who is the lowest risk borrower?

9. What is another phrase for inflation risk, and why is it called that?

10. To help combat inflation, some bonds have inflation protection built into them. One example is "I-bonds." How do they work?

11. What is one of the greatest benefits that bonds provide?