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The Investment Process

What is investing? Any time you invest, you are putting something of yours into something else in order to achieve something greater. You can invest your weekends in a good cause, you can invest your intelligence in your job, or you can invest your time in a relationship. Just as you do each of these with the expectation that something good will come of it, when you invest your savings in a stock, bond, or mutual fund, you do so because you think its value will appreciate over time.

Investing money is putting that money into some form of "security" - a fancy word for anything that is "secured" by some assets. Stocks, bonds, mutual funds, certificates of deposit - all of these are types of securities. As with anything else, there are many different approaches to investing. Some of these you've probably seen on late-night TV. A well-dressed, wildly positive (though somewhat whiny) young man sits lazily waving palm fronds and shakes his head over how incredibly easy it is to amass vast wealth - in no time at all! Well, hey! That sounds fine! However, discerning minds will wonder: If it were so easy, wouldn't everyone who saw the same pitch be rich? Then, too, you always have to send some money to learn the secrets. So we suggest you take the $25 you'd spend on the hardcover *EZ Secrets to Untold Billions* book and the $500 you would shell out for the EZ Seminar, and invest it yourself - after you've learned the basics here.

Time Value of Money

Is a dollar always worth a dollar? OK, you sly fox - you caught us, it's a trick question! And you guessed it - a dollar is not always worth a dollar. Sometimes a dollar is only worth 80 cents, and sometimes it is worth $1.20. (Say! You give us your dollars worth $1.20, and we'll give you ours worth $0.80, in an even trade! Have we got a deal?)

But let's think about this. How can it be? The value of a dollar changes dramatically depending on when you can take control of the dollar and invest it. The critical variable in the exact value of a dollar is time.

If someone owes you a dollar, do you want him to pay you today or next year? (Yes! Another trick question! The answer is, "Today.") With inflation consistently destroying the purchasing power of a dollar, a year from now a dollar will be worth slightly less than it is today. "Inflation" is an economic term used to describe the gradual tendency of prices to rise over time. If inflation is 2% per year, that means that prices, on average, will rise 2% over the next year, which in turn means that your dollar can purchase 2 cents less in a year than it can today. That's right, all you mathematicians out there - with 2% inflation, a dollar today is worth only 98 cents in a year.

However, if you got the dollar back today, you could invest it. If you invested it (along with a few of its cousins, we hope) in the stock market, and your investment returned 10% over the course of the year (which is somewhat less than the market average has historically returned), then you'd have $1.10 at the end of the year. So your money would be growing instead of shrinking, and you'd be staving off the negative effects of inflation.

The Miracle of Compounding

In fact, if you leave this dollar invested, its value will mushroom over time through the miracle of compounding. As we discussed back in Step 1. Getting Started, as you earn investment returns, your returns begin to gain returns as well, allowing you to turn a measly dollar into thousands of dollars if you leave it invested long enough.

The more money you save and invest today, the more you'll have in the future. Real wealth, the stuff of dreams, is in fact created almost magically through the most mundane and commonplace principles: patience, time, and the power of compounding. To heck with your lousy odds in the lottery or with someone's "Wealth in Nanoseconds!" pitch.

Look at it another way -- if you were to take a mere $20 a week and put it into an index fund, then at the end of 40 years, assuming a modest 12% return, you would have just over a million bucks. In short, you would basically have won the lottery -- for $20 a week, or a total of $40,800 out-of-pocket along the way.

We like those odds.

Real Returns

Compounding is so miraculous that even at relatively low returns you can double and triple your money over long periods of time. When someone brags about doubling his money in 10 years, for instance, you shouldn't just smile and nod about how great he did. You only need a 7.1% annual return to double your money in 10 years. If the Standard and Poor's 500, a widely used barometer of the stock market, has gone up 10.6% a year, the poor fellow who doubled his money in ten years has actually underperformed the market. So now the trick becomes: In order to increase your money, how could you invest it so that it outperforms the market? (We'll learn more about finding good investments in Step 6. Analyzing Stocks.)

Now, let's say your investments earned 10% last year. How much did you really make? Well, the last time we checked the taxman wants to grab a piece of what you earn. One of the most significant factors investors tend to leave out when assessing their investment returns is the tax consequence. Even if you have a long-term capital gain that is only taxed at 20%, a 10% return quickly becomes 8%. And for short-term gains, the tax bite is even greater. At any rate, the question of importance for you is: "How much do I end up with at the end of the day?"

Another factor that affects returns, as we mentioned above, is inflation. So if your investments made 10% after taxes last year and inflation reduced your principal's buying power by 2%, then you actually only made a real return of 8%. All you need to do is to take your annualized after-tax return and subtract the annual rate of inflation. How can you find out what inflation was? Every quarter the government reports the Consumer Price Index (CPI), which is what most investors use as a proxy for general inflation at the consumer level. You can find it in your local newspaper's business section or at the Bureau of Labor Statistics.

Investing Versus Speculating

About now you may be sitting back thinking about your brother-in-law who "made a killing" in options. Or maybe you're reminiscing about that Nevada vacation when one lucky quarter magically drew out 700 more with the pull of a slot machine lever. Why put your money in slow-and-steady investment vehicles that merely promise double-digit returns when you could have near-instant riches? With compounding, you have to wait patiently for years for your riches to accumulate. What if you want it all now?

Granted, there is nothing exhilarating about predictability. Sure, tales of your fifth year beating the performance of the Standard and Poor's 500 Index won't make you the life of the party. However, neither will the far more common tales about how you lost your savings on some speculation, and your subsequent adventures in bankruptcy court. (Actually, that might make for some entertaining party chatter, especially given our penchant for reveling in the misery of others. But let's try for the moment to ignore sad musings about human nature.)

What are the odds of winning the lottery jackpot? Well, it depends on the lottery - they may be 1 in 7 million, or 1 in 18 million, or somewhere in between. You have a far greater chance of dying from flesh-eating bacteria - 1 in a million - than you do of winning that jackpot!

You don't need a card dealer, dour strangers, or Wayne Newton background muzak to gamble. There are plenty of stock market gamblers who do an admirable job of losing their money on seemingly legitimate pursuits. At the Motley Fool we think that commodities and options are just as risky as a Vegas craps game. In fact, we believe investors "gamble" every time they commit money to something they don't understand.

This, of course, may be true of stocks as well as of commodities and options. Say you overhear your best friend's dentist's nanny talking about a company called Huge Fruit at a cocktail party. "This thing is gonna go through the roof in the next few months," she says in a stage whisper. If you call your broker the first thing the next morning to place an order for 100 shares, you've just gambled. Do you know what Huge Fruit does? Are you familiar with its competition (Heavy Melon)? What were its earnings last quarter? There are a lot of questions you should ask about a company before you throw your hard-earned cash at a "hot" stock. There's nothing too hot about losing your money because you didn't take the time to understand what you were investing in.

Remember: Every dollar that you speculate with and lose is a dollar that is not working for you over the long-term to create wealth. Speculation promises to give you everything you want right now but rarely delivers; patience almost guarantees those goals down the road.

Planning and Setting Goals

Investing is like a long car trip. There's a lot of planning that goes into it.

- How long is the trip? (What is your investing "time horizon"?)
- What should you pack? (What type of investments will you make?)
- How much gas will you need? (How much money will you need to reach your goals?)
- Will you need to stop along the way? (Do you have short-term financial needs?)
- How long do you plan on staying? (Will you need to live off the investment in later years?)

Running out of gas, stopping frequently to visit restrooms, and driving without sleep (this is the last of the travel analogy, we promise) can ruin your trip. So can saving too little money, investing erratically, or, as we said in Step One, doing nothing at all.

You must answer the following questions before you can successfully set about your savings/investing journey:

- What are your goals? Is this money for retirement? A down payment on a house? Your child's education? A second home? Income to live on in the proverbial Golden Years?
- How much money can you devote to a regular investing plan?

Don't let yourself get away with fuzzy answers, either. In the end, investing is a lot of numbers. You need to get used to that, and quickly. As a matter of fact, it can be quite liberating. You can see exactly what you need to get to your destination, and can be accountable to yourself along the way. Ask yourself some more pointed questions:

- How much will college cost when my child needs to go?
- How much yearly income is reasonable for retirement?

Don't worry ... you don't have to do all the math yourself. There are online interactive calculators available that can help you figure your future money needs. The more specific you can be, the more likely you are to set and achieve reasonable goals.

After you have a rough idea of how much money you'll need and how much time you have to get there, you can start to think about what investment vehicles might be right for you and what kind of returns you can reasonably expect.

Time Is on Your Side

To help put this into context, let's look at how various types of investments have performed historically. Bonds and stocks are the two major asset classes that have been used by investors over the past century. Knowing the total returns on each of these, and their associated volatility, is crucial to deciding where you should put your money.

Putting your money into cash reserves - U.S. Treasury bills, or more recently, money market funds - has yielded roughly 4.2% per year during this century, according to Global Financial Data. While this may not seem like a lot today, it is important to remember that for most of this century, inflation was nonexistent, making a 4.2% average annual return attractive until the 1960s. Though it is interesting that cash reserves have outperformed bonds this century, if one expands the time frame back to 1802, cash returns trail the return of bonds, and during the 1980s and 1990s, cash reserves have consistently trailed bond returns.

Long-term government bonds have returned around 4.0% per year since 1900; surprisingly, they're not that superior to short-term bonds. The best decade for bonds in the past century was the 1980s, when bonds returned 13.81% annually. The worst was the 1950s, when bonds lost -3.75%. Had you invested $1 in long-term bonds in 1900, you would have about $50 today.

Stocks have also been very good to investors. Overall, stocks have returned an average of 9.8% per year since 1900 - quite a bit higher than bonds. Surprisingly, the range of the returns for stocks is not that much larger than the range for bonds over the same period. According to Global Financial Data, the worst return in one decade was the 1930s, when stocks declined 0.17% per year, including dividends. The best decades have been the 1950s, when stocks increased by 18.23% annually; the 1980s, when stocks increased by 16.64% annually; and the 1990s, during which stocks have increased by 17.3% annually. Had you put $1 into stocks in 1900, you would have over $10,000 today.

Determining Your Investment Style

What kind of investor are you? Are you a swing-for-the-fences type, or are you content hitting singles and doubles, racking up slow and steady gains? Or do you prefer to sit in the stands, chatting with your companions and occasionally cheering your home team on?

Before you start investing, you should determine your investment style. There are two major variables in figuring out your investment style - your risk tolerance and the amount of time you can dedicate to investing.

> **Risk**. How comfortable will you be if you invest in something in which the price changes every day - sometimes not the way you want it to change? There are various degrees of risk across the investment spectrum, from government bonds, which are considered risk-free as they are guaranteed by the government, to commodities and options, where you can and often do lose all of your money.
>
> You need to consider how comfortable you will be seeing your investment decrease in the near term while you wait for it to increase over the long term. Although stocks have historically increased in price over the past two centuries, there have been some pretty bad periods. Without counting dividends, your equity investments could have lost almost 80% of their value had you bought stocks

at the high in 1929 before the crash. You could have lost 40% had you bought at the high in 1972. Heck, in October of 1987 the Dow decreased 25% - in just one day! The important thing to remember about stocks, though, is that you don't lose anything until you sell them. For example, if you didn't panic and sell your stocks in October of 1987, you did quite nicely as the market rebounded in subsequent years. That's why, when you're investing in the stock market, you need to think long-term. Don't invest any money in stocks that you'll need in the short term.

Government bonds provide guaranteed returns, and bank savings accounts are insured by the Federal Deposit Insurance Corporation (FDIC). For stock investing, there is no similar guarantee or insurance that the ride will be smooth or that every investment will make you money, but if you buy good businesses and hold for the long term, the odds are in your favor. Just remember that the safest road isn't always the best one. At the Motley Fool we believe that the biggest risk is not taking enough risk, meaning not investing enough in stocks.

It should also be said that you can learn to increase your risk tolerance for investing in stocks. Once you see the kind of returns you can generate over time, you'll come to realize that it really doesn't matter if your stock drops or rises over the course of a few hours or days or weeks or even months. It may be fun to check your stock prices (and it's so easy on the Internet!) but it doesn't mean much over the long term.

Time. Speaking of the long term, time is another important element of your investing profile. How much time do you want to spend on investing? How active do you want to be in the management of your money? Do you want to spend 15 minutes a year on it? Then maybe you should consider using the Passive Strategies detailed below. Or maybe you have eight hours a week, in which case you might enjoy researching companies and poring over financial statements to pick individual stocks.

Another time factor is: When do you need the money? As we will discuss in Step 8. Keys to Success, whether you need the money next week or in a hundred years will dramatically affect what investment vehicle you decide to use. Although stocks have great long-term returns, the returns over periods of three years or less can be downright scary. Luckily for you, as you have now determined your goals and how much money you will need to get there, you also know how soon you will need the money and will be able to make the appropriate choices when you are ready to invest.

Active and Passive Strategies

The two main methods of investing in stocks are called active and passive management. No, active investors aren't the ones who exercise and eat leafy greens while passive investors watch too much TV and eat junk food. Instead, the distinction between active and passive investing is whether you (or whoever manages your money) actively choose the companies in which you invest or whether your investments are determined by some index created by a third party.

Active investing is what most people mean when they talk about stock investing. Whether they do it, their broker does it, or a mutual fund manager does it, the money is managed "actively." The hardest part about making the case for passive investing is convincing people that active investing may not always be all that it is cracked up to be. According to Lipper Analytical Services, over the five years ended in June 1998, 90% of "general equity" mutual funds, meaning garden variety stock funds, underperformed the Standard and Poor's 500 Index - the major benchmark for stock mutual funds.

With 9 out of 10 equity mutual funds failing to beat the market average over five years, you can understand why some people want an alternative to "active" management. Many people who just want a return equal to that of a major stock index use passive investing as a way to do this. The most famous passive investment strategy is investing in the Standard and Poor's 500 Index, also known as the S&P 500, although the Russell 2000, the Wilshire 5000, and various international indexes are also used for passive investment options.

Summary and Next Steps

Now you have figured out your goals, set your investment horizon, thought about your investment style, and considered whether or not to use active or passive investment strategies. You have come a long way from the tow-headed investment novice we met in Step One. At this point you may decide that investing in an S&P 500 Index mutual fund or the Dow Dividend Approach is the best investing course for you. But if you have aspirations of more actively managing your money or are curious about how doing so might improve your returns, please join us in Step 3. Stocks as we learn about stocks.

For further reading about basic investing concepts, check out our bookshelf.

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