

Finances For My Daughter

Everything a person just starting out needs to know about saving and investing (in plain English and less than an hour)

by Bob Veres



This book is for my daughter Moriah Grayce Veres,
who asked a lot of great questions
and forced me to keep it simple and straightforward.

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The extremely simple Table of Contents

Chapter 1: The Importance of Systematic Saving	2
Chapter 2: Tax-Free Accounts Made Easy	11
Chapter 3: Investing Made Easy	14
Chapter 4: The Straightforward Approach to Asset Allocation	25
Chapter 5: Microbudgeting	30
Chapter 6: Insurance Stuff	32
Chapter 7: Getting Financial Advice One Stage at a Time	37

Preface

Investing isn't hard. It's not even especially complicated.

Saving for the future is not rocket science. Even with all the savings vehicles out there, despite all the complex investment products and even more complex fees and commissions, you can learn everything you need to know--and far more than most people know--in about an hour.

If you have a mental block about this stuff (and many people do), then it might take two hours.

How do I know this? I've been a writer and columnist for a wide audience of professional financial advisors for the past 37 years. I may be the best-known writer in the financial planning field, working daily among financial advisors and CPAs who practice financial planning as a profession.

In that time, I've written mostly for people who LOVE the complexities of investing, and associated topics like tax planning, estate planning, trusts vehicles, charitable gift planning, and a lot of other things that are not included in this book.

If you're one of those people who enjoys the deep complexity of financial services advice, then this book is definitely not for you. For those people, I recommend becoming a professional in the field, and buy my more complicated book entitled *The New Profession*. (Financial planning is a really terrific career for those who like to help people.)

The majority of individuals, in my experience, hate even thinking about budgeting, saving, choosing investments and slightly more complicated subjects like whether to invest through a 401(k) plan or a taxable brokerage account. And that's okay.

Why? Because over the years, I've learned that there is a small, uncomplicated set of concepts and truisms that everybody should know in their financial lives. Master these, and your odds of living a fulfilled, prosperous life are much better than average, even if you never earn a better-than-average paycheck.

Hidden away in all the complexity, there are some fairly simple-to-explain guidelines that you can follow, which wealthy people seem to know by instinct, which most people never get a chance to learn.

Not long ago, I shared these simple concepts with one of my daughters, after she asked me what she should do with the money she was putting aside from her first job.

This book was actually written for her, providing the best advice I can give her for the first ten or twenty years of her saving and investing life—made understandable, made easy.

You're welcome to look over her shoulder at what I said.

Everything here is written in question and answer format. Because my daughter is smarter and savvier than I am (and you probably are too; it seems like everybody in her generation is), the questions she asked are great ones.

Because I love her, and care about her future, I gave the very best answers I could.

Here is the most important thing you will learn in this book: investing is not complicated. Or, at least, it doesn't have to be. You can learn enough in ten or twenty minutes to get a good return on your investments, year in, year out.

If you do just a few simple things, your investments will almost certainly give you a higher return than many professionals are getting. I know that's hard to believe, that you can achieve this in less time than it takes to cook dinner in the microwave. But I promise you that it's true--and along the way, I'll explain why.

The second most important thing to understand is that if you follow the advice in this book, becoming financially self-sufficient is almost foolproof. That doesn't mean it will happen quickly, or the ride won't be bumpy. It's possible that there are shortcuts, but even after studying investing at an advanced level for more than 30 years, I still don't know of any that I feel comfortable with.

All I'm saying is that there is a very clear, well-trodden path to becoming wealthy, which is only followed by a very tiny percentage of the human population.

Now that we have the most important lessons out of the way, let's get started on the rest.

Ready?

Chapter 1

The Importance of Systematic Saving

Okay, now that I'm earning a paycheck, I think I should start investing. Do you know of any good books or resources that will tell me how to do it?

Wow! I just looked on Amazon.com and couldn't believe what I found. So I went to the locally-owned bookstore, and I found the same thing.

There seem to be a LOT of books on the general subject of investing, but none that I feel comfortable recommending to my own daughter.

Why?

They're all too complicated. They all get into a lot of unnecessary minutia and make it sound like saving and investing is really hard work that requires a professional. When you get up to half a million or so dollars to invest, I think maybe you'll need to hire a professional or start reading those books.

But just starting out, it makes no sense at all to delve into all that stuff.

So what do I do?

Let's take this in steps, starting with the very most important thing first, and I'll walk you through it. It may not take more than an hour, two tops. Are you okay with that?

That's actually how I prefer it.

Fundamentally, what we're talking about here is accumulating wealth. If you have wealth, then you can do what you want. You can take a year off. You can take trips abroad. You can reward yourself. Eventually you can make work optional altogether--which is what we used to call retirement, but now I don't know what to call it, because a lot of people want to stay relevant and do something productive and fun regardless of how old they are.

Making work optional sounds good. So does all the other stuff.

The first and most important thing about building wealth is getting in the habit of saving some of the money you make, out of every paycheck.

Every single one?

Yes.

I thought you said this was going to be easy.

I probably should have said it was going to be UNCOMPLICATED. Saving regularly can actually be quite difficult for some people. Very difficult. So hard that only a small percentage of people are able to do it consistently. And if you'll look around, that happens to be the same small percentage that becomes wealthy.

Sigh.

But there ARE ways to make it easier. I'll walk you through some steps. Does your company have a 401(k) plan (or a 403(b) plan if the company is a nonprofit)?

I don't know.

Did they ask you whether you wanted to enroll in a company-sponsored retirement plan when you were hired?

No.

Then you probably don't have a plan where you work. Only about half of all American workers DO have access to a company-sponsored retirement plan, which is something our country needs to fix.

If your company DID have a 401(k), or if you ever, sometime in the future, work for a company that does, then you should sign up and contribute whatever the maximum is. That's the best place to start.

Why?

Two--and maybe three--reasons. First, the money comes right out of your paycheck. You never see it, so you can't spend it. That's a great, easy, automatic way to save; to have the money come out of the paycheck and go straight into an investment account where it earns a return, and then you get a return on the return, and the compounding works its magic on your wealth.

Second, money that goes into a 401(k) plan isn't taxed as income.

I don't pay much in taxes anyway.

Trust me; you will. But meanwhile, not having to pay 10% up to 37% on that money, plus state taxes, gives you a little bit of a boost.

But it gets better. The money in that account is never taxed, as it grows, until you take it out.

Wait. What does that mean?

In general, there are two kinds of pots of money that you can save and invest in. One kind is called a tax-deferred account, which means that whenever the investments inside the account earn interest or dividends or increase in value (and we'll talk about those things in a minute), the government doesn't require you to pay taxes on the increase in the value of your account each year.

Why does that matter?

Paying taxes every year on every penny of interest and dividends is a drag on your portfolio.

My what?

Sorry. Your 'portfolio' is just a fancy name for all your investments lumped together. It's easier than saying 'all your investments lumped together.'

The important thing to realize is that whenever you can have your money grow tax-free, it will grow faster and you will get wealthier more quickly. Basically, it keeps Uncle Sam's hand out of your pocket.

That's a good thing. What was the third reason to put money in a 401(k)?

Often--I would say usually--the employer will match some of the money you put in. That means if you put in 5% of your salary every paycheck, your employer will put in an amount equal to 2.5% of your pay, sometimes more, sometimes less, sometimes none at all.

And there are no strings attached. It's free money.

Who doesn't like to get free money? Get as much of it as you can, whenever you can.

I'm pretty sure I knew that already.

But since you don't have a 401(k) plan, we can move on. Whenever you have a chance, you want to sign up to have them take the maximum amount out of your paycheck. It won't make much of a difference in your take-home pay, but it will make a huge difference in your ability to accumulate wealth.

Wait just a minute. If I did have a plan, what should I invest in?

Let's talk about that later. There's an easy answer, but I want to take this one step at a time. What you invest in, within limits, will actually be less important than how much you save.

So if I don't have one of those 401(k) plans, I'm screwed out of growing my money tax-free. Right?

Actually, you still have options. And they're pretty good ones.

Do tell.

To start with, take a look at your paycheck. Look at your take-home pay, after taxes and FICA, which is the amount you can deposit in the bank.

Okay.

Now move the decimal point from the right to the left, one number. So if your check says \$613.72, when you move the decimal point over, you get \$61.37.

So?

That's ten percent of your income. Or one-tenth.

I knew that already.

I'm sorry; I didn't mean to talk down to you. But that's a magic number. That is the minimum amount you want to save out of every single paycheck for the rest of your life, until you have saved enough that work becomes optional.

You can save more, but you should try never to save less.

What makes that number magical?

If you save ten percent of your income, you will be one of very few. Just one-hundredth of one percent of all people on this planet save at that rate. If you decide, here and now, to become one of them, then you will almost certainly reach all your financial goals in your lifetime.

How do you know that?

I could get into the power of compounding, and show you a lot of numbers based on assumed rates of return on your investments--which basically means how many dollars your investments earn for you each year. But those are just numbers, and guesses, and no two years are alike and no two people will ever have the same investing experience.

So I'm not going to spend ten pages on numbers and graphs and charts. I'm going to tell you that I've seen thousands of spreadsheets and financial plans and talked with professional advisors about their clients' investment experience, and everything I've seen in 30 years tells me that if you can become one of those very few people who is diligent about saving at least 10% of your income, you'll come out way ahead of just about all your friends and neighbors.

The basic idea is that as you put money aside, the money itself will be earning money while you are earning money from your work.

At some point down the road, maybe in 20 years, maybe in 30, the money itself will be earning more than you are. At that point, work becomes optional. You work for the fulfillment, to make your contribution to society, and the income is a nice perk rather than a necessary part of the package.

Okay, let me stop you there. Tell me why everybody doesn't do this.

There's actually been a lot of research into saving habits and what researchers call "mental accounting." The simple gist of it, which is basically the conclusion of all the studies, is that we have a built-in, hard-wired human tendency to spend a little more than we make.

Mental accounting means our brains kind of keep track of how much we make, and what is interesting is that we tend to underestimate how much we're spending.

Then an unexpected expense will happen which we'll pay for with a credit card—your car might break down and need repairs (plus the towing charge), or a friend will get married and you need to buy a gift. Most people are surprised at how much they spend on Christmas gifts. If you own a house, your refrigerator or washer-dryer or hot water heater might stop working, and you have this extra expense that you didn't plan for.

So for most people, the credit card balances will grow slowly, and then bump up faster occasionally because of those unexpected expenses.

Then you get a raise, and you immediately, unconsciously, out of reflex, raise your living standards. You buy a nicer car, you go out to eat more often, you move into a bigger apartment, and the bottom line is that very little, if anything, gets saved.

Am I like that?

Pretty much all of us are like that--even (you'd be surprised) many of the professionals. It seems to be hard-wired into the human brain. That's why you have to trick yourself into saving.

Tricking myself? Isn't that a little like tickling myself?

Maybe I'm using the wrong word. And maybe I should back up, because at some point you'll need to start budgeting.

That word makes me feel sick to my stomach.

Bear with me. All I mean here is to figure out roughly how much you're going to spend, and then making some basic decisions.

This is going to be painful, I can tell. So where do I start?

Many of your expenses are kind of hard-wired into your spending amounts. You have rent or the house payment. You have the car payment and travel expenses. If you're carrying a credit card balance, there's a monthly amount you have to pay. You buy food and clothing on a regular basis. You probably pay for medical insurance.

Yes. So?

Add up the rent or house payment and the auto payment. Look at what you auto-pay for your phone and electric and water bills—and don't forget the cable TV. Take your current credit card balance, divide it by ten, and add that amount to your monthly expenses—so you'll have it paid off over the next year or so. Look at your checking or credit card account and see how much you pay for food in a given month, and add up how much it costs to eat out in a month.

This should take you about 15 minutes of your time. And there are online programs like mint.com which will categorize all of your expenditures automatically, just by linking up to your credit card and checking account information. Then it takes no time at all, except for the hassle of getting the links in place.

Yeah. Okay, I guess...

Don't be so enthusiastic!

Then you need to take a look at your credit card statements, online, and see what you spent for Christmas last year. You need to look for any other non-regular expenses, like the car breaking down. Take that total yearly cost of unexpected stuff and divide it by 12—which means you are saving every month so that when those expenses come, you'll have money to pay them out of your cash.

Sigh. So what does that do for me?

Add it all up and you have your monthly total cost of living. That's your budget. That's what you spend. Then you can compare that with how much you make, and see if there's anything left over. Chances are, there isn't.

Hmmm. So I'm screwed.

I didn't say that. But you need to figure out how to get your cost of living down below what you're making.

How do I do that?

You could fill a library with books on budgeting, and ironically I think most of them give you terrible advice.

How so?

They mostly try to get you to reduce spending in very minor areas of your overall budget, like buying cups of coffee, and tend to ignore the areas where you can really make a difference, quickly and easily.

Tell me both areas, if you would.

The typical budget advice says you should reduce eating out or buying coffee at Starbucks. I read an article recently that said to stop eating avocado toast.

We'll get to what to do about those smaller expenditures in the next chapter, and there ARE ways to reduce your spending there. But compared with some of the other expenses in your budget, those are nickels and dimes—and they're also harder to give up than it is to cut back on some of these bigger items.

I'm not sure I follow you.

Somebody once wrote a very simple budget plan:

Don't buy a house you can't afford.
Don't buy a car you can't afford.
Don't take out student loans you can't afford.

Okay, but what do you mean 'can't afford?'

I'm actually not totally sure what that means. The point is that these are the key expenses that are under your control, and they're the ones that are big enough to make a difference.

I'm still not sure I'm following you.

When you go through your expenses, you'll notice that you spend more on housing and shelter—basically your rent and car payment—than on everything else combined. If you look at the government figures from the Bureau of Labor & Statistics (<https://www.bls.gov/>), the average family—and yes, I know, you're not average—spends about one-third of their total budget on shelter and roughly a sixth of the total budget on cars and car insurance and other vehicle expenses.

Those are the two biggest items, even more than healthcare—which I DON'T want you to scrimp on.

But what do I do? What are you recommending?

This is the bottom line: If your total expenses are more than your total income, then you should first think about cutting back to a smaller apartment. While you're renting, ask yourself: could I live in a smaller place? And could I trade in my car for a cheaper car that also uses less gas?

When it comes time to buy a house, find out what the mortgage, taxes and insurance will cost, and make sure it doesn't take your expenses up over the amount you take home every month.

If it means you are spending, total, more than 80% of your total income on various expenses, including that house, then you can't afford that house. Buy a cheaper one.

I thought you said this wouldn't be painful.

Do you want to make work optional, or not? Do you want to be able to afford trips abroad periodically?

The point, which we'll get into later, is that there are interesting tradeoffs that most people don't realize they're making. If you can downsize a little bit, in a month or two you'll fit comfortably in that smaller apartment and you won't even notice the fact that your car is a little less fancy, so long as it gets you where you want to go.

In the case of somebody like you, just starting out, you are starting to define your lifestyle. You're going to purchase your next car before long, and you're going to be moving out of college into your first apartment. Make sure that the expenses fit comfortably below your income, and the best way to do that is not to splurge

on a big apartment or a fancy car. Sharing rent probably makes sense. And before too long, the ride-sharing services will be sending out autonomous vehicles to ferry people around, and you won't even NEED a car.

All right; suppose I've done all that. So now I have to trick myself, right?

Here's what you do. When you deposit your paycheck, on that very same trip, you open up an account at another bank or (better yet) a credit union, and you write a check for that ten percent of your income and make a deposit.

Then, whenever you deposit your paycheck, you make a deposit at the other bank or credit union. And that other account, the savings account, you never write a check out of.

For starters, that's your emergency account.

But I have direct deposit of my salary.

Then you only have one trip to make. Just make that savings deposit right after every paycheck hits your account.

What if I have credit card debt?

That's part of your budget: pay off at least one-tenth of it every month, and after a year or so you won't have to worry about it. Then the credit card is used for convenience, where you pay it off every month.

Okay. Then what? Aren't I going to invest that money?

Yes. But first you need to accumulate roughly \$1,000 in that account, and keep that balance. We'll call that your emergency fund.

Is that a scientific number? Or did you just make that up?

I made it up. It's just a round number.

There's actually a lot of debate and controversy about how much each of us should have in our emergency fund. Some experts say it should be equal to your total salary for a year, others a half year, others not so much. But after hearing all those rules of thumb, I'm going to stick with my \$1,000 number.

Can you tell me why?

Two reasons. First, that's enough to get you through most emergencies, like the deductible on your car repair or the deductible on your medical insurance coverage or, for people who own a house, if the hot water heater goes out.

It is NOT enough to get you through being laid off for six months, which I would consider a real emergency. But there's a better way to put money aside for that kind of bigger emergency.

Plus, you want to start investing. Right?

Right. I think.

So put aside \$1,000, and then after your savings account grows bigger than that, we'll start putting money in one of those tax-free compounding accounts I referred to earlier.

Which are?

Since we're switching topics, let's leave that for the next chapter.

Chapter 2

Tax-Free Accounts Made Easy

You have two choices to have money grow without the drag of yearly taxes. You can open up a traditional IRA, or a Roth IRA. As of this year, you can put up to \$6,000 in one or the other.

Before I ask which one is better, how do I open one of those IRA accounts?

Any bank or discount brokerage firm will give you the paperwork. There are ways you can do it online. Here are a couple of links that I would trust:

<https://www.tdameritrade.com/retirement-planning/retirement-suite.page>

<https://investor.vanguard.com/ira/vanguard?WT.srch=1&cmpgn=PS:RE>

And...?

You fill out some information about yourself, to open up an account. Then you send them a check for the amount you want to invest, maximum \$6,000. Or, if you're all modern and fancy, you do an online transfer of money into the account.

So which is better? The traditional IRA or the Roth IRA?

Most people will give you the horrible answer: 'It depends.'

On what?

The traditional IRA lets you make "pre-tax" contributions, which means the money you put into the account is not counted in your taxable income.

If you are also contributing to a 401(k) plan through your employer, or a 403(b) plan (basically the same thing, but for nonprofits like colleges and hospitals), then there are additional limits you would have to know.

In that case, which doesn't currently apply to you, the IRA contributions are deductible (not taxed for income tax purposes) if your income is below \$64,000 for single people, \$103,000 for people who file their taxes jointly.

As I said before, the money grows tax-free until you take it out.

When can I take it back out?

If you take the money out before age 59 1/2, in most cases, you'll pay a painful 10% penalty, so you want to make sure you won't be needing your contribution for quite a few years.

And after I'm that old?

When you want to start taking your money back out, which is probably after you've finally quit working at the end of your career, you pay taxes on it just like you would on income. And after you reach age 70 1/2, you are *required* to start taking money out for retirement income.

I think I understand. What about the Roth thing?

With the Roth IRA, you can make basically the same contribution, but it's after-tax, which means the money is not deductible. The money you put into the account is counted in your taxable income. How much depends on your tax rate, which happens to be pretty low right now since you're just starting out.

Higher income earners, over \$137,000 (single) or \$203,000 (joint filers) don't qualify to contribute to Roths—but of course that doesn't affect you just yet.

Just like the traditional IRA, the Roth IRA money grows tax-free.

Is that tax deduction, or not, the only difference?

There are two others. Unlike the traditional IRA, when you take money out of a Roth, it is not taxed. At all.

So here's your choice: you either don't pay taxes on your *contributions* (traditional IRA), or you don't pay taxes on your *distributions* (Roth IRA).

The other difference is that there are no required distributions from a Roth IRA. You can just let the money build up, tax-deferred, for as long as you want.

So which is better?

There are fairly complicated calculations which basically show that if you expect to be paying higher taxes in the future when the money comes out than you are today, the Roth is mathematically the better option. If not, then the traditional IRA is better.

But of course, you can't predict what tax bracket you'll be in, or what taxes will be like 20 or 30 years in the future. So you can't make a calculation that actually means anything.

So do you think one is better for me than the other?

Yes. I would prefer the Roth IRA in your situation.

Why?

Three reasons. First, I suspect that tax rates are going to creep up in the future. That's just a guess, but a lot of people agree with me.

Second, I suspect that you're going to be making more money in the future, so you'll be in a higher tax bracket even if taxes stay the same.

Both of those guesses favor the Roth IRA.

But there's a bigger reason.

And that is...?

Remember that the traditional IRA locks up your money until you reach age 59 1/2. If you try to take money out before that, the government hits you with a 10% penalty on top of the taxes you have to pay.

The money you put in a Roth IRA can come out, tax-free, at any time. Not the *earnings* on that money, you understand, but the amount of your contributions can come back out without penalty.

So remember when I said that there was a better way to create an emergency account?

Yes.

This is it. Set aside \$1,000 in that savings-related checking account for fairly minor emergencies. Make your contributions to a Roth IRA, and consider your Roth contribution amounts as money you don't want to

touch, but that you COULD touch, without tax penalty, if you experienced a real emergency.

Wow! That's brilliant!

Well, your father is really smart, and I've been--

Okay, but after I put \$6,000 in this Roth IRA, what if I still have some savings money left over? Can I put that money into a traditional IRA?

Alas, no. The limit applies to both. You can contribute to one, or both, but only up to that limit. By the way, that limit goes up with inflation, so next year you might be able to contribute more.

So what do I do with that other money--assuming I have some above the \$1,000 emergency account, and above the \$6,000 I put into the Roth IRA?

You can open up a traditional investment account at the same discount brokerage firm. And you can send them a check, or invest that money online just like you do with your Roth IRA.

What do I invest in?

That's the next lesson.

Chapter 3

Investing Made Easy

I've got some cash in my Roth IRA and my investment account. And let's say we're in the future, and I also have made contributions to one of those 401(k) plans.

What do I do now?

Congratulations. You've done the really hard part. Pat yourself on the back. Most people take decades to get as far as you have--and you did it all in the first year.

The savings part was hard at first. But then it became kind of a habit. When I got a raise, I started putting some extra money in the account, and it felt good.

Okay, let's start deploying your investment portfolio. Right now, everything is in cash, right?

Yes.

In both the Roth IRA and the taxable investment account?

Yes.

So you have three broad generic investment options. We call them stocks, bonds and real estate.

I can already feel my eyes glazing over.

Instead, should I talk about inverse floaters and master limited partnerships that trade in commodities futures contracts?

Sure, if you want me to hang up the phone. So don't patronize me or make me feel like I'm stupid, but tell me exactly what a stock and a bond are so I have it totally clear in my head.

I'm actually making a point. The investment industry—call it Wall Street—does everything they can to make investing sound complicated and difficult, and they invent a lot of useless investments with complicated-sounding names and a lot of moving parts, which they try to sell you so that they can make a bigger profit on your money than you do.

I'm just giving you the basics, and this may be the most important point you'll hear: for 99% of the human population, maybe 100%, the basics are all you have to know.

When somebody starts talking about really tricky stuff that is different from what I'm about to tell you, just turn off your ears. There's no point in listening to that crap.

That's actually somewhat encouraging. So what are the basics?

Can we start with stocks?

Sure. I've always wondered exactly what a stock is.

A share of stock--we call them 'shares'--is a piece of a company. If you owned one share of Apple Computer, you would own roughly, last time I checked, about one 900 millionth of the overall company. They probably wouldn't invite you to sit on their board of directors, but you would participate in the growth of the company right alongside those people who own big chunks and sit on the board.

What do you mean: 'participate?'

I mean, when the company grows, when it sells more stuff and earns more money, it becomes more valuable overall. And your little tiny piece of it becomes more valuable right along with it.

So every day, the share price goes up?

Alas, no. This is probably the hardest thing to understand about stocks, but I can give it to you in about two minutes.

I just set that little timer thing on my phone. Ready, set--

I'll talk fast. The stock price, day-to-day, will go up or down for basically no reason whatsoever. That's true for every stock.

I REALLY don't understand that.

Actually, nobody else does either, so don't feel stupid. I certainly don't understand it.

Every day, every stock is bought by some people, and sold by other people, all day long. People are constantly buying and selling them.

In any given day, roughly 15 million shares of Apple Computer stock will be sold by one group of investors and purchased by another. The same is true, with different numbers of shares, for just about every other company that has what we call "publicly-traded" stock--which is to say, tens of thousands of companies, many of which you've heard of.

But what is it that makes those share things go up or down every day?

In every one of those transactions, there is a buyer and a seller. In every one of those transactions, they have to agree on the price the buyer wants to buy shares for, and the price the seller wants to sell for, and the two have to match.

All of this trading happens electronically through stock exchanges like the New York Stock Exchange or the NASDAQ stock exchange, which post the prices people want to sell for, and want to buy for, and it all runs like a constant endless auction, with prices moving up and down depending on how people feel about each of thousands of stocks that day.

That sounds like a total waste of time.

I completely agree with you. But unfortunately, there is no universally agreed-on way to decide what a company, or a stock, is actually worth at any given moment with any precision.

There's an old saying that an investment is worth whatever you can sell it for that day. And you don't actually know until you put your stocks up for sale.

So when stocks go up one day, and down another, or go up one year, and down the next, that's just a bunch of people guessing what the value really is?

Pretty much, yes. I could make it sound more complicated, and talk about sophisticated ways to analyze companies, and get into accounting numbers. But everybody has a different way to interpret numbers like “price-earnings ratio” and “earnings per share” and cash flow and a lot of stuff that goes into the guesswork of what a company—and a share of it—is worth.

The truest thing I can tell you is that the value of a stock, from one day to the next, from one month to the next, is a kind of a group guesstimate, and these guesstimates change unpredictably.

Why would I want to get involved in something like that?

You wouldn’t. As you’re just starting out, I recommend that you put your money to work in the simplest, cleanest possible way. You buy a basket of stocks—a big bunch of shares of companies all packaged up in a single investment, and let somebody else worry about the individual prices. You buy once and hold on through the ups and downs, and don’t get involved in trying to figure out whether it’s time to buy or sell.

Do I trust that ‘somebody else?’

If you follow my recommendation, you don’t have to.

What’s your recommendation?

You put the stock part of your portfolio into some index funds or ETFs.

My eyes are starting to glaze over.

Thanks for the warning. ‘ETF’ is short for ‘exchange-traded fund.’ An index fund is basically the same thing. Both of them are collections—baskets—of stocks; that is, they buy up a bunch of stocks that fall into a certain category. Large companies. Smaller companies. International companies. And they hold them in proportion to one of the indexes that you hear about on the nightly news.

Indexes?

The Standard & Poors 500 is a common one. It’s made up of 500 of the largest companies based in the U.S. The Russell 2000 includes 2,000 small companies. You might hear about the MSCI EAFE index, which is made up of large companies that happen to be based in different countries in Europe and Asia, or in Australia.

Okay, but what’s the point? Why am I investing in stocks at all if all they’re doing is bouncing around based on a lot of guesstimates?

That’s actually a great question, and I’d bet most of the people you talk to have no idea what the answer is.

A legendary investor called Benjamin Graham once said that short-term, the investment markets are a voting machine, but long-term, they are a weighing machine.

And that means...?

It means that day-to-day, week-to-week, even year-to-year, the price is largely moving up, down and around as a result of a lot of guesses, and emotions, and things that have nothing to do with the actual value of the company.

But here's the important thing to understand: long-term, if the company is growing, inventing new products, selling more, building factories, eventually that additional value will show up in the share price.

The price will still bounce around, but eventually it will bounce up and down around a higher number. That means the value of your shares will grow.

How can I be sure that will happen?

When you buy a broad basket of stocks, what you're really doing is buying a piece of the results of the labor of tens of millions of workers all around the country, or all around the world, who get up every morning and come to the office and make things, and design things, and come up with new ideas, and work together to expand the value of the companies they work for.

Long-term, taken together, those day-to-day-to-day efforts by tens of millions of workers slowly, incrementally produce incredible value.

THAT is what you want to participate in with the stock part of your portfolio. As all of these hard working people slowly, over time, grow the value of their companies, they grow the value of your stock shares.

Does the market always go up over longer periods of time?

You would be amazed at how much value, over time, all those people are generating. Remember that S&P 500 index I talked about earlier?

Yes.

The whole index was worth about 92 bucks back in 1970. Guess what it's worth today.

I don't know. A couple hundred dollars?

Almost three thousand dollars.

But the market does go down sometimes. Didn't you say that? What if it stays down?

So far, it has always rebounded from what they call "corrections"—meaning prices went down more than 10%—to reach new highs. If you hold a basket of one of the indices for more than ten years, you are almost certain to not only enjoy a positive return on your investment, but to beat inflation.

Inflation?

You know how things get more expensive, a little bit at a time, each year?

Yes. I think so.

That's inflation. One year a dollar buys, let's say, a loaf of bread. 20 years from now, it takes two dollars to buy the same loaf. So you have to have more dollars in the future to buy the same stuff that fewer dollars would buy today.

Okay, so I want the stocks I own to not only be more valuable in the future, but to become more valuable faster than the inflation rate. Right?

That's actually the best way you could possibly have put it.

And stocks will do that? Promise?

There is no written guarantee that I can provide you, but that has always happened before, even during horrible global wars and the scariest of economic events.

Okay, I have a dumb question. Instead of these ETF things, or index funds, why can't I just buy Apple stock and reap the benefits of whatever the Apple employees do each day?

You could, and many people do. But owning just one stock is very risky. What if iPhones started exploding in peoples' ears because of a manufacturing defect in Guangdong Province?

There has been a lot of research, which would make your eyes glaze over, which conclusively proves that you are highly likely to get more return with less risk if you own at least 50 companies than if you confine yourself to just one or two stocks.

So the bottom line is that when you invest in stocks, you want to buy a package of many stocks. This is called 'diversification.' It's a safer way to invest.

And you recommend ETFs and index funds.

At first, and for a beginner, yes. There are other options, called actively-managed mutual funds, which also buy packages of stocks for you.

What's the difference?

The ETFs and index funds I would recommend are what we call passively-managed. That means that instead of having somebody do a lot of research to decide which are the best stocks to buy, you get a specific group of stocks that is predetermined in advance. 'Passively-managed' basically means that nobody is making specific decisions about which stocks to buy based on those informed guesses I was talking about earlier.

All that research effort and management input and expensive experts that are employed by actively managed funds all costs money. So the ETFs I'm recommending tend to be less expensive; that is, they take less money out of your account every year to pay for their services. Sometimes a LOT less, as in the difference between 1% and practically 0%.

But if those active managers are doing the work to identify the best stocks for me to own, won't I get a higher return if I invest with them?

That's the single most surprising thing about investing, the thing that after 30 years I still have a hard time getting my head around.

The answer, from a statistical standpoint, is no. On average, historically, the passively-managed ETFs or mutual funds have delivered higher returns than 70% of the actively managed mutual funds, consistently, over rolling 5-year and 10-year time periods.

That doesn't make any sense whatsoever.

I agree. I've read hundreds of explanations, which suggest that the managers ARE beating the market, but not by as much as they're charging, or that larger pools of money have trouble investing nimbly in and out of the markets, or the tax drag on constant buying and selling causes active managers to underperform. Or all three.

But the most persuasive research I've seen seems to suggest that all those active fund managers are kind

of canceling each other out. That is--and this is an oversimplification of an analogy—they're all searching the same street for lost nickels, and because there are so many managers looking on the street and they are so good at searching, there are very few nickels to be found.

So shouldn't I invest in the 30% of the active managers who are beating those index funds?

That's another problem. Sometimes one fund or group of funds is beating the heck out of the market, and then they fall back in the pack and others rise up and beat the market--and it is almost impossible to tell from track records of 20 years or less whether a manager who is doing really well is riding skill or luck.

Most of the time, great short-term performance seems to be the result of luck, and it suckers investors into a fund with great performance one year, and then, as soon as they rush in with their money, the fund sinks back into the pack and underperforms the next.

The net result is that people who try to buy actively managed funds with a great short-term track record (we call them 'hot' funds) get less return than the overall market. We'll talk about that in the next section of your lessons.

Please don't get me wrong; I have nothing against active fund managers. Some of them--including many I have personally interviewed over the years--are genuinely brilliant people, and some of them are finding those nickels much better than others as a result of superior intelligence, skill and methodology.

But I don't think you should even think about trying to find those rare individuals when you're just starting out.

When you get up to \$250,000 in your investment accounts, you'll have the money to hire somebody who can guide you through the nuances of investing.

Okay, so can you tell me which stock ETFs or index funds I should invest in?

Yes. In general, I think you should start with a basket of larger companies based in the U.S., with some ETFs or funds that invest in international companies mixed in, and some ETFs that invest in real estate and bonds.

Before we go any further, can you help me understand, what ARE bonds?

Bonds are basically IOUs. That's the simplest, most accurate way to think about it.

You give the U.S. government a certain amount of money--that is to say, you buy a Treasury bond--and the government promises to pay you a certain amount of interest twice a year over some period of time—from six months to thirty years. It also promises to repay the full amount of your loan--what we call the "face value" of the bond--at the end of that time period.

It works the same way with corporate bonds. A company borrows a certain amount of money from you, which means you are buying its bond, and the company agrees to pay you a certain amount of interest twice a year and then repay the loan at the end of that time period.

We call that buying a corporate bond.

You can also lend money to a municipality, like a state, a city or a particular project that the state or city is working on. Those are called municipal bonds, and they work the same way.

I don't recommend, at this stage, that you invest in muni bonds, as they are called, but you should know they are another option.

In each of these cases, you are really lending, not buying. But "buying bonds" is the term everybody uses.

What time periods are we talking about?

With Treasury bonds, it can be any of the following: three months, six months, a year, three years, five years, ten years, 20 years or 30 years.

The longer the time period, in general, with very rare exceptions, the higher the interest you'll get.

With corporate bonds, the time periods can be anywhere from one year to 30 years, and there are even some newfangled bonds that never mature.

Once again, loaning money over longer time periods--buying bonds with 'longer maturities,' as the pros call it--will get you higher interest rates.

Maturities?

If it's a 20-year bond, we say that the bond has a '20-year maturity.' All that means is that you get your money back at the end of 20 years, guaranteed, unless the company or the government goes out of business.

Since it is far more likely that any particular company will go out of business than the government, corporate bonds generally pay higher interest, to make it worth your while to take that extra risk. Different companies pay different rates, depending on their credit ratings.

How does that work?

Some corporate bonds are issued by companies that are considered somewhat riskier--that is, their chance of going bankrupt is greater--so they have to pay you a higher interest rate than more stable companies. We measure this by the ratings: higher-rated AAA 'paper' (as bonds are sometimes called) is considered less risky than bonds rated AA, or BB, or B, and anything with a C in the rating is probably riskier than you want to deal with.

Does the interest rate change? I think I read that it does.

Interest rates go up and down just like stocks, but not nearly as quickly or to the same degree as stocks. That doesn't change the rate you get for your bond unless you're invested in more complicated vehicles called floating-rate bonds, which I don't recommend.

But whenever interest rates go up, the value of a bond you own will go down.

Wait; I'm not sure that made sense.

Some people can never get their head around this, but it isn't really that complicated. If you buy a 2-year bond that pays 5% interest each year, what happens if bond rates suddenly jump to 6%? Would somebody want to buy that bond from you that only pays 5%?

No. They'd want to buy the new ones and get a higher rate.

Right. But what if you offered to sell the 5% bond you're holding at something less than what you paid for it? Then somebody might want to buy it, because they'd get your 5% plus something extra when the bond matures.

I'd be selling my bond at a discount.

Wow! You're actually picking up on the terminology.

All this really means is that the market value of your bond went down on the open market because interest rates went up--and a bond trader can figure out mathematically how much value it lost based on the new interest rate.

That isn't so complicated, is it?

No, it isn't. And if interest rates go down, my bond is more valuable?

Yes, for the same reason. If the newer bonds are only paying 4%, then a buyer would have to give you more than you paid for the bond, or else you wouldn't give up your 5% interest payments. It's all very mathematical and precise in the world of bonds.

So whenever you invest in bonds, you have two kinds of risk. You have what we call 'interest rate risk,' which is the danger that rates will go up while you own your bond--and of course, that risk is greater when you buy a 20- or 30-year bond than when you buy a bond with a one- or a two-year maturity. A lot more unexpected stuff happens over 30 years than over one year.

And then there is 'credit risk,' which is that risk I was talking about where the company might go bankrupt and not be able to pay back some or all of the money you lent to it.

What if I don't want to take any credit or default risk at all?

The shorter the maturity, the less you are exposed to those risks. The shortest borrowing time is a money market fund, which generally lends money overnight and collects the next morning. Of course, because the risks tend to be lower, money market funds pay the lowest interest.

But--I want to make sure I understand this--no matter what interest rates do, if I hold the bond all the way to maturity, will I get all my money back?

Yes. Because of that, and because interest rates are less jumpy than stock prices, bonds are considered a more stable investment than stocks.

So I should invest mostly in bonds, right?

Well, the problem is that bonds just pay you a fixed amount, while stocks let you participate in the growth of the U.S. or global economy.

This introduces an investing concept that some people think is really complicated. In general, the riskier the investment, the more return you can expect to get. The more return you DEMAND, since you're taking on more risk.

Since stocks jump around in price more than bonds, they are considered scarier, a.k.a. riskier, and so therefore they also tend to give you higher returns.

There's actually a fancy term for this. It's called the 'risk premium.' The equity risk premium basically means the difference in average yearly return between risky (or volatile) stocks and a totally safe investment like short-term government bonds.

How much is this equity risk premium thing? How much more can I expect to earn if I invest in stocks instead of bonds?

There's a whole world of research on this subject, and of course it depends on whether we are talking about smaller stocks, which generally return more than larger ones, or international stocks.

But if you blend all these studies together, the equity risk premium, the excess return you get from the stocks of bigger safer companies over the return you would get from the safer sort of bonds, has historically ranged from four percentage points to six percentage points a year. If very safe short-term government bonds are giving you a risk-free rate of return of, say, 2% a year, then you can expect to get, on average, over longer time periods, 6% to 8% a year from the stocks of large companies.

This number has been different over different historical time periods. Some people think it is trending downwards while others think it might be rising.

The number is meaningless for any single year, because stocks might bounce high or low. But the thing to understand is that you tend to make more money, over the longer-term (say, ten years or more) as an owner of companies than as a lender.

So I shouldn't invest in bonds at all?

I didn't say that. Actually research has shown that if you invest in a mix of different kinds of stocks plus bonds, then you tend to make a higher long-term return than if you leave out any of those ingredients.

What kind of bonds should I buy?

My recommendation is that you not buy individual bonds at all. If you tried, you would get taken directly to the cleaners. In my opinion, bond dealers are among the shadiest people in the investment markets.

Instead, once again, buy through ETFs and index funds. It's easy and cheap and accomplishes the same thing--except that you get to own a bunch of bonds instead of one or two, which is actually safer.

So I should have some bonds in my investment portfolio?

Yes.

And some stocks of big companies. And some stocks of smaller companies. And some stocks of foreign companies.

Yes.

Anything else?

There are a variety of other types of investments--professionals call them 'asset classes'--but the only other one I would recommend that you look at is real estate.

Like hotels and shopping malls?

And industrial facilities, warehouses, skyscraper office buildings, undeveloped land in premium locations and maybe a casino or two.

Right now, I can't even afford a rundown house. How am I going to afford all those things?

Real estate is another area where people go to work every day to create value, developing, building, maintaining and renting out properties that are essential in our ever-growing economy. You want to participate in that growth.

How?

Two ways. First, there's Real Estate Investment Trusts, which investment professionals call REITs. Those are like mutual funds that invest only in real estate, usually a diversified portfolio of different properties in different locations around the country.

Some REITs specialize in different types of properties, and some specialize in making loans to develop-

ers or buyers of properties. They're a little bit different from mutual funds in that they have to pay out to investors like you at least 90% of the income they receive from their activities. But the idea is the same: you buy a share of a REIT and participate in its growth, the same way you would buy an ETF that invests in stocks.

Can you tell me which REITs to buy?

With real estate, I would add another layer of protection. Since you probably aren't going to be very good at evaluating or keeping track of individual REITs, I would recommend, once again, that you invest through an ETF or index fund that invests in different REITs.

Okay. Anything else?

I don't think so. Not until you get up near the million dollar mark, and maybe not ever. At that point, you should be talking to a professional advisor, who will also help you with taxes and a lot of other complicated things that aren't really relevant to your life at the moment.

Maybe it's time for you to tell me which ETFs and index funds I should invest in. Right?

Now you're building what they call a "portfolio." That's a fancy word for a mixture of different assets—U.S. stocks, international stocks, and bonds. And maybe some real estate thrown in as well.

There are literally thousands of different investment options to choose from. I'll give you the fund or ETF and also the CUSIP, which helps you tell the trader exactly which fund you're buying.

Fidelity Total Market Index Fund (FSTMX)

The iShares Core S&P Total U.S. Stock Market ETF (ITOT)

The Schwab Total Stock Market Index Fund Index (SWTSX)

The Vanguard Total Stock Market Index Fund (VTSMX). (This also comes in the ETF form, with the cusip VTI)

In the total international stock market:

iShares Core MSCI Total International Stock ETF (IXUS)

SPDR MSCI ACWI ex-U.S. ETF (CWI)

Vanguard FTSE All-World ex-U.S. Index Fund (and ETF) (VFWIX or VEU)

Vanguard Total International Stock Index Fund (and ETF) (VGTSX or VXUS)

For real estate:

Fidelity MSCI Real Estate ETF (FREL)

iShares Core U.S. REIT ETF (USRT)

Schwab U.S. REIT ETF (SCHH)

Vanguard Real Estate Index Fund (and ETF) (VGSIX or VNQ)

For the total U.S. bond market:

iShares Core U.S. Aggregate Bond ETF (AGG)

Schwab U.S. Aggregate Bond ETF (SCHZ)

SPDR Portfolio Aggregate Bond ETF (SPAB)

Vanguard Total Bond Market Index Fund (and ETF) (VBMFX or BND)

American and foreign stocks, bonds and real estate. How much of my total money should I put in each?

Now we're talking about something called 'asset allocation.' That's a fancy term for how much of each different asset class you want in your 'portfolio.'

Let's leave that to its own chapter.

Chapter 4

The Straightforward Approach to Asset Allocation

Okay, so I have this Roth IRA, and also a taxable investment account, and maybe someday a 401(k) plan. How much should I put in American stocks, international stocks, bonds and real estate?

I have no idea.

What?!? After all those years of—

There are a lot of scientific studies on what percentages to use, but they're all based on guesswork. You'll hear people talk about the 'efficient frontier' of investments, which means the best mix of different assets per amount of risk you're taking on.

But there's a big problem with all those studies. To know the ideal mix of investments, you would have to know what future returns you'll get from all those different categories of investments, and how much they will move up or down in tandem in the future compared with today.

But of course we don't know those things in advance. I don't think we ever will, until somebody comes up with a working crystal ball—which would really make investing interesting.

So I should give up?

I didn't say that. I think you can give up imagining that you can create a mix of these investments with any degree of precision. Even the experts, who are very smart and charge a lot of money, can't agree on the right mix.

But you do have a recommendation for me. Right?

I think you should keep it as simple as possible. One thing the experts all agree on is that it will be beneficial to divide your holdings among different types of investments, and it will be beneficial to rebalance with the new money you invest.

So if you're asking me how to do this, I would have you divide the total amount of your portfolio into four parts.

Start by putting a fourth of your money in the large U.S. companies, a fourth in bonds, a fourth in international stocks, and a fourth in REITs.

All at once?

Not necessarily. In the first year, you can start by putting money in the large company ETF, and then, when you feel comfortable with that, put money in the international stock ETF, and then put some money into the other asset classes gradually over time until you have the percentages the way you want them.

Remember, this isn't some precise, scientifically-determined allocation. There's nothing magic about it. So you can take your time building the portfolio.

In the Roth, or the discount brokerage account, or what?

There's a lot of theory around "asset location," which is a fancy way of saying which accounts should hold your stocks, and which your bonds. But I wouldn't worry about that in your first years of investing. Just keep the same percentages in each account for now.

When you get above \$250,000, you can get a little more scientific about it, and start allocating different types of investment to your Roth IRA or taxable account to give you the best tax profile. By then, you'll actually know how to do it. Or you'll be able to hire somebody.

I read that there are online websites that will take my money and give me a precise asset allocation.

There are. They do more or less what I am telling you to do here, except they charge you for it and they pretend that they can know, scientifically, the precise percentages to allocate to get the best return per unit of risk.

I think for starters you can do these things yourself, and you have the benefit of not fooling yourself that you can know the future.

Okay, let's say I have the percentages the way I want them. What if one of the groups goes up and another goes down? Won't that change the percentages?

That's an extremely perceptive question. And it WILL happen.

But the answer is pretty simple. When you build up enough in that bank savings account to put more money in your Roth IRA and traditional investment accounts, do a quick calculation of the current percentages. Then invest more in the ones that are below those figures and less in the ones that are above, to constantly bring them back toward the original percentages.

The fancy term for this is 'rebalancing.' It's a great discipline, because it means you're adding more of your money to the things that have gone down, and less to the things that have gone up.

That sounds exactly backwards.

It isn't, though. Let me walk you through an example. Suppose you have 10 shares of two investments, each worth \$1 a share, so both investments are worth \$10.

Okay...

Stock A goes up 50 cents a share, and Stock B goes down 50 cents a share. On balance, you're exactly where you were before, with \$20 worth of investments.

Then you put \$5 more into the account. Where is it going to go?

Into the one that lost money? Is that what you said before?

Right. You buy 10 shares of Stock A at 50 cents a share, and don't put any money into Stock B shares. Now you have 20 shares of Stock A and 10 shares of Stock B. You have invested a total of \$25 altogether.

I'm with you so far.

Now suppose that Stock A goes back up 50 cents a share and Stock B goes back down 50 cents--the reverse of what happened before. Both stocks are back to selling at a dollar a share, as if nothing ever happened--except that you now have 10 more shares of Stock A than Stock B.

Right?

Yeah. So?

You've invested a total of \$25--the original \$20, plus the \$5 you put into the losing stock. During this time period, each stock went up and down by exactly the same amount, so they are trading at \$1 a share, just like they were before.

If you had not added that extra \$5, if you had not rebalanced, your return would be zero. Right?

Right. Of course.

Yet now you have \$30 in your account, not \$25. You have 20 shares of one stock and 10 of the other, all at \$1 a share. You made five dollars.

Wait; how can that be?

It's an extreme example of something that happens all the time. Stocks are constantly bouncing around. But if you consistently buy shares when they're cheaper, and rebalance back to the original percentages, you can make additional money that has nothing to do with the overall success of your investments.

This isn't guaranteed, of course, but it's always better to buy when stocks are on sale than when they're overpriced. And of course that goes totally against what your instincts tell you to do.

I'm still a little bit worried about the way stocks go up and down all the time. Why do I have so little money in bonds?

This asset mix is just a simple suggestion. If you're uncomfortable having so much in stocks, if the portfolio bounces around too much, then you can put a higher percentage in bonds. This is your money, not mine.

But there's an easier way not to get freaked out about the up and down movements of the stock market.

What is that?

Just don't pay attention. Check the percentages when you put new money in and rebalance, and let the market--that is, those tens of millions of hard-working company employees--do their thing.

Stocks will do scary drops from time to time, but it won't scare you if you aren't watching the (extremely boring) investment cable channels every day or reading the Wall Street Journal every morning.

But wait. Shouldn't I pay MORE attention when I have money invested, so I can move out of stocks when they're going down, and back in when they're going up?

No.

Why not?

I've spent 30 years looking at what is commonly known as market timing, sometimes known as dynamic asset allocation, sometimes described as shifting assets around to avoid market downturns. I'm not totally convinced it can't be done, but I know that I, personally, can't read the papers, or listen to the experts, and then predict when markets are going to go down, or even if markets are in the process of going down, or just having a bad week or two.

It's possible that nobody else can either, despite billions of dollars and genius-level IQs thrown at the problem.

One thing I'm sure of is that YOU won't be able to do it as you start out as an investing beginner. Another thing I'm sure of is that most people who try this end up hurting themselves.

How so?

There have been a lot of studies showing that people tend, on average, to put more money into stocks after stocks have gone up, and to sell stocks after they've gone down. It's human nature. But what does that really mean?

I give up. You tell me.

It means that they're selling stocks after they've gone on sale, and buying when the price has gone up. You wouldn't buy and sell that way at the mall, would you?

Never.

Then why do it with stocks? This is just another version of the mistake where you sell the mutual fund you already own because it hasn't been doing very well, and buy a fund that went up dramatically. If you add up all the millions of transactions where people were trying to reposition their money in order to gain an advantage--which researchers have actually done--you find that the more they move around, the less high their returns are.

They lose money trying to outsmart the market.

For just about all of us, buying and hanging on and rebalancing back to the original allocation is a strategy that beats just about everything else.

And it's easy and uncomplicated. You don't have to waste your time thinking about things that you don't enjoy thinking about. What's not to like?

Okay, I think I have a pretty good handle on how to invest. Do I do the same thing with my 401(k) account when I have one?

Pretty much. The difference is that your 401(k) account will have specific investments for you to choose from. Instead of tens of thousands of choices, you might have just 20 or 30.

And they won't be the ones you recommended earlier?

No. Probably not.

So what do I do then?

I think the easiest way to navigate this is to find a broad stock index fund--there is usually one of those in the mix--and put all your 401(k) money in there. That may not be a perfect solution, but it has the advantage of being easy, and will keep you out of some of the overpriced options that the plan might be offering.

Then, whenever you invest in the Roth IRA and your taxable account, add up the total from all three accounts, and then calculate it down to those original percentages. See how much you have in the 401(k) plan's broad stock investment, and add around that so that the overall mix is consistent with the percentages you want.

You'll do this differently when you have at least \$250,000 in your investment portfolio--because there are tax reasons to have certain investments in taxable or non-taxable accounts. But for now, with the investments I'm recommending, this approach won't hurt you.

Anything else I should know?

Not really. Eventually, you'll want to know the best tax-efficient ways to take money out of your various accounts if and when you stop working, and you'll want to do some serious tax planning as you get into the higher income brackets.

But in general, if you can save ten percent of your income, and maybe a little more, with some set aside for really great fun things, you'll be ahead of the great majority of all people.

If you invest in the kind of investments I'm recommending, you'll get a better return than most really smart professionals are getting.

If you do systematic rebalancing the way I recommended it, you may get an extra kick in your returns--and even if you don't get any extra boost from buying at lower prices, you'll get the full benefit of the returns that the market offers you, which studies show is a much better return than most investors--even professional investors--get.

And if you make a pledge not to waste time reading about what the markets did yesterday or predictions on what they will do tomorrow, you will save yourself a lot of aggravation—and maybe also some money.

It can't be this simple.

That's the funny thing about it. It can.

And after going through this one-hour tutorial, you now know more about saving and investing than just about anybody else you're likely to meet, and everything you really need to know until you've accumulated significant wealth.

Yes, this is hard to believe. Because you're my daughter, and you know that I love you and only want the best for you, I think you know that I wouldn't lie to you or hold anything important back.

Don't you?

Yes. Thank you. But I think I might be ready now for some more advice on budgeting.

Why?

One day I wanted to go out to eat, and didn't have enough money in my account. And I started to wonder: what am I going to use this saved-up money for?

Sigh. That opens the door to all the bad budgeting advice I was steering you away from before. But it DOES help to know where your money will go in the short term as well as the long term.

Let's make that a new chapter, shall we?

Why not?

Chapter 5

Microbudgeting

You said once to me that I should spend money “intentionally,” but you never explained what you meant.

I meant that most people get into spending habits kind of on auto-pilot, without actually setting clear goals for what they really want their money to do for them. Do they want the money to buy coffee every day or do they want the money to accumulate for a nice trip somewhere? Do they want the money to go to a nicer car, or to pay for their son’s college education?

It can’t do both?

The challenge is that you can’t spend the same dollar twice. You have to decide on one thing or the other.

So what do you recommend that I do?

I think it helps to have some shorter-term goals--something you really want that isn’t nebulous like “retirement.”

When you didn’t have the money to eat dinner at the restaurant, you made what we call a “lifestyle sacrifice.” It made your life less fun.

But I think you want to give yourself MORE fun as a consequence of not doing some of those fun things.

I’m not sure I follow you.

A lot of people go to Starbucks every morning. Right?

Actually, I do that. Not every morning, though.

And you get the pleasure of having an excellent cup of coffee made the way you like it, as opposed to drinking the brown sludge from the coffee maker at work. Right?

The coffee at work actually isn’t too bad.

My point is that the money you spend at Starbucks, and at the taco place, and at a restaurant, could be set aside for a more interesting goal.

Like what?

Let’s guesstimate that you spend \$15 a week on Starbucks, and another \$15 on--whatever. It might be a fast food lunch a few days a week when you could pack your own lunch for much less. Add it up and what do you get?

You’re the math wizard.

\$30 a week times 52 weeks comes to \$1,560—that's how much you would be spending in a year on fairly minor pleasures. Right?

I guess so.

So look at the \$1,560--and if you invested it, it would probably be more--and think about whether there is a MAJOR pleasure that the same money could buy.

Like what?

That's up to you, but I can give you some suggestions. The money saved by packing a lunch and drinking your coffee at work could be more than the total cost of a one-week trip to Europe. It's more than the cost of a week on a cruise ship. It's a living room suite plus a nice TV screen.

You really have to decide which you want more, the incremental pleasures of going out to eat on a regular basis (the trip to Starbucks, the fast food lunches) or... the big vacation trip, or the living room suite--or anything else you can think of.

So you're saying--

All I'm saying here is that instead of settling for small lifestyle pleasures, why not give yourself a couple of really big ones? That's all.

In the context of a nice trip to Paris, having to drink the office coffee and make your own lunch isn't such a bad trade-off. Is it?

No; it actually sounds pretty nice.

My point was that ALL the money doesn't have to be invested for some nebulous future. You can save more than 10% of your income, and some additional money can be set aside for shorter-term goals that will be fun and rewarding.

Point made. Now you said that someday I should hire somebody to help me with my finances. What if I have questions that I want answered, and you're not there to answer them for me. What do I do then?

That's the subject of the last chapter.

Chapter 6

Insurance Stuff

I hate to keep bothering you, but I have some more questions.

You're not bothering me. What's up?

I have to buy my own car insurance this year. So I called a company, and got this really pushy insurance guy who wants me to spend, like, a third of my salary on insurance or else I'll be really sorry.

I'm sorry you had that experience, but I'm afraid it's not unusual. There are a lot of types of insurance, and some of the people selling it are, shall we say, a bit overzealous. A cynic might say this is because they're normally paid a commission based on how much they sell you. So they don't have a lot of incentive to help you save or shop wisely.

I know this sounds weird, but I actually don't really understand what insurance IS or what it's supposed to do.

Insurance is actually one of the great inventions of the modern world.

You're kidding, right?

Insurance is risk pooling. What that means is that everybody has huge gigantic terrible financial risks hovering over them all the time. Like, for example, getting in an accident and totaling your car. Or coming down with a terrible and expensive disease like cancer. If you got into a wreck, you'd have to buy a new car and you might have to pay for the hospital costs of the people in the other car.

Right. That's why I'm such a careful driver.

But you still have those risks, right?

Yes. I guess so.

Like when I saw you talking on your phone when you were pulling out of the driveway the other day.

You weren't supposed to see that.

The point is: you don't have the money to afford the consequences when they happen, right?

I couldn't buy a new car out-of-pocket. Or pay for cancer treatments.

And truth to tell, pretty much neither can the rest of us. But fortunately, not everybody has these terrible things happen to them. So what do you do?

I give up.

You create a company, called an insurance company. You get a lot of people to pay a small amount of

money every month, and in return, when something terrible happens, instead of them paying for it out of their pockets (which they probably can't afford), the company takes some of the money it's collected from all the lucky people who didn't get in an accident, and it pays for fixing up the car and the hospital bills. Presto! Some of the financial risks of life are finessed away, and our journey through life is smoother as a result.

So what should I do with this insurance guy?

First, understand that there are different kinds of insurance, and they all take away some of the risk of normal living. This person sells auto insurance, which takes some of the financial risk out of driving a car. There's also health insurance, which takes in monthly payments--the payments are called 'premiums' for some reason--and pays some or all of your medical bills, so you don't have to live in fear of going to the hospital. There's life insurance, where you pay in a certain amount every month or every year, and somebody gets a certain amount of money when you die. There's renter's or homeowners insurance in case you're robbed or your house burns down. And there's disability insurance, and long-term care insurance.

My budget is doomed.

You don't need all of those right away, but you should at least understand how they work. They all have one other thing in common.

What's that?

Insurance companies all make a profit. That is, they take in more than they pay out, year after year.

So?

So that means you should only insure for the kind of disaster that you can't pay for out of pocket. Like, remember when we talked about having an emergency cash reserve fund?

Yes.

If you have \$1,000 in your cash reserve fund, then if something happens to your car that costs less than \$1,000, then you can pay for that, and you don't need to rely on the insurance company.

Why does that matter?

Now we're back to the car insurance guy. You can buy coverage that pays for everything that happens to your car, or you can pay for coverage that pays for anything that happens that cost more than \$1,000. You can basically choose your 'deductible,' is what they call it. The deductible is just the amount that you'll pay yourself before the insurance company steps in.

Let's go over that one more time. Just to make sure I've got it.

Let's say you're talking on the phone while driving--not that you would ever do that--and you heard some really exciting news, and you took your eye off the road and ran into a telephone pole. Let's say your car was worth \$20,000, and now you have to replace it. You would pay \$1,000 and the insurance company would pay everything else. If you had a \$2,000 deductible, the insurance company would pay everything over \$2,000. Got it?

That's not too hard.

So first of all, you should select a deductible you can afford, and you wouldn't believe how much just that alone will reduce your premium.

Okay. What else?

Then only buy collision insurance for what your car is worth. If your car is worth \$20,000 today, it probably will be worth less tomorrow, especially with how you never wash it.

So I only buy collision insurance for the value of my car.

Right. And after four or five years, you can probably drop it altogether. Most people are still paying for coverage they'll never collect on, because the insurance company will only reimburse you for the actual value of your car. That leaves liability coverage, which pays for the hospital costs and damage to the other person's car. You should probably get the minimum required by the state, for now, and as you get wealthier with all the investing you're to be doing, you can raise that as you go along.

But how do I know this insurance guy is charging me a fair price?

Shop around. Go online and put in your deductible, and your collision amount, and see what prices different companies are offering. If you do those three simple things, you'll end up getting a better price for your coverage than 95% of all consumers.

Okay, but what about all those other types of coverage? Like health insurance.

If I remember right, you get health insurance through where you work. Right?

Yes. They take money out of my paycheck every two weeks.

So you don't have to worry too much right now; that's probably your cheapest option. But if you did have to buy health insurance on your own, it works pretty much the same way as auto insurance. You figure out how much you can pay out-of-pocket, which might be that same \$1,000, and then you go online. The insurance coverages are all relatively standardized now, and picking a higher 'deductible' can save you a ton of money.

I think you mentioned renter's insurance. Is that the same thing?

If your apartment is destroyed by a fire or you're robbed, your landlord won't cover the cost. You probably want to select "replacement cost" coverage, which will pay to replace whatever you lost. The policy should also pay for your legal defense if you cause damage or injuries if people who visit you fall or your dog bites them or they have another kind of accident, and pay some of their medical bills.

Just like auto insurance, you pick a deductible, and shop online--and the higher deductible, the lower the premiums are going to be. Just make sure you can afford the deductible. Same with homeowners insurance when you finally own a house. Chances are your house isn't going to burn down, but some do every year, and the insurance companies are there to cover the cost of rebuilding.

So what about life insurance? What's my deductible there?

Life insurance--and also disability insurance--are there to cover the value of your future earnings in case you die young. But those are mostly there for married couples who have a child.

I'm not sure I follow you.

Suppose, God forbid, you died tomorrow. Who would suffer a financial catastrophe?

Nobody.

Right. Because nobody relies on your income right now. But suppose you get married to that really nice gentleman that I introduced you to who comes from a good family and has a much better job than your current boyfriend.

He says he's started looking for a job.

So now you're married, and you have a baby. You're a two-income family. What would happen if you died?

He might have to quit work to take care of the baby.

What would happen if he died?

We'd be a one-income family. Either way it would be a financial mess.

So both of you buy life insurance. If either of you dies, the insurance company would pay a lump sum amount to the survivor which would help you get by financially.

I know from personal experience that this can be a real life saver. When your grandfather died young--he was 49 when he passed away, and I was in college--we were fortunate that he owned a life insurance policy. My mother was able to pay off the house, and she had to go back to work, but it was part-time work while she raised my sister.

Do YOU have life insurance?

I did until the last of you were grown. And then I didn't need it any more. Once you retire or get near retirement, you hopefully have enough saved up that the family can go on if you die. That's especially true when the kids are grown up and out on their own.

One more thing: I would recommend that you buy 'term' insurance rather than the various other kinds.

I'm not sure I understand.

There are two basic types of insurance. One of them is just covering the risk of death. You pay a 'premium' every month or year, and they pay your survivors a certain amount when you die. You designate who gets that money: that person is called your 'beneficiary.'

And the other kind?

There are a variety of flavors: whole life, variable, universal, variable-universal life, but what they have in common is that you are investing with the insurance company, and the investment account is growing, and

also paying the insurance premiums each year.

What's wrong with that?

For somebody just starting out, just avoid the complexity. When you have somebody relying on your income, in your early stages, I recommend keeping it simple. Go online and compare prices, and buy inexpensive term and you know what you're getting.

And didn't you say that there's disability insurance and long-term care insurance?

Same idea. Disability is like life insurance, except that it covers the possibility that you're injured and can't work any more. It pays you a monthly sum to replace the wages you would have been earning. If you can get this through your work, then you should probably buy it. Otherwise, I'd just keep that in the back of your mind, that if your income goes up, at some point you want to protect it.

And long-term care--?

You don't need to worry about that until you're in your 50s. That pays for retirement home care and specialized home care if you get too old or feeble to take care of your self, or if you have dementia. Those costs are very high and rising fast, so as you get older, you should probably consider risk pooling the potential costs away.

When you do, remember that you can self-insure some of the costs. If you buy a policy that will only start paying after you've been in a facility for a year, or only pays for three years in a facility, the cost of the policy goes down a lot.

Did that help at all?

Well, I won't be intimidated by that pushy auto insurance guy. In fact, I think I'll just bypass him altogether and do my auto insurance shopping online.

And you'll stay off the phone while you're driving?

Of course, daddy.

Chapter 7

Getting financial advice one stage at a time

Okay, I think I know enough to get started. But I'm sure I'll have a lot of questions as I go forward. Where do I got to get guidance and advice?

There's a lot of information online these days, so when you have a specific question, just type the question into Google.

There's even a website which is specifically set up by and for Millennials like you, called NerdWallet. It offers a lot of basic information about student loans and other debt, about credit card rewards programs, traveling on the cheap and all sorts of other things that are relevant to you at this stage of life.

Is there anybody I can talk with that I can trust?

There is a whole profession that gives financial advice, and it's made up of a bunch of different flavors.

This isn't going to be complicated, is it?

I'll keep it very straightforward, because my advice really is pretty simple. But I want you to know who the professionals are, so you have some idea what you're dealing with.

Okay. Where do I start?

Let me start with the people you want to avoid. There are professionals who, in my opinion, are really sales people in disguise. They work for large brokerage firms like Morgan Stanley and Merrill Lynch. They call themselves financial advisors, and they give advice. But they aren't required to give advice that is in your best interests.

How come they can call themselves advisors then?

Beats me. My point is that in your novice condition, you're best off avoiding them altogether. You wouldn't know if they were selling you something to line their pockets or giving you good advice.

Thanks for the warning. What else?

There are advisors who basically manage assets. You won't be able to get in to see a lot of the more established firms until you have at least \$250,000 worth of investments, and there are many who don't work with anybody with less than a million or two.

So I don't have to worry about avoiding them. They're avoiding me.

Right.

So what's left?

I recommend that you take a two-step approach. First, when you're just looking to have a few questions answered and your finances are pretty simple, there are professionals--mainly young professional advisors who have good education and training--who will help you organize your finances and be on call to answer any question for a monthly subscription fee, like your cable bill.

But I thought you said I wouldn't be able to afford a financial advisor.

You can't afford some of the older advisors who mostly manage assets. But there are younger advisors, not much older than you are, who charge by the month to give you advice.

When you get to that point where you want a coach and thinking partner about finances, you can pay \$100 or more a month for an assessment and an ongoing relationship.

Who do you recommend?

There are actually a lot of established financial planning firms that now work with younger people, and when a younger person has parents who are working with an advisor, that's the first place I would inquire.

If the parents' firm doesn't offer services for younger or less-wealthy people just starting out, then there are other options. For instance you could go to the website of the XY Planning Network (<https://www.xyplanningnetwork.com/>), and be very specific about who you are and what you do for a living, and ask them to recommend somebody who works with people like you.

Chances are, you and this person can work remotely through Skype or whatever that Google thing is--

Hangouts.

Right. You'll find names of advisors, and you can look them up on the web and see who you like.

And what's step three?

I'm not sure there is one. This person may be your financial advisor for life. If you and she—or he—don't get along, you can go back and search for someone else.

When do you think I should start looking for this person?

There are two ways to know. First, when you want to stop hassling with the investment and financial stuff, and want somebody else to do some of that work for you. The other is when you start paying serious taxes and start having complicated questions that require somebody to really know you before they can give you a decent answer.

When will that be?

It's totally up to you.

The thing to do now, though, is recognize what you've just accomplished. You now understand more about finances than 90% of all people, and you did it in, what? An hour or two?

Thanks Dad. Is there some way I can pay you back?

Just do what every father wants his children to do: become financially self-sufficient, then prosperous

and personally fulfilled, and have a terrific life. Your finances are one of the best tools to accomplish that.

About the author:

Bob Veres has been writing for professional financial planners for more than three decades. He publishes the *Inside Information* service for financial planners (<http://www.bobveres.com>), and has won a number of industry and journalistic awards for his work, including the Distinguished Service Award from the National Association of Personal Financial Advisors and the Heart of Financial Planning award from the Financial Planning Association, plus the AZBEE award and the Jesse H. Neal awards for his financial columns.

His book about financial planning, entitled *The New Profession*, (<http://www.bobveres.com>) is popular in the financial services world.

He is also publisher of several novels, including

Song of the Universe (https://www.amazon.com/Song-Universe-Robert-Veres/dp/0595846335/ref=sr_1_1);

Conversations With My Daughter (https://www.amazon.com/Conversations-Daughter-author-published-January/dp/B01BBBKUI8/ref=sr_1_3);

The Root of All Evil (https://www.amazon.com/Root-All-Evil-Robert-Veres/dp/1462012434/ref=sr_1_1) and

South of Maya (https://www.amazon.com/South-Maya-Robert-Veres/dp/0999830708/ref=sr_1_1).

