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STOCKS, MUTUAL FUNDS, AND BONDS: STARTING AT THE BEGINNING

The stock market has been a scary place lately. Between the tech stock crash of 2000 and the Enron fiasco of 2002, it's enough to make you want to put your retirement savings under a mattress and forget about it.

But you've got to resist that urge with all your will, and here's why: Despite its occasionally stomach-wrenching ups and downs, the stock market is *the* place to be if you're going to build wealth over the long term.

Over the past 76 years, the stock market has grown by an average of nearly 11 percent a year, while a typical savings account accumulated just 2 percent on average every year. Nine percentage points a year is a *huge* difference. And the longer your time horizon, the bigger difference those nine percentage points will make, thanks to the beauty of compounding. After 10 years, \$10,000 invested in stocks would be worth \$16,204 more than the same amount invested in a savings account; after 25 years, the difference between the two portfolios would have grown to more than \$120,000.

The fact is, on average nothing does better than stocks over time. Bonds will do a bit better than a savings account. But over the long term they probably won't improve the return you'll earn on stocks. For a retirement article in *SmartMoney* a couple of years ago, we studied every possible time span going back to the 1920s, testing several different mixes of U.S. stocks, bonds, and cash in a hypothetical tax-deferred account. While we found

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many 10-, 12-, and 14-year periods in which adding bonds or cash to your holdings resulted in higher gains than a diversified stock portfolio produced (and they were mostly periods that started in the Great Depression), we could find no period longer than 18 years where adding some bond assets improved the outcome.

This is a message *SmartMoney* has been spreading for the past decade. And, we're glad to say, our readers have benefited from it. Back in our premiere issue in April 1992, when the United States was still recovering from a recession and the debilitating savings and loan debacle, we produced an article called "The 10 Stocks for the '90s." Readers who followed our suggestions and bought those 10 stocks have since witnessed gains of better than 560 percent. (The big winner in that portfolio was semiconductor equipment company Applied Materials, up an amazing 3,336 percent since we wrote about it.)

No, you don't want to have 100 percent of your investments in stock—particularly if you are already nearing retirement age. You want a *mix* of stocks, bonds, and cash. And in Chapter 4, we'll help you select the ideal blend for your needs with our exclusive asset allocation worksheet.

But first, allow us to walk you through the investment basics. Though some people would have you believe otherwise, don't worry: This isn't rocket science. The truth is, investing can be rather simple. Half the battle is understanding the language—some of which, we admit, comes off sounding more like mumbo jumbo than anything else. Once you get the basic concepts down, you'll find it comes pretty easily. So let's get started.

Stocks

When you buy shares of a company's stock, you are buying a piece of that company. It's as simple as that. Buy even one share of Pfizer and you, as a shareholder, own a tiny sliver of the drug company—and you will get to share in its profits. The more shares you buy, the bigger your stake becomes.

A company's stock price reflects what investors are willing to pay for a piece of that company. Take a look at the chart in Figure 1.1. It tracks the price movement of Pfizer stock from 1997 through early 2002. You can see it had a tremendous run-up in the late 1990s, lifted in large part by blockbuster drugs like the impotency cure-all Viagra and the antidepressant

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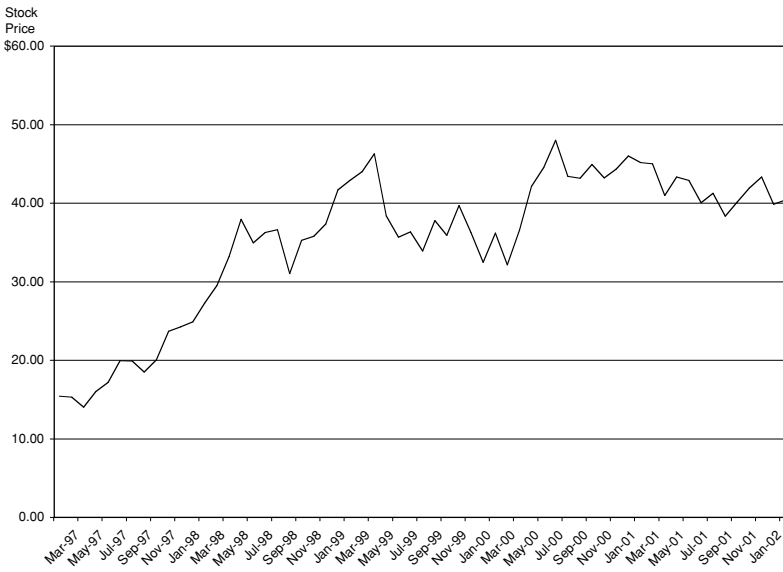


FIGURE 1.1 Pfizer stock, March 1997 to January 2002

Zoloft. But in the final fever pitch of the bull market in tech stocks (and as interest rates began to rise), the stock went out of favor with investors—only to rebound in mid-2000 when investors sought safer havens as the tech rally ended.

Whether it's Pfizer or any other stock, the supreme measure by which companies are valued is their earnings. Wall Street is obsessed with them. Companies report their earnings, also known as profits, four times a year, and investors pore over these numbers—expressed as earnings per share—trying to gauge a company's present health and future potential. The stock market rewards both fast earnings growth and stable earnings growth. But it has little patience for companies with declining earnings or unexplained losses. Companies that surprise Wall Street with bad quarterly reports almost always see sharp declines in their stock prices.

The worst-case scenario is that a company goes bankrupt and the value of your stock investment evaporates altogether. Happily, that's rare. More often, a company will run into short-term problems that depress the price of its stock for what seems an agonizingly long period of time.

Along with ownership, a share of stock also gives you the right to vote on management issues. Company executives work at the behest of

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shareholders, who are represented by an elected board of directors. By law, the goal of management is to increase the value of the corporation's equity. If it doesn't happen, you and your fellow shareholders can vote to have management removed.

How do you know when it's a good time to buy a particular stock? We recently wrote an entire book on that subject (*The SmartMoney Stock Picker's Bible*, John Wiley & Sons, 2002). But the short answer is this: What we're looking for is opportunity. We don't necessarily want stocks that are cheap (because there's often a good reason for that), but we do want them to be trading at a discount to their normal levels. This can happen during times of market distress, say, or an industry going through an inevitable down cycle, or even a company that's been beaten down but is about to turn around.

What we're talking about is closer to "value" investing than just about any other style. In case you're not familiar with the term, you should know that the investing world is divided into two broad groups: growth and value. Growth investors seek stocks that are growing earnings and sales at annual rates that beat the market, and they are willing to pay a hefty price for such a stock—generally speaking. Cisco Systems in the late 1990s was a classic growth stock. Its earnings and revenue were growing 30 to 40 percent a year, easily double what you'd find at the average company. But that came at a price. Cisco stock had a price/earnings (P/E) ratio of 50 or 60, again easily double what you'd pay for most stocks. (A price/earnings ratio is the price of the stock divided by its annual earnings per share.) For more on this and other important valuation measures, see the Glossary in the back of this book.

Value investors, on the other hand, want bargains, or stocks that trade at a discount—and that discount can be measured in a variety of ways against the market or a stock's peer group. We don't mean a low price, necessarily. A \$10 stock might seem very expensive to a value investor if the company has no assets and no earnings.

We would never suggest you turn your back entirely on growth. After all, investors are never going to get excited about a company (and bid its stock price up) if they have zero hope for any earnings growth. This is why the *SmartMoney* style of investing is in effect a hybrid: To us, the ideal stock will have a low P/E ratio and a rapid rate of earnings growth. It's an investing style some call growth at a reasonable price (GARP).

But we can't stress enough the importance of that value underpinning,

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for study after study shows that value trumps growth over time. If you had invested \$10,000 in large-company value stocks in 1974, you'd have \$639,200 in 2001, according to a well-respected research outfit called the Leuthold Group. But pity the investor who put the same amount in big-name growth stocks: A \$10,000 investment in 1974 would be worth just \$405,500, a shortfall of nearly 37 percent.

Value wins out among small and midsize companies, too. Another influential study, conducted by, among others, Josef Lakonishok, a professor of finance at the University of Illinois at Urbana–Champaign, examined all the companies listed on the New York Stock Exchange and the American Stock Exchange between 1968 and 1990. Deep value stocks beat their growth-stock counterparts by an average of 10 percent per year over most five-year periods.

But performance isn't the only reason we like value investing. Buying cheap stocks requires a certain amount of discipline, and that can save even the most inexperienced investors from the biggest pitfall of impulse investing: themselves. All too often, investors let panic take over when the market starts to tank—they sell when they should buy—and they let greed tell them to buy when the market is climbing, which is just when they should sell.

Most would-be growth moguls wind up selling off their winners too early and hanging on to their losers too long. According to a study of discount brokerage customers conducted by University of California, Davis finance professor Terry Odean, the stocks investors sold from 1987 to 1993 went on to outperform the stocks they held by more than three percentage points a year. "People tend to get excited about growth stocks. They build up expectations, and they end up getting quite disappointed," Lakonishok says.

Big Stocks

Market capitalization—market cap for short, or market value—is a term you'll come across a lot. This is simply the number of shares a company has outstanding in the market multiplied by the share price. If a company has 5 million shares outstanding and each one trades for \$5, its "market cap" would be \$25 million.

As the name suggests, large-capitalization stocks are the biggest players in the market. How big? A market value of \$5 billion is generally considered

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the low end of this group, while behemoths like Citigroup and Exxon Mobil weigh in at more than \$225 billion. Then there's General Electric, the biggest of them all, which at the beginning of 2002 had a market capitalization greater than \$382 billion. (See Table 1.1.) Taken together, stocks with market values over \$5 billion account for 80 percent of the market's total \$12.8 trillion in value, according to the Center for Research in Security Prices. (See Table 1.1.)

These companies play an especially significant role in driving the economy. That's why everybody pays so much attention to them. The two most watched stock market indexes—the Dow Jones Industrial Average and the Standard & Poor's 500-stock index (S&P 500)—are both composed of large-cap stocks. The Dow tracks 30 of the biggest stocks. The S&P tracks 500 companies with an average market value of \$21.2 billion.

The bigger you are, the harder it is to grow quickly, so large caps don't tend to expand as fast as your average technology upstart. But what they lack in flash, they make up in heft. The classic "blue chip" has steady revenue, a consistent stream of earnings, and a dividend. It also has critical mass, which means it can withstand ill economic winds better than its smaller cousins.

TABLE 1.1 MARKET VALUE
OF LARGE-CAP STOCKS*

Company Name	Market Value as of Mid-2001
1. General Electric	\$382 billion
2. Microsoft	\$315 billion
3. Exxon Mobil	\$282 billion
4. Wal-Mart Stores	\$277 billion
5. Pfizer	\$259 billion
6. Citigroup	\$227 billion
7. AIG	\$193 billion
8. Intel	\$192 billion
9. Johnson & Johnson	\$186 billion
10. IBM	\$169 billion

*As of February 28, 2002.

Source: SmartMoney.com.

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Because of their size and stability, large-cap stocks are not generally speculative in nature and appeal to a more cautious investor. That's not to say they can't run into serious trouble, but they tend to grow along predictable trend lines and, since they are well known to Wall Street analysts, their problems often come with ample warning. Big companies also tend to pay regular dividends, which act as ballast by attracting income-oriented, long-term investors. Don't be fooled: Large caps can experience jarring price swings. But there's no doubt they are less volatile than small, hot-growth stocks.

Lower risk comes with a price, however. Except during periods of rampant uncertainty, large-cap stocks tend to produce slightly lower returns than small caps (10.5 percent annually vs. 11.7 percent).

Small Stocks

Small-capitalization stocks are fleet of foot. Or at least that's their reputation. There are plenty of small, stodgy banks and rust-belt manufacturers in the group, and there are periods when small caps don't perform so well because investors want bigger, more stable names. But companies with a market value below \$1 billion can grow more quickly than bigger companies, often producing double-digit annual returns for investors.

There are several indexes that track small-cap stocks. Probably the best known is the Russell 2000, which follows 2,000 companies with an average capitalization of \$530 million. Companies in Standard & Poor's small-cap index, the S&P 600, average about \$524 million in market value.

Small-cap companies tend to have correspondingly small revenues. And that means many of them have just started up or are poised to expand their markets, either geographically or with new products. EPIQ Systems is a good example. The Kansas City, Kansas, software solutions provider had a market value of \$264 million in early 2002. Yet, because it was so small, it was able to increase its earnings at a much faster rate than could software giant Microsoft Corporation, which had a market value of more than \$300 billion.

Microsoft needs no introduction—more than 80 percent of all computer users work off its operating system, Windows. Over the five years between 1997 and 2002, its stock price gained 185 percent, fueled by earnings growth of 27 percent. Not bad for a large cap. But over the same period,

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EPIQ’s stock gained more than 1,264 percent as its earnings soared, on average, 44 percent per year. (See Figure 1.2.)

Of course, EPIQ was also more volatile than Microsoft. And the smaller company ought to be much more vulnerable than the mighty Microsoft during an economic downturn. But EPIQ’s incredible performance over the past few years would have been a great sweetener to any diversified portfolio.

Little companies are significantly more volatile than big companies—meaning there’s much more downside risk. And they don’t pay dividends as often, a real detriment for investors who want some income. There are other risks as well. When the economy is uncertain, investors looking for safety and stability will often abandon small caps for blue chips. Also, because small companies have fewer shares outstanding, their price movement is necessarily more erratic. When good news hits, investors clamoring to get in will drive the price up quickly. When bad news hits, the opposite is true, and it can sometimes be difficult to get out. Because fewer Wall Street analysts cover these stocks, there’s also less reliable in-

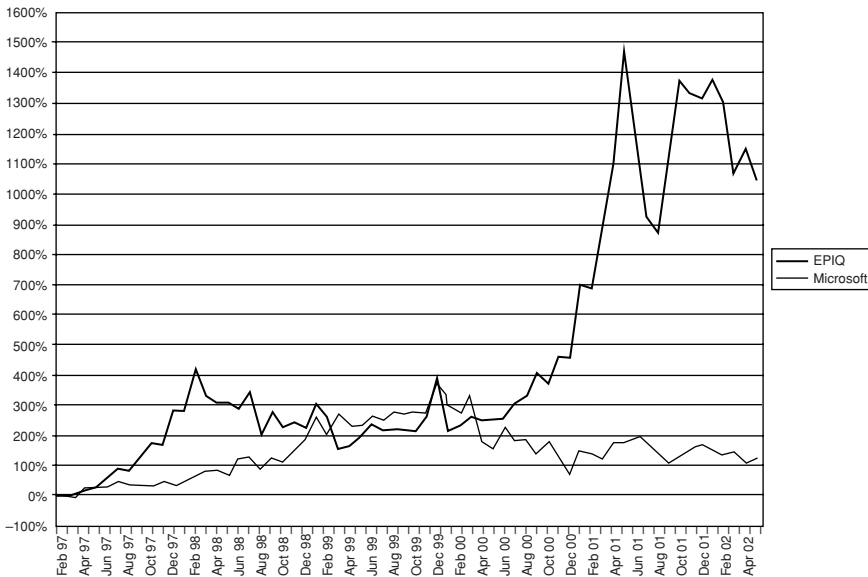


FIGURE 1.2 Percentage change of Microsoft versus EPIQ

formation on them. That means bad news can strike out of the blue, pounding stock prices overnight.

For all of that, however, most investors—especially young ones who have the time to make up any losses—want exposure to small caps. As we saw with EPIQ, the upside potential is simply too great to pass up.

Foreign Stocks

At a time when the world economy has become increasingly interconnected, investors can hardly afford to ignore foreign stocks. There's too much opportunity out there and too many ways to tap it. And since the economies of the world's different regions tend to boom and bust in cycles that often offset each other, international stocks can provide excellent diversification for a portfolio heavy on U.S. equities.

Like stocks on the U.S. exchanges, foreign stocks vary in size and do not move as a single group. So you can't really say how a "Japanese stock" behaves, or how an "Italian stock" will perform. It's also true that foreign companies are subject to different rules of accounting and far less government scrutiny than U.S. investors are used to. It all adds up to this: Investing abroad is more complicated than buying stocks in the United States.

That's why most U.S. investors get international exposure either by investing in large, well-established overseas companies like Finland's Nokia or by putting their money in professionally managed mutual funds that have the expertise and resources to assemble winning portfolios from many different foreign stocks. (We'll have more on mutual funds in the next section.)

International markets are nothing if not volatile. They are highly susceptible to changes in foreign currency exchange rates, as well as shifts in regional and global economies. As the global economy slowed in 2000, for instance, stocks in most areas of the world slowed, too. But international markets are rarely that monolithic. Usually, one region is up while another is down.

A dramatic example of that sort of divergence came in 1998 during the meltdown among the Asian economies. Economic turmoil in a region that was once the world's darling taught many investors about the treachery of

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betting your money abroad. Japan's Nikkei index lost almost 40 percent between June 1997 and October 1998, as trading partners throughout the Pacific Rim imploded due to financial mismanagement and corruption. The ripple effects were felt worldwide, as companies with exposure to those markets lost revenues.

At the same time, however, European markets blossomed as the Continent came closer to true economic union and a rash of U.S.-style corporate restructurings began to pay dividends. One region collapsed; another made up for it. That's why it makes sense to diversify your foreign investments, or let a professional money manager do it for you.

Tech Stocks

We live in an age when technology can change our lives seemingly overnight, and that phenomenon invariably creates rich new markets and explosive earnings growth for countless companies.

Of course, as investors learned in 2000 and 2001, there's a dark side to all that opportunity. Fearful of an economic slowdown, investors abandoned growth stocks and looked for safety in less volatile sectors like pharmaceuticals. In 2001, profitless Internet stocks like Amazon.com felt the worst impact. But even big, established technology companies like Cisco Systems and Sun Microsystems took a drubbing.

Clearly, new markets are by nature filled with danger, and that means actual earnings—or the prospects for future earnings—can fluctuate wildly. News of a personal computer (PC) sales slowdown at Christmas can cause investors to flee any number of related stocks—from PC maker Gateway to Novellus Systems, which makes the equipment that fabricates the chips that power the PCs that Gateway sells. Investors will return to the good companies once the dust has cleared. But unless you have patience and staying power, such crises can easily wipe you out.

As the tech roller-coaster ride of the past few years has demonstrated, technology stocks as a group tend to be more volatile than the broader market. Still, a selection of high-tech blue chips should be in everyone's long-term portfolio, since the volatility they do exhibit is easily offset by their superior growth over time.

Mutual Funds

Whether you like it or not, mutual funds will probably play a big role in your retirement savings. Why? Aside from company stock, most 401(k) plans offer only funds as investment options.

But that's not the only reason to pay attention to funds. While stock picking can be fun and can boost your returns significantly (as long as you invest in great companies), the truth is, most individual investors find it difficult to build and maintain a well-diversified portfolio. To do it right, you might have to keep an eye on as many as 60 different stocks at once. Some people thrive on that sort of thing; others lack the time, interest, or experience to give a complex portfolio the attention it demands. Others may not have the money.

That's where mutual funds—pools of stocks or bonds that are managed by professional investors—come in.

At the moment there are nearly as many mutual funds out there as there are common stocks—over 9,000 at last count. Staggering, to say the least. All told, these funds comprise more than \$4 trillion in assets, two times the 2002 U.S. federal budget. And unfortunately, not all of them make good investments. More than 75 percent routinely fail to beat the S&P 500 index over 10-year periods. Of course, there are times when mutual funds excel. Over the past three years through early 2002, 70 percent of equity funds have outperformed the S&P by an average of 8 percentage points a year. Over the long run, however, most mutual funds don't keep pace with the S&P 500.

Clearly you can help yourself a great deal by choosing the right funds. But to do so you'll need to learn some basics first: How do mutual funds work? What should you look out for in terms of fees and expenses? And how do you sort through the different types of funds?

Like stocks, funds come in all shapes and sizes, from Fidelity's \$77 billion Magellan fund—the largest in the country—to the \$1 million Oak Ridge Small Cap Equity fund. Here's how they work: Typically, a sponsor company like Fidelity or Vanguard rounds up money and pays a portfolio manager to buy securities based on a specific investing strategy. The company then sells shares in the fund to the general public. The large-cap growth fund Fidelity Magellan, for instance, invests in large companies

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with fast-growing earnings. But Fidelity's Small Cap Stock fund invests in smaller companies.

When you buy shares in a mutual fund, you own a small percentage of the total portfolio. Depending on the fund, you can own a piece of 20 to 500 different stocks. A \$1,000 investment in Oakmark Select in late 2001, for instance, would have bought you just over 37 shares in the fund. Because the fund owns 21 stocks, your small investment would have bought you a level of diversification that would have been impossible to achieve on your own with such a small sum of money. You may have to pay a fee for the service, but a good fund offers plenty of advantages. Ideally, the pros have years of experience and are given access to piles of industry and company research. Their expertise means you don't have to keep track of dozens of stocks on your own. And unlike a bank certificate of deposit or an annuity, a mutual fund investment is completely liquid, meaning you can get in or out at any time simply by picking up the telephone.

Today there are funds geared to just about any investment objective—from funds that buy only Internet-related stocks to those that invest in Latin American utilities. In fact, Morningstar, the Chicago-based fund database firm, tracks 29 distinct kinds of equity funds—and that includes the newly hatched breed of exchange-traded funds.

For investors, this diversity provides the opportunity to tailor a portfolio of funds to meet particular objectives. Take a 55-year-old man eyeing retirement in a few years. Seeking some growth but not much risk, he may put part of his money into a steady, large-company equity fund, while protecting the bulk of his nest egg in a money-market fund with lower—but virtually guaranteed—returns. A 30-year-old woman, on the other hand, has years to make up for any short-term investment losses. So she may want to put most of her money in a more aggressive, small-company equity fund that promises more risk, but higher returns.

You don't have to understand all 29 categories to invest in funds. The truth is, there are only a few broad categories of funds that really matter to most people. And if you are investing through your retirement plan at work, you'll probably be limited to those groups, anyway. In Table 1.2 you'll find what we feel are some of the essential fund categories to know about and how they stack up next to each in terms of average return, risk, and expense ratios.

One more thing before we move on: Every fund has to publish a document called a prospectus that states clearly its strategy, or investment style.

TABLE 1.2 ESSENTIAL FUND CATEGORIES

Type of Fund	10-Year Return through Early 2002	Standard Deviation	Expense Ratio
Blend	10.98	16.63	1.26
Bond	6.19	4.57	1.10
Financial	16.89	21.20	1.67
Foreign	5.85	16.34	1.64
Growth	10.52	19.33	1.43
Index	10.25	14.26	.76
Large-cap	10.61	16.93	1.34
Microcap	12.59	16.87	2.19
Mid-cap	10.74	21.94	1.48
Money market	4.43	.33	.65
Small-cap	11.05	21.54	1.54
Technology	14.08	39.54	1.75
Utilities	8.81	13.46	1.44
Value	11.94	15.00	1.42
World	6.93	18.34	1.78

Source: Morningstar.com. Reprinted with permission.

Managers have been known to drift from this strategy—something you have to watch out for—but the good ones toe the line.

Index Funds

First, what's an index? It's a grouping of stocks chosen to represent a certain market segment. The S&P 500 index, for instance, is comprised of 500 large-company stocks. The Nasdaq Composite index is heavy on technology companies. And the Dow Jones Industrial Average contains 30 large, kind of "old economy" companies. You can't watch the evening news without finding out about how one of these indexes performed in any given day in the market. They—and many others—are used by investors and together function as a barometer of the market as a whole.

An index fund, then, attempts to mimic the performance of a particular

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group of stocks. An S&P 500 index fund (e.g., the Vanguard 500 Index) will buy shares in the same 500 companies that comprise the S&P 500 index. Sounds boring, but it works. In mid-2000, the Vanguard 500 Index fund was the biggest fund in the world, with \$107 billion in assets, largely because investors flocked to its exceptional 21.75 percent five-year annual return. By merely copying the S&P 500, it beat 93 percent of the “active” fund managers—those picking and choosing stocks instead of mirroring an index—over the same period.

Index funds have a pair of really important advantages over actively managed funds: low expenses and tax efficiency. Since the fund manager doesn't have to go out and hunt around for stocks, these funds are relatively cheap to run. The Vanguard 500 Index fund, for example, has an incredibly low annual fee of 0.18 percent of your investment. An average actively managed large-cap fund like Alliance Growth may charge six times that much. Meanwhile, low turnover limits the amount of capital gains registered by index funds, which lessens their tax liability for investors. Small wonder that many investors find that index funds are by far the easiest, most effective way to go—particularly if your goal is long-term growth without having to pay much attention to your holdings.

Actively Managed Funds

Every fund manager approaches the market from a slightly different angle, but there are three broad archetypes when it comes to investment strategy: growth, value, and blend. Let's walk through each one now.

GROWTH FUNDS

As their name implies, these funds tend to look for the fastest-growing companies in the market. Growth managers are willing to take more risk and even pay a premium for their stocks in an effort to build a portfolio of companies with above-average earnings momentum or price appreciation.

For example, biotech firm Chiron and the drug company Forest Laboratories are generally considered expensive stocks, because their prices have been bid high relative to their profits. But because they enjoy vibrant markets and have rapid earnings growth, top-performing managers like Richard Freeman of Smith Barney Aggressive Growth know that investors

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crave these supercharged growth stocks and will keep piling into them as long as the growth keeps up. But if the growth slows, watch out—the more momentum a stock has, the harder it is likely to fall if and when the news turns bad.

That's why growth funds are the most volatile of the three investment styles. It's also why expenses and turnover (which leads to greater taxes for investors) are also higher. For these reasons, only aggressive investors, or those with enough time to make up for short-term market losses, should buy shares in these funds.

VALUE FUNDS

These funds like to invest in companies that the market has overlooked. Managers like Marty Whitman of Third Avenue Value search for stocks that have become undervalued (priced low relative to their earnings potential).

Sometimes a stock has run into a short-term problem that will eventually be fixed and forgotten. Or maybe the company is too small or obscure to attract much notice. In any event, the manager makes a judgment that there's more potential there than the market has recognized. His bet is that the price will rise as others come around to the same conclusion.

Whitman, for instance, bought passive-component manufacturer AVX in late 1998 before it was discovered by the rest of Wall Street. The stock rose 198.3 percent in 1999 and still traded at 28 times the past 12-month earnings—a steal when you consider that peer Analog Devices registered similar performance while trading at 85 times earnings.

The big risk with value funds is that the undiscovered gems they try to spot sometimes remain undiscovered. That can depress results for extended periods of time. Volatility, however, is quite low, and if you choose a good fund, the risk of lousy returns should be minimal. Also, because these fund managers tend to buy stocks and hold them until they turn around, expenses and turnover are low. Add it up, and value funds are most suitable for more conservative, tax-averse investors.

BLEND FUNDS

These portfolios can go across the board. They might, for instance, invest in both high-growth telecom stocks and cheaply priced automotive companies. As such, they are difficult to classify in terms of risk. The Vanguard

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500 Index fund invests in every company in the S&P 500 and could therefore qualify as a blend. But because it's also a large-cap fund, it tends to be steady. The Legg Mason Special Investment fund is more aggressive, with heavy weightings in technology and financials. To know whether a particular blend fund is right for your needs, you'll probably have to look at the fund's holdings.

International Funds

When it comes to risk, some foreign funds are fairly tame; others can make your hair stand on end. Consider the experience of the summer of 1998, when the Asian economies fell like dominoes and plundered stocks in the region. Funds like Pioneer Emerging Markets and Ivy Developing Markets, with heavy exposure to Asia, got hammered. Even when foreign economies are doing reasonably well, currency fluctuations can have a negative effect on stock prices.

Of course, economic and currency risk can also swing very strongly in a positive direction. So, as always, diversification is the key to managing risk. Funds investing overseas fall into four basic categories: world, foreign, country-specific, and emerging-market. The wider the reach of the fund, the less risky it is likely to be.

WORLD FUNDS

World funds are the most diverse of the four categories, but that's true largely because they're able to invest in any region of the world, and that includes the United States. As such, they don't actually offer as much diversification as a good foreign fund (which cannot invest in U.S. companies). A prime example: Pimco RCM Global Small Cap, which is 50 percent invested in the United States and Canada, 23 percent in Europe, 8 percent in Japan, 2.6 percent in the Pacific Rim, and the rest in smaller regions. World funds tend to be the safest international-stock investments, but that's because they typically lean on better-known U.S. stocks.

FOREIGN FUNDS

These funds invest most of their assets outside the United States. Depending on the countries selected for investment, foreign funds can range from rela-

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tively safe to more risky. Fidelity Diversified International, for instance, has its assets spread over 35 different countries, many of which are in Europe. In early 2002, Oakmark International Small Cap, on the other hand, had significant exposure (23 percent of the portfolio) to some of the most traditionally volatile regions in the world: Japan, Hong Kong, and South Korea. It is wise to choose a fund with the best balance, or make sure the manager has done a good job of moving in and out of regions profitably.

COUNTRY-SPECIFIC FUNDS

These funds invest in one country or region of the world. That kind of concentration makes them particularly volatile. If you pick the right country—Japan in 1999, for example—the returns can be substantial. The average Japan fund, according to Morningstar, returned a whopping 120 percent that year. But pick the wrong one, and watch out. Only the most daring investors should venture into this territory.

EMERGING-MARKET FUNDS

Emerging-market funds are the most volatile. They invest in undeveloped regions of the world, which have enormous growth potential, but also pose significant risks—political upheaval, corruption, and currency collapse, to name just a few. Don't go near these funds with anything but money you are willing to lose. Why? Over the past five years, the average emerging-market fund is down more than 3 percent. Still, these funds do pack a punch once in a while: In 1993 and 1999 these types of funds posted better than 70 percent returns.

SECTOR FUNDS

Sector funds do what their name implies: They invest in stocks in a particular segment—or sector—of the market. A fund like Firsthand Technology Leaders, for instance, buys only tech companies for its portfolio. Munder NetNet cuts it even finer by holding only Internet-related stocks. Fidelity has a whole stable of sector funds from Fidelity Select Insurance to Fidelity Select Wireless. The idea is to allow investors to place bets on specific industries or sectors whenever they think that industry might heat up.

While such a strategy might appear to throw diversification to the wind,

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it doesn't entirely. It's true that investing in a sector fund definitely focuses your exposure on a certain industry. But it can give you diversification within that industry that would be hard to achieve on your own. How? By spreading your investment across a broad representation of stocks. Fidelity Select Financial Services fund holds 122 different stocks; the Evergreen Health Care fund includes 112; and T. Rowe Price's Media & Telecommunications fund has 55.

Of course, such concentrated portfolios can produce tremendous gains or losses, depending on whether your chosen sector is in or out of favor. In 1999, Firsthand Technology Leaders soared 152.6 percent because software and semiconductor companies were hot. Real estate fund Franklin Real Estate lost 5.6 percent in the same year because the category sputtered.

Because of this specialization, any sector fund carries more risk than a generalized fund. But some sectors are clearly more volatile than others. For example, Vanguard Utilities Income fund, which invests primarily in staid electrical companies, has about one-third the volatility of PBHG Technology & Communications fund, which buys supercharged software makers.

Charges and Fees

If there is a single drawback to investing in mutual funds, it's the corrosive effect that fees and taxes have on returns. If you aren't careful, management expenses and capital gains taxes can shave hundreds—if not thousands—of dollars from your returns over the years.

LOADS: FRONT- AND BACK-END

A load is simply a sales charge—like the commission you pay when you buy and sell shares in a stock—that is tacked onto the price of a mutual fund to compensate the broker or financial adviser who sells it to you. Loads work in two ways: You pay them either up front when you buy your shares or later when you sell them, depending on the fund. Of the 9,543 equity funds in existence in early 2002, 5,207 (55 percent) charged a load; 4,336, or 45 percent, did not.

A front-end load is charged when you buy your shares. It typically ranges between 1 percent and 5.75 percent of your initial investment, and some funds charge you again for reinvesting your dividends in new shares

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of the fund. A back-end load is a fee the fund charges when you sell—or redeem—your shares. These deferred fees are essentially a tactic to keep you invested in the fund for the long term. A typical scenario would work this way: In the first year of ownership, you'd pay a charge in the range of 4 percent to 5.75 percent if you sold out of the fund. After that, the percentage declines each year until it disappears altogether after about six to eight years.

The obvious problem with a load is that it immediately trims your investment return. That might be acceptable if you believe the fund will post such superior returns that the load will pay for itself over time. But since there are plenty of quality no-load funds out there, why pay a fee if you don't have to? We never say never when it comes to paying fees, especially when it comes to some top-rate managers, but at *SmartMoney* for the most part we tend to recommend no-load funds.

EXPENSE RATIOS

Even a no-load fund duns its shareholders for the costs of doing business. These include everything from the advisory fee paid the fund manager to administrative costs like printing and postage. These costs are expressed as an expense ratio, which is an annual percentage of the fund's average net assets under management. Published fund returns are usually calculated net of annual expenses, but you should definitely pay attention to these costs. When you get your statement at the end of the year, you can count on the costs being skimmed off the top.

There's a temptation to associate high expenses with good fund management. Some people figure it's like anything else: You get what you pay for. The fact is, however, that low-expense funds are more likely to outperform high-expense funds over the long haul. Recently, the average expense ratio for domestic equity funds was about 1.4 percent. For fixed-income funds it was about 1.1 percent. Foreign funds have higher expense ratios, averaging around 1.7 percent. There is no reason to buy funds with expense ratios higher than that.

12B-1 FEES

Charges known as 12b-1 fees are included in the expense ratio, but are often talked about—and listed—separately. They go to pay the fund's

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marketing and distribution expenses. These fees are charged in addition to a front- or back-end load, and you'll find that many no-load funds charge them, too. Note that once a 12b-1 fee rises above 0.25 percent, the fund is no longer considered a no-load. Our advice? If a 12b-1 fee puts a fund's expense ratio above the average for that class of fund, think twice before buying.

Does it sound like we're obsessing over nickles and dimes? We suggest you check out SmartMoney.com's interactive Fund Fee Analyzer to see for yourself how much a high load or expense ratio can eat into returns.

Here's an example: Say you invest \$10,000 in a fund that charges 4.7 percent every time you put money in (a front-end load), and a 1.5 percent expense ratio per year (to pay management fees). Both charges are about average for the fund industry. After one year, assuming a steady 10 percent return, the fund will have made you \$1,000 in profit, but after fees (about \$660), your profit dwindles to \$340. That means fees swallowed 66 percent of your profits in one year. After five years, that percentage diminishes to 29 percent, but after 20 years, you'll still have paid a whopping \$18,522 in fees, which will diminish your overall profit of \$57,143 to just \$38,621.

Share Classes

A single fund may have up to five clones—and each one carries charges and fees that are levied in slightly different ways. Ever wonder what all those As, Bs, and Cs mean that you often see after the names of some funds? Those letters indicate the different share classes of a mutual fund—the different ways charges are assessed. Although these classes are not standardized, they primarily apply to load funds and determine the various ways that investors can pay the sales charge. For example, A shares traditionally indicate a front-end load, while B shares most often indicate a back-end load. Other share classes include C shares, which usually incorporate a small back-end load and the maximum 12b-1 fee.

Taxes

Think of a fund manager as a proxy for you as an investor. It stands to reason, then, that when he or she sells a stock for gain, it becomes a taxable

event. Of course, a keen fund manager will offset that gain by a loss (i.e., by selling a losing stock), if at all possible. But if at the end of the year, the sum of all transactions adds up to an overall gain, guess who pays the tax bill? You.

These gains are paid out in the form of taxable distributions. There are a few things worse than ending the year with a fat one you weren't expecting. It's even more bitter when the gain falls into the short-term category—a big problem with fund managers who trade often. Short-term gains are taxed as regular income instead of at the lower, 20 percent tax levied on long-term capital gains.

A high turnover ratio can be a sign of a high capital gains distribution further down the line. And clearly, one way to avoid this potential problem is to be wary of managers who trade a lot. A fund with a turnover ratio of, say, 500 percent indicates that the average holding in the fund lasted less than three months. And all that trading could produce a capital gains liability for you, unless the manager is able to offset his or her gains with losses.

That said, quick trading isn't always the issue. As seen recently, funds with substantial shareholder redemptions also can produce capital gains liabilities. For example, the Credit Suisse Japan Small Company fund plunged in 2000 after triple-digit returns in 1999. As a result, an outsized proportion of investors redeemed their shares, causing the fund to sell stocks to make the payments. Remaining shareholders then had to swallow a whopping 55 percent capital gains distribution.

Bonds

Think of a bond as an IOU. Buy one and you are in effect lending money to the issuer—whether it's the U.S. Treasury or US Airways. The issuer promises to pay you interest until the bond is due, at which point you'll get your principal back.

Bonds, with their steady stream of income, can add much-needed ballast to an otherwise volatile long-term portfolio. Here are the main types of bonds you should consider buying. We'll help you decide how much exposure to bonds you want in Chapter 4, when we discuss your ideal asset allocation.

Buying Directly from the U.S. Treasury

If you are just starting out, you can simply buy five-year Treasury bonds, or—if you have considerable assets allocated for bonds—you can put together a so-called ladder of Treasuries. We'll show you how in a moment. Either way, your best bet for buying bonds is the government's commission-free Treasury Direct program, which allows you to bypass brokers and their fees. An application to open an account may be obtained online by linking to the Treasury Direct web site (www.treasurydirect.gov), by contacting your nearest Federal Reserve Bank, or by calling 800-722-2678.

Two-, three-, five-, and ten-year notes are available for a \$1,000 minimum investment. You can set up an account online. If for some reason you need to sell the Treasuries in this account before they mature, you will have to have them transferred to a broker, who will charge at least \$50 per transaction. In addition, Treasury Direct accounts of \$100,000 or more face an annual \$25 maintenance fee.

Agency Bonds

Also extremely safe and liquid, but offering a slightly higher yield, are government-agency bonds issued by the likes of the Tennessee Valley Authority, the Farm Credit Financial Assistance Corporation, the Federal National Mortgage Association (FNMA), and the Government National Mortgage Association (GNMA). (These debentures should not be confused with the mortgage-backed bonds that are also issued by FNMA and GNMA; mortgage-backed securities are extremely sensitive to fluctuations in interest rates and should be avoided.)

It's hard, however, to gain any edge with these bonds over Treasuries. That's because they're generally available only through brokers and thus incur commission costs that cut into their yield. How much? The standard retail brokerage fee comes out to 0.5 percent, or, in the lingo of the bond world, 50 basis points. Even if you have \$100,000 to invest and negotiate a lower commission, perhaps 20 basis points, the advantage over Treasuries will probably come to only around \$50 a year.

The exception is if you have a very large portfolio and can sink perhaps \$1 million into agency bonds; you might then be able to get the institutional commission rate of just 10 basis points. Or, at a more modest level,

you might be able to hook up with a financial adviser who specializes in making bulk government-agency bond purchases directly from banks, lumping clients' investments together in order to build million-dollar packages of agency debentures.

Muni Bonds

Investors with substantial income should also consider combining tax-free municipal bonds with their Treasuries. While the stated yields of munis are lower than those of Treasuries, the effective return for investors in high tax brackets is almost always better. As with Treasuries, individual muni bonds can also be laddered (a technique of diversifying your bond portfolio across dates of maturity) to limit your interest-rate exposure. But because they tend to trade in fairly large lots (usually \$25,000) and because, as a precaution against default risk, investors should spread their money among a variety of different locales, building a muni portfolio requires a commitment of \$100,000 at a bare minimum.

If you don't have enough now to build a muni ladder, the next best option is to look to a series of municipal-bond mutual funds. The best are Vanguard's Municipal Limited-Term Tax-Exempt and Intermediate-Term Tax-Exempt funds, which both have a minimum initial investment of \$3,000. They maintain a low 0.19 percent expense ratio and are run with minimal maturity fluctuation and risk taking.

What about Corporates?

While investors have traditionally been steered to these vehicles because they offer higher interest income than government bonds, we are dubious about endorsing them. In part, it's a question of costs eating into those higher yields. First there are the taxes: Income from corporates is fully taxed at all levels. If your state and local rates (which are not applicable to government bonds) are a mere 6 percent, that would cut the effective return of an 8 percent yield to 7.5 percent. Next come the transaction costs: both brokerage commissions and the cut taken by the bond dealers (known as the spread). All told, they can easily eat up 1 percent or more of your investment.

Perhaps most important, though, is that the best bonds are usually callable by the issuer, meaning the corporation can, at its discretion, pay off

its obligation at a stated price and stop paying interest. That becomes a heads-you-win, tails-I-lose proposition for investors. If interest rates decline and the value of the bonds goes up, the corporation may call them, disrupting your expected income stream and cutting off a potential capital gain. Meanwhile, if interest rates rise, you are stuck holding a less valuable security that is yielding below-market rates.

Up the Ladder

Diversification is as important in bond investing as it is in stock investing. It's best to spread your risk over a series of different maturities, while maintaining an average maturity of your liking in your portfolio. The best way to do that is to set up a ladder of Treasury bonds—in essence, a series of bonds with a range of maturities.

Here's how it works: You buy equal amounts of Treasuries due to mature in one year, three years, five years, seven years, and nine years. That portfolio would have an average maturity of five years ($1 + 3 + 5 + 7 + 9$ equals 25, divided by 5, equals 5). The next year, when the first batch comes due, you would reset the ladder by putting the money into new 10-year notes. Your portfolio would then have an average maturity of six years.

Two years later, when the next round of notes matures, you would buy more 10-years, continuing to buy new 10-years whenever a note matures. That would always keep the average maturity in the five- to six-year range.

One advantage to this scheme is that you don't need to worry about fluctuations in interest rates—especially if the ladder you construct has notes coming due each year. If rates do rise soon after you bought this year's bonds, you can take comfort in the fact that soon you will have money coming available to take advantage of the change by purchasing your new 10-years at lower prices. Similarly, if rates decline after you buy, you've managed to lock in the higher rates for that portion of your portfolio. The bottom line is, you won't get stuck one way or the other.

Treasuries for your ladder may be purchased straight from the government through the Treasury Direct program, with few fees and low minimum investments. As mentioned earlier, an application to open an account may be obtained online at the Treasury Direct web site (www.treasurydirect.gov) or by calling 800-722-2678.

A ladder may also be constructed of municipal bonds, but that would

typically require a bare minimum of \$100,000 in capital to gather a diversified group of issues. Trading in a muni, which you can do through most brokerage firms, also creates higher transaction costs, but if your tax rate is high enough—anything above 28 percent—the tax savings may make the costs worthwhile.

Bond Funds

Bonds are complex—there’s no doubt about it—especially if you’re a novice investor with little experience in the markets. That’s why a lot of people opt for bond funds when they seek to diversify their investments with some fixed-income exposure. Our view is, if you’re willing to put in the effort, you’re better off buying individual bonds instead of bond funds. But in the real world, a fund is sometimes worth the convenience.

Here’s what you have to consider:

Like a stock mutual fund, a bond fund is managed by a professional investor who buys a portfolio of securities and makes all the decisions. Most funds buy bonds of a specific type, maturity, and risk profile—15-year corporates, for instance, or tax-free municipals—and pay out a “coupon” to investors, often monthly, rather than annually or semiannually like a regular bond.

The chief advantage of a bond fund is that it is convenient. It’s also true that when it comes to buying corporate and municipal bonds, a professional manager backed by a strong research organization can make better decisions than the average individual investor. Consequently, if you want to dabble in junk bonds or shelter your income with triple-tax free New York City 30-years, you may be better off going the easy route and picking a good fund.

The disadvantage of a bond fund is that it’s not a bond. It has neither a fixed yield nor a contractual obligation to give investors back their principal at some later maturity date—the two key characteristics of individual bonds. Then there are the fees and expenses that can cut into returns. Finally, because fund managers constantly trade their positions, the risk-return profile of a bond fund investment is continually changing: Unlike an actual bond, whose risk level declines the longer it is held by an investor, a fund can increase or decrease its risk exposure at the whim of the manager.

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The other thing about building your own portfolio of bonds is that you can tailor it to meet your circumstances, meaning the bonds will mature precisely when you need them. A bond fund cannot deliver that sort of precision.

Our advice is this: If you lack the time or interest to manage a bond portfolio on your own, or if you want a mixed portfolio of corporates or municipals, buy a bond fund. But if you want a tailored portfolio of Treasuries to mature when your youngster goes to college—and you want to avoid the fees and added risk associated with bond funds—go ahead and take the plunge yourself.