

The Motley Fool Guide to

INVESTING FOR BEGINNERS



The Motley Fool Investing Library



The Motley Fool Guide to...

Investing for Beginners

by The Motley Fool

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Intro:

Your Ticket to Financial Independence

Why do you want to invest?

Some people have dreams of an early retirement. Others want to be sure they can afford to send their children to their college of choice. And many more want to be able to leave a legacy for their families. A few just want to buy a really sweet boat.

Whatever your reasons — and there's no bad reason to invest — it's really all about creating opportunity. You want to earn enough through your investments to ensure your financial comfort and to be able to do the things that matter most to you.

You may not realize it, but you're about to embark on a journey to financial independence. In the same way modest initial investments can amount to life-changing sums down the road, these few modest pages might well make a huge difference in your life, enabling you to retire in your 50s, send your grandchildren to college, buy that summer place on Lake Whatchamacallit, or fly around the world in a zeppelin.

If you're an investor — or a soon-to-be investor — you've probably heard of The Motley Fool. But you might not yet have a good grasp of what we're all about and what it could mean for you.

The Motley Fool was conceived by David Gardner, Tom Gardner, and Erik Rydholm, who created the first issue of The Motley Fool printed newsletter in July 1993. The Fool debuted online a year later, with the same goal we have today: To help you to invest for

yourself and gain control of your personal finances.

We were founded as an antidote to the conventional wisdom that the individual investor was doomed to underperformance. In fact, we've proven empirically and unquestionably that individuals can beat Wall Street.

Our mission is to help the world invest — better.

The Motley Fool truly is a place with a passion and a purpose. Our workplace has won awards and been highlighted as one of America's greatest places to work, and we settle debates at the foosball table. There is a lot of laughter within the walls of Fool HQ. But we are serious about the business of financial education and advice — after all, your money is on the line, and so is ours. Our name comes from Shakespeare, whose fools instructed and amused, and could speak the truth to the king... without getting their heads lopped off. We speak our minds.

We strive to educate, amuse, and enrich, all at the same time. We know that most people have never been taught much about finance or investing, and that a glance through the *Wall Street Journal* or a mutual fund prospectus can be confusing or intimidating. In the wake of the financial crisis and the Great Recession, many people stayed out of investing completely, missing out on the more than 200% gains the market has posted since 2009.

Let us help you untangle and demystify the world of finance. Give us a little time, and we'll show you how you can beat Wall Street at its own game. Your portfolio shouldn't have much trouble trouncing 75% to 90% of professionally managed mutual funds.

We think that the person who most has your financial best interests at heart is you. You're the one who should be making the decisions affecting your financial future. And you don't need an MBA, a bow tie, or a pair of suspenders. Believe it or not, some fifth-grade

math is pretty much all you need. Once you've got a little painless learning under your belt, we suspect you'll find that taking control of your financial future can actually be fun. And you can feel good about avoiding the hidden fees, questionable motives, and high costs for the underperformance so common among brokers.

You're the one who should be making the decisions affecting your financial future.

Tending your financial garden isn't as mysterious and complex as you've imagined. The professional Wise men on Wall Street, however, would like you to keep thinking it's too difficult to do yourself. That way you'll entrust your hard-earned dollars to them so that they can generate fat commissions for themselves. (Yes, there are some good brokers out there worth the money they charge. But know that most financial advisors earn much of their pay by churning you in and out of investments, often leaving you with subpar performance. More on this later.)

If you're like many people, you want to learn to invest, but don't know where to start. That's understandable, given the plethora of financial information — and misinformation — out there. Enter this modest book. In it we lay out a systematic approach to investing that should benefit novice and seasoned investors alike.

We first focus on getting your financial house in order, then move into a discussion of various investment options, and later address more advanced investing topics.

No material in this book should frighten or intimidate you. You don't need any fancy credentials to understand anything in here, but that doesn't mean you should jump immediately into the

market whole hog. Ease into investing. Take it one step at a time. For example, you might want to first move your mutual fund into an S&P 500 index fund (we'll explain why shortly) and then take a breather while you read and learn more. Don't take any action until you're comfortable with what you're doing.

Without further ado, let's part the curtains and unveil the Foolish approach to investing.

Step 1

Change Your Life With One Calculation

If there were an eighth wonder of the world, we'd nominate the equation for compound interest:

$$\text{Your money} \times (1 + i)^n.$$

(If you're not a math geek, don't worry; we're going to decipher that for you .)

Albert Einstein declared this simple formula the “greatest mathematical discovery of all time.” And it's your ticket to financial independence.

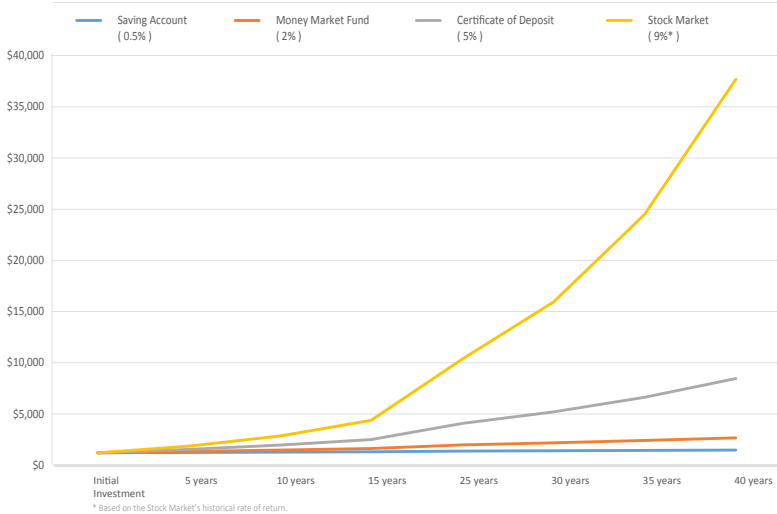
That's right — just three straightforward inputs can change your life: the amount of money you invest; the rate of return you get; and how much time you have to let your money grow.

Hate math but like money? Read on.

Since words cannot adequately describe the magical nature of compound interest, let's try a few visuals.

Here's how a single \$1,200 investment grows over time in four savings scenarios.

How a Single \$1,200 Investment Grows

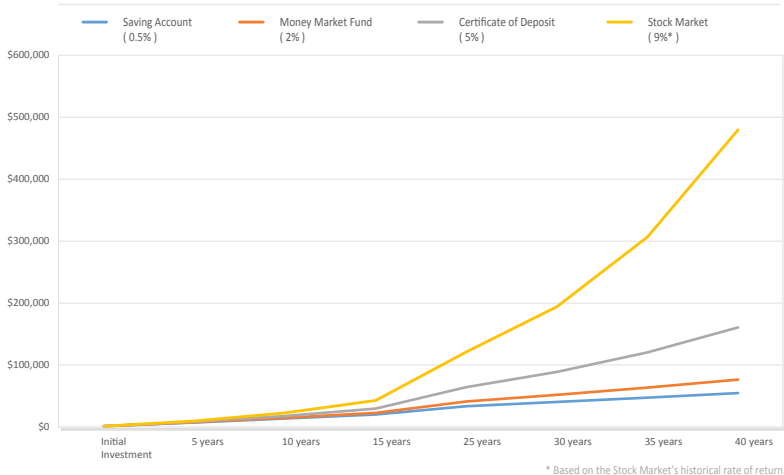


When most people say they want to be a millionaire, what they really mean is “I want to spend \$1 million,” which is literally the opposite of being a millionaire.

As you can see, simply socking away one lump sum and leaving it alone could turn \$1,200 into nearly \$40,000 over 40 years. Not only have you earned interest, but you’ve earned interest on your interest. And all you had to do was invest your first paycheck.

That said, let’s be honest: \$37,691 ain’t what it used to be. So let’s make one small revision and invest \$1,200 every year. Behold compound interest in a mildly caffeinated state.

A More Compelling Chart Than the Last One



Now we're at half a million. Not bad, right?

Still, we think you can top it. In fact, it's not a stretch to get near that magical \$1 million milestone. Just save \$2,500 a year (a mere \$208 a month), and at 9% you've got a million dollars in 40 years. Or stick with the \$1,200 annual contribution but improve your investing skills (which the rest of this book will show you how to do). If you are able to best the stock market's average annual returns by a mere 3 percentage points, the \$1 million prize is yours.

You see, it all lies in the beauty of that compound interest calculation we showed you earlier.

The calculation: **(Your money x (1 + i)ⁿ)** has three variables working in your favor. Improve one (or all three) and the more your money will grow.

The three inputs are:

1. How much you invest (your money)
2. The rate of return on your investments (i)
3. How many years you keep your money invested (n)

The best part about compound interest is that it works the same for everyone, whether you have \$20 to invest or \$200,000. If you don't believe you can become a millionaire with just the resources you have right now, keep reading.

Typically, the more risk you are willing to take on (by, say, investing in stocks rather than bonds), the higher your potential return. Unfortunately, risk is a four-letter word to a lot of folks: They're happy to settle for lesser returns to avoid it.

But stuffing all your savings under your memory-foam bed — or even relying on safer investments like Treasury bills or bonds — can be far worse for your financial future. It's not simply that they

return less. It's that they barely keep up with the rate of inflation, and that means your money isn't going to go as far as you think. We Fools believe the best place for your savings for the long term (key word, as you'll discover) is the stock market.

In finance textbooks, "risk" is defined as short-term volatility. In the real world, risk is earning low returns, which is often caused by trying to avoid short-term volatility.

Your golden ticket to financial independence

There you have it: your ticket to financial independence boiled down to one simple calculation. But obviously a calculation is only as good as the variables you provide it with. So start saving right now (as much as you can), and invest it well. After all, the sooner you get the wonder of compounding working for you, the sooner you'll reach your financial dreams. And that's exactly what this book will help you do.

Step 2

Trade Conventional Wisdom for Foolishness

In Shakespearean literature, the court jester was the one character who could speak the truth to power. The Fools of yore weren't simply stand-up comics sporting belled jester caps — they entertained the court with humor that instructed as it amused. More importantly, the Fool was never afraid to question conventional wisdom, particularly when popular thought was detrimental to the kingdom's people.

"The fool doth think he is wise, but the wise man knows himself to be a fool."

William Shakespeare
As You Like It

See where we're going with this?

For decades, Wall Street has insisted that only experts can succeed at investing or figure out the best way to manage your family's finances. We're here to tell you that's bunk. You can secure a comfortable financial future, and you don't have to go it alone.

Our job is to show you how to take control of your own financial life so you can make confident, well-informed decisions about every dollar that passes through your hands, whether you're saving it, spending it, paying it back, or making it grow. Most everything in Fooldom is here to fulfill this part of your mission, and we want nothing more than for you to succeed.

Take a look at these seven essential principles of investing. They represent the core of Foolish investing and provide the foundation for everything else you'll learn in this book.

Principle No. 1: Buy Businesses, Not Tickers.

This one is straight from the mouth of famed investor Peter Lynch, who generated 30% annual returns while at the helm of Fidelity's Magellan mutual fund. At The Motley Fool, we buy into a company's prospects, its future, and its management. We're not interested in trying to divine value from a stock chart, and we don't blindly invest in a hot industry. We prefer to put our money alongside a company we believe will generate shareholder value over the long term.

Bill Seidman once said, "You never know what the American public is going to do, but you know that they will do it all at once." Change is as rapid as it is unpredictable.

Principle No. 2: Be a Lifetime Investor.

We're long-term investors who believe in capitalism and thriving industry. But we don't just buy our stocks and forget about them. We keep tabs on them, follow the news, study the earnings reports, and strive to learn more about the industries. We also add money to our shares regularly, so we're continuously saving and investing.

Principle No. 3: Diversify.

We believe in building a diversified portfolio, much like Walter Schloss, who generated astounding annual returns during his lifetime and held nearly 1,000 securities. We need not own that many stocks, but a diversified portfolio of at least 15 stocks protects us from the inevitable blips — and allows us to sleep well at night.

Principle No. 4: Fish Where Others Aren't.

We're not interested in following the crowds. We are interested in thinking for ourselves, doing our own research, and making our own decisions.

Principle No. 5: Check Emotions at the Door.

We recognize that stocks will move up or down for a variety of reasons — and often these movements happen daily. We manage our temperament and don't let our emotions affect our decisions. If stocks we like dip for an unjustified reason, we'll load up rather than sell out.

Principle No. 6: Keep Score.

We believe in accountability and have tracked our positions from the get-go. Day or night, you can find the performance of all of our picks on our online scorecard. Does your broker do the same?

Principle No. 7: Be Foolish and Have Fun.

People are conditioned to believe that investing is too difficult for the average Joe saver — and that money issues are best left to the professionals. But we believe you can do it better than your broker — and we think you should have fun along the way.

Oh, and there's one more big difference between us and all the other folks pitching financial products and services to you: We actually want our members to talk to each other — to talk about us, even.

My Biggest Investing Mistake



Always Listen to Grandma

by Jim Mueller

I was in college when I first considered investing. I decided to talk with my grandma, who often talked about her broker — her “little man” as she called him — whenever I visited. She had done very well following his advice — her years-long investment in Exxon had helped pay to build the house where she lived — and I wanted to do just as well. But one phrase held me back:

“Only invest what you can afford to lose.”

Obviously, as a college student, I couldn’t afford to lose any of the money I was making. Between books, rent, food, gas, and beer, all my money was accounted for.

Oh, how I wish I had that decision back.

My biggest mistake wasn’t listening to Grandma but misinterpreting her. I’d decided that I needed all the money I was making just to keep body and soul together and entertained.

What I should have realized is that in any situation, there are always a few dollars that can be set aside to invest. Skip the rental of a movie, eat out less often, don’t pay vending machine prices for soda. The money is already spent, even “lost,” on other things that are usually short-lasting, so why not “spend” some of it by investing it? With discount brokers charging only a few dollars for online trades, just about anyone can begin a portfolio that, over time, can grow to thousands and thousands of dollars.

It may not seem possible when living on a tight budget, but setting aside just a few dollars a week can lead to big things down the road.

This is the idea of paying yourself first — setting aside a little bit now in order to have more in the future. With low commissions, using a few dollars to buy a few shares of stocks is easy. While no one can guarantee that investing in these companies will pay off, not investing anything will lead exactly nowhere.

Step 3

Treat Every Dollar as an Investment

You've probably heard the adage, "Pay yourself first." It's part of the financial canon — the de facto Rule No. 1 for managing your money. It's certainly sound advice, but it might leave you wondering: How much? How often? Where to put it? What's next?

Don't pay yourself just yet

As far as financial rules of thumb go, we think we've come up with a better one. In case you overlooked the big, bold headline, we prefer this mantra: *Treat every dollar as an investment.*

That's the very foundation of successful investing. We like it because it offers a clear guideline for every financial decision you encounter.

An investment is anything that affects the quality of your life.

Make one great investment every day

To us, an investment is more than a trade you make in your brokerage account. An investment is anything that affects the quality of your life. Once the basics (food, shelter, workplace-appropriate attire) are covered, every dollar equals opportunity. And every day presents new opportunities to make your money work harder for you, whether for long-term gain (retirement

savings), short-term safety (emergency fund), or immediate pleasure (mocha latte — hey, we’re not here to judge).

After a while “treat every dollar as an investment” becomes second nature. It seeps into your subconscious like a catchy song you just can’t shake. Soon you’ll be looking for “investment” opportunities in every nook and cranny.

Dean Williams once noted that “Expertise is great, but it has a bad side effect: It tends to create the inability to accept new ideas.” Some of the world’s best investors have no formal backgrounds in finance — which helps them tremendously.

But before you set up your brokerage account and dive in, make sure you’re not overlooking a few essential rules.

Rule No. 1: Pay off The Man first.

In almost every scenario, there is no better use for your first freed-up dollars than paying off high-priced debt, which, for most, means revolving credit card debt. We’ll prove it.

Consider the difference between saving \$200 a month and coming up \$200 short and covering it with a credit card. If you assume you stuff your \$10s and \$20s into a coffee can, your credit card charges 18% interest, and you pay a minimum \$15 a month toward the balance, here’s where you’d be :

Years	\$200 in monthly savings amounts to...	Putting \$200 per month on a credit card amounts to...
1	\$2,400	(\$2,652)
2	\$4,800	(\$5,583)
3	\$7,200	(\$9,088)
4	\$9,600	(\$13,278)
5	\$12,000	(\$18,288)

As you can see, “Pay yourself first” points you in exactly the wrong direction in this scenario. Stashing your cash in a savings account earning nearly 20 times less in interest than you’re paying on those lingering credit card balances leaves you \$6,288 in the hole after five years, and you’ve paid nearly \$7,000 in cumulative interest charges alone.

The bottom line: If you have credit card debt, invest in its destruction.

If you have credit card debt,
invest in its destruction.

Rule No. 2: Amass a cash cushion.

Stuff happens — stuff that requires you to have some cash on hand — you lose your job, your car’s transmission fails, your dog needs emergency tail surgery. If you don’t have the money readily available, you’ll likely have to patch over the problem with a credit card... which works against Rule No. 1.

Your emergency fund needs to be readily accessible in a simple savings account. Don’t expect to make a killing on this investment. The interest you can get on most savings accounts won’t even keep up with inflation. That’s a bummer, but an emergency fund is a necessity.

How big should this essential investment be? Here are some basic guidelines.

If you...	Then your emergency fund should cover living expenses for...
Have no dependants relying on your paycheck	3 to 6 months
Are the sole breadwinner or work in an unstable industry	6 to 12 months
Are retired and living on a fixed income	5 years

Sweat the big stuff and the 80/20 rule

One other thing we want to make clear: Not every “investment” has a dollars-and-cents return. Or, in more practical terms: Go ahead and enjoy your daily latte. At The Motley Fool, we’re hardly advocates of excruciating denial and extreme penny-pinching in the name of “investing.”

We’d much rather you spend your energy on the big stuff that really pays off — the 20% of line items on your budget that counts for 80% or more of your spending — things like your mortgage, cars, travel, insurance, and any four-figure line items in your budget.

Budgeting tools like Mint, Quicken, HelloWallet, and YNAB (You Need a Budget) can give you an instant snapshot of your spending and saving. Pinpoint your 20%, and earmark a few hours to cut those costs. Then take that savings and put it to work in bona-fide investments — in the traditional sense, that is.

Don’t get us wrong, those lattes can add up. If you spend your money like a drunken Powerball winner — or even a heavily caffeinated scratch-off winner — then it’s worth taking a look at how you’re allocating your dollars. Because even if it seems like small potatoes today, remember how even small investments can make a significant difference to your financial future down the road.

Did you know that you can renegotiate much of your debt? If your credit card interest rate is 18% a year, call the company and inform them that you plan to transfer to a lower-rate card if they won’t bring your rate down to something less like highway robbery. They’ll likely comply, as they’d still be making good money off you. If not, transfer to a new card as you dig out of debt.

Not coincidentally, making those first stock market investments is the topic of the next step.

Rule 3: If you need the money in the next year, it should be in cash.

Yes, it might seem contrary for a company whose bread and butter is stock advice, but investing in the market isn't the right decision for all of your dollars, particularly if you'll need it in the near term. You don't want the down payment for your vacation home to evaporate in a stock market — or bond market — crash. Keep it in a money market or savings account. And, of course, make sure it's FDIC-insured.

Rule 4: If you need the money in the next one to five years, choose safe, income-producing investments such as Treasuries, certificates of deposit (CDs), or bonds.

Whether it's your kid's college money or the retirement income you'll need in the not-so-distant future, stay away from stocks.

As with all investments, risk and reward go hand-in-hand when it comes to "safe" assets. So, in order of "safest" to "still safe but technically riskier," we have Treasury notes and bills, CDs, and corporate bonds. That's also the order of lowest to highest yield. CDs are still very safe as long as they're FDIC-insured, and they can usually be bought commission-free. Shop around for the best rates; your local bank may not offer the best deal.

Wall Street consistently expects earnings to beat expectations. It also loves oxymorons.

As for corporate bonds, the general rule is to choose bond mutual funds over individual bonds if you have less than \$25,000 to invest. However, keep in mind that bond funds can actually lose money, which can be awfully inconvenient if it happens right before you need it.

Stick with funds that focus on short- to intermediate-term bonds. And be vigilant about costs — you can find plenty of good funds with expense ratios below 0.50%.

Ask yourself every time you whip out your wallet, “Is this the best investment I can make with this dollar bill?”

Rule 5: Any money you don’t need within the next five years is a candidate for the stock market.

Don’t get us wrong... we don’t want to scare you away from stocks.

After all, over five- and 10-year periods, the market’s daily ups and downs morph into a gently rising upward slope.

But the key is time. You must give your money time to ride through the stock market’s bumps and tumbles to reap the rewards of long-term investing.

We Fools are fans of the stock market, and we know our history. Here’s how stocks, bonds, and Treasuries have fared historically:

Nominal Returns (1920 through August 2014)

Asset Class	Average Annual Return
Large-Cap Stocks	10.1%
Long-Term Government Bonds	5.2%
U.S. Treasury Bills	3.6%

Source: Deutsche Bank

Of course, that's one long time frame, and in the short run, no one knows what stocks will do. But make no mistake: *Even if you're in or near retirement, a portion of your money should be invested for the long term.* That's because, according to the Social Security Administration, the average 65-year-old American male could expect to live until age 84.3; a female of the same age can expect to live until age 86.6. And those are just the averages. Approximately one in four 65-year-olds will live to see their 90th birthday, and one in 10 will live to see their 95th. A 110-year-old, however, should sell everything and get to Vegas while he still can. (Kidding... mostly.)

Even if you're in or near retirement, a portion of your money should be invested for the long term.

So, unless you're a 95-year-old skydiver who smokes, expect your retirement to last two to three decades. To make sure your portfolio lasts that long, you should...

Rule 6: Always own stocks.

Over the long term, equities are the best way to ensure that your portfolio withstands inflation and your retirement spending.

According to Jeremy Siegel's *Stocks for the Long Run*, since 1802 stocks outperformed bonds in 69% of rolling five-year investing periods (1802-1807, 1803-1808, etc.). The percentage of the time that stocks whoop bonds only improves as you look over a longer horizon.

Holding Period	Stocks Outperform Bonds
3 Year	67%
5 Year	69%
10 Year	80%
30 Year	99%

Data from *Stocks for the Long Run*, by Jeremy Siegel

For holding periods of 17 years or more, stocks have always beaten inflation, a claim bonds can't make. The bottom line is that when you need your money will partially dictate where you put it.

Cover Your Assets, Fool!

What else determines your asset allocation? That favorite term among financial gurus: your tolerance for risk.

Risk drives return

Most people base their investment strategies on the returns they want, but they have it backward. Instead, *focus on managing risk and accept the returns that go along with your tolerance for it*. It'd be great if we could get plump returns with no risk at all. But to achieve returns beyond a minimal level, we have to invest in things that involve some possibility that we'll lose money.

So ask yourself: What would you do if your portfolio dropped 10%, 20%, or 40% from its current level? Would it change your lifestyle? If you're retired, can you rely on other resources such as Social Security or pensions, or would you have to go back to work (and how would you feel about that)? Your answers to those questions will lead you to your risk tolerance. The lower your tolerance for portfolio ups and downs, the more bonds you should hold in your portfolio.

As an extra aid in determining your mix of stocks and bonds, consider the following table, from William Bernstein's *The Intelligent Asset Allocator*:

I can tolerate losing ___% of my portfolio in the course of earning higher returns	Recommended % of portfolio invested in stocks
35%	80%
30%	70%
25%	60%
20%	50%
15%	40%
10%	30%
5%	20%
0%	10%

So, according to Bernstein, if you can't stand seeing your portfolio drop 20% in value, then no more than 50% of your money should be in stocks. Sounds like a very good guideline to us.

And remember that our appetite for risk changes depending on current market and personal circumstances. So err on the conservative side if you're taking this quiz during a bull market (and vice versa).

Action: Spend less — instantly. Someone somewhere has probably given you the advice to track your spending for a month to see where your money goes. But let's fast-forward the process. Instead of recording your every purchase for a full month, just do it for three days. In fact, you don't even need to track it — just consciously ask yourself every time you whip out your wallet, "Is this the best investment I can make with this dollar bill?" We guarantee you'll start making smarter money choices.

Step 4

Open and Fund Your Accounts

We're ready to find proper accommodations for all of your savings needs and devise a strategy for funding your long-term financial goals.

The best places for your short- and mid-term savings

There's a vast array of appropriate places to stash the money you may need to access soon, including basic checking and savings accounts, high-yield savings accounts, money market accounts and funds, certificates of deposit, Treasury bills, and all sorts of bonds. These types of accounts are safe harbors: They won't provide killer rates of return (and may not even keep up with inflation), but they do provide a guarantee that the money you deposit will all be there when you need it.

Only 7% of Americans know stocks rose 32% last year, according to Gallup. One-third believe the market either fell or stayed the same. Everyone is aware when markets fall; bull markets can go unnoticed.

Keep in mind that one type of account might not best serve all of your short-term savings needs. For example, cash earmarked for a home down payment that you plan to make in a few years is ideal for a CD. Your child's summer camp tuition is better off in a high-yield savings account. Once you've deployed your funds for near-term needs, it's time to find the right spot for the money you'll need to cover Saturday date nights ... in the year 2041.

Long-term parking

Your long-term cash stash (specifically, money designated for your retirement years) belongs in accounts set up solely for that purpose. We're talking IRAs and employer-sponsored retirement accounts such as 401(k)s.

Long-term parking, lot A: Your 401(k) (or other workplace plan)

What if you could invest your money in a place where at least a portion of your contribution was guaranteed to double?

Investors anchor to the idea that a fair price for a stock must be more than they paid for it. It's one of the most common, and dangerous, biases that exists.

Well, if you work full-time, chances are you have that opportunity through your employer-sponsored retirement account — most likely a 401(k). If your company offers one of these plans — with a company match — for goodness sake (and your sake), don't pass up the free money! That would instantly

double your investment, without even breaking a sweat. We typically recommend that you put your first long-term investment dollars into this type of account if it's available. Simply ask your friendly HR colleague how to get started.

These plans allow you to contribute pre-tax money directly from your paycheck (within limits; see the IRS's website for this year's allowable contribution amounts). That way your money will grow tax-free, and (added bonus alert!) your contributions lower your taxable income each year, which means a lower tax tab come April. You'll pay taxes only after you retire and begin to withdraw the money.

Unfortunately, not all plans are created Foolishly. Some employers don't offer a match, and some plans provide horrid investment choices and charge high fees. Plus, it's not always easy to figure out if your plan is one of the lemons. Don't worry; we've got your back.

Long-term parking, lot B: An IRA

Once you've maxed out your workplace retirement account (or, if it's an atrocious plan, invested enough to get your employer match), divert your next retirement dollars into an IRA.

IRAs have one big advantage over workplace retirement accounts: They typically offer more investment options. Unfortunately, Uncle Sam won't let you contribute as much money to these accounts each year (again, check with the IRS for this year's limits). And, depending on your income, you may not be eligible to contribute to one fully — or at all.

IRAs come in two varieties — Roth and traditional — and they offer different tax advantages:

- **Traditional IRA:** Tax-wise, this account works just like a 401(k) — the money you put into it is not taxed until you make withdrawals during retirement. Also, like a 401(k), you can deduct the money you contribute from your income, lowering your tax bill in the year you make the contribution.
- **Roth IRA:** This account gives your future self a tax break. The money you sock away here is never deductible. However, when you retire, you get off scot-free and will pay no taxes on the gains or the principal when you withdraw the money. A Roth IRA also allows you to withdraw your contributions tax-free at any time for certain things, such as a first-time home purchase or education expenses, whereas with a traditional IRA (and 401(k)), you'd not only pay taxes, but you'd also get hit with penalties.

Which one is right for you? We like the flexibility of the Roth — and the fact that the earnings grow tax-free. That said, the Roth is not necessarily the best choice for everyone.

Long-term parking, lot C: Taxable accounts

If, after maxing out the tax-advantaged retirement accounts above, you still have money to sock away, we have just two things to say: (1) Huzzah!, and (2) watch out for Uncle Sam!

The only real difference between retirement accounts (IRAs and 401(k)s) and regular (taxable) accounts is, you guessed it, how the investments are taxed. Follow these two basic guidelines to (legally) dodge the taxman (as much as possible):

- Fill your tax-favored retirement accounts with the most tax-inefficient investments. Those are the investments that generate the biggest tax bills — bonds, real estate investment trusts (REITs), and high-turnover stock mutual funds (though we'd encourage you to avoid the latter for other reasons as well). The payouts from these investments are taxed at ordinary income tax rates, so shelter them within your plan for as long as possible.
- Use non-retirement accounts for investments that are already tax-efficient. That includes long-term, buy-and-hold vehicles such as stocks that pay little or no dividends, or tax-managed stock funds. Since you won't pay taxes on these investments until you sell, they have a built-in tax-deferred benefit — as long as you hold for many years. When ultimately cashed in, the gains will be taxed at the long-term capital gains rate, which is lower than ordinary income tax rates.

Setting up a taxable account is as easy to do as opening an IRA. Compare fees at the broker center, broker.fool.com, and you'll be off and investing in no time. Once you set up your accounts, just three things are left on your "to do" list: Lather. Rinse. Repeat.

Put your savings on auto-pilot

OK, now you know that saving and investing your money is good for you — just like eating right and exercising. Fortunately, discount

brokers and fund companies make it a whole lot easier than counting calories and doing your cardio — through dollar-cost averaging. That's just an academic name for automatic investing. It works just like your 401(k): Money is taken out of your account before you can even think about spending it.

What are you waiting for? The sooner you get your short- and long-term savings accounts set up, the sooner you can get to the fun stuff — investing.

Action: Take the free money!

Part I: If you haven't signed up for your workplace retirement plan yet, consider this your friendly Fool nudge to go talk to HR. (If you don't have a job that offers a retirement match, consider opening an IRA.) You may be passing up a guaranteed way to instantly double your money — and all it requires is 7.3 minutes to fill out a few forms. Go ahead, we'll wait.

Part II: OK, you're back. Fantastic. Next, get ready to put your investing dollars to work outside of your employer-sponsored retirement account. You'll need a discount brokerage account for either an IRA or a taxable account, which are even easier to set up than your 401(k). Check out the brokers we like at broker.fool.com.

My Biggest Investing Mistake



Avoid the Common Pitfalls

by Adam Weiderman

My greatest investing failure so far has been my investment in Allied Irish Banks, a stock whose price was absolutely crushed.

And yet, painful though that loss is, seeing how avoidable this was in hindsight hurts even more.

My first major mistake was falling prey to social proof. I put too much weight on the research, opinions, and actions of others without thinking through the investment decision for myself and deciding whether it made sense in my portfolio.

Prior to my purchase of Allied, it had been recommended in two of our services. Advisors in both services wrote that the stock was trading with low historical and relative multiples, a very attractive dividend yield, and a significantly undervalued price.

While they made compelling arguments, I failed to carefully evaluate whether I agreed with their assessments. And I became even more hooked as these fellow analysts also began purchasing Allied for their personal portfolios.

As a result, I also began to give in to confirmation bias — where I sought out opinions that further confirmed my buy decision rather than seeking a contrarian opinion that might indicate danger ahead.

Turns out that's one of the most common predispositions that investors face. I've since learned that truly great investors develop an ability to honestly look at both sides of an investment thesis.

As if those mistakes weren't enough, I also became anchored to the price at which each service recommended the stock. I fixated on those price points; in my mind, anything lower than their entry prices became a clear bargain. So, when the stock fell another 50%, it became twice as attractive to me, as did the doubled dividend.

These mistakes fed off each other, collectively convincing me to overlook my normal investment process. I took shortcuts. I failed to perform as much research as I typically do. I fell in love with the stock, viewing it as mostly upside, without truly understanding the risks and pressure points.

The key takeaways from my mistakes, then, are:

1. While it can be helpful to look at the opinions of others, you still need to carefully consider whether you agree with their investment theses.
2. It's much better to leave a stock's price history out of your analysis so that you're not tricked into a value trap.
3. It's best to simply bypass investments that are too complex, or that you don't believe you solidly understand.

Step 5

Avoid the Biggest Mistake Investors Make

We're about to share with you the secret to avoiding a \$10 billion investing mistake. It has nothing to do with more money, a higher IQ, or superb market timing. It's mind control.

The way we're wired — our natural inclinations to seek more information, look for patterns, compare options, and even flee to safety — is great at keeping us out of harm's way in the wild. But these same emotional tendencies are also our biggest liability when we're in investing mode. In other words, your brain is to blame for all those boneheaded money mistakes.

Just ask uber-investor Warren Buffett. The chairman of Berkshire Hathaway openly admits that a short in his analytical circuitry — his “thumb-sucking” reluctance (his words) in the 1980s to pick up more shares of Wal-Mart because of a one-eighth of a point uptick in the stock price — cost him \$10 billion in potential profits over time. And this is from a guy who has famously said, “Success in investing doesn't correlate with IQ... what you need is the temperament to control the urges that get other people into trouble in investing.”

In other words, the Oracle of Omaha made a \$10 billion investing blunder because his emotions got in the way. But don't worry, you can train yourself to ensure you don't make the same mistake.

2 traits you must have to be great

The secret ingredients to investing success, regardless of education, investing styles, or golf handicaps are time and temperament.

Time: As we mentioned, investing in stocks requires a minimum five-year time horizon. Think of it this way: You're sending some of your money on vacation while your other money takes care of the more immediate chores, like paying for car repairs, a house, or a kid's college tuition.

Of course, it can be tough to be a long-term investor in a short-term world — which brings us to the second secret ingredient for investing greatness.

Temperament: Successful investors have the ability to remain calm and levelheaded when everyone around them is freaking out. That mindset makes the difference between investors who consistently outperform the market and investors who get lucky for a

while. The Wal-Mart foible aside, Warren Buffett says this is the key to his success. When a group of business-school students asked Buffett why so few have been able to replicate his investing success, his reply was simple: “The reason gets down to temperament.”

“People do not get what they want or what they expect from the markets; they get what they deserve.”

— Bill Bonner

If you can keep your emotions
in check and ignore the noise,
you'll be able to hang on rather
than selling out at the worst
times.

Money, IQ points, and lucky socks are no help when your investment is down 50%. But if you can keep your emotions in check and ignore the noise, you'll be able to hang on (even back up the truck and load up) rather than selling out at the worst times. If you look back at history and study how investing fortunes were made, you'll find it wasn't by jumping in and out of stocks based

on fear and greed, but by buying great businesses and investing in them over the long haul.

Hop off the emotional roller coaster

To cultivate a good temperament — one that focuses on the long term, not the short term, and ignores the crowd in favor of a well-thought-out strategy — channel your inner Warren Buffett. Build resistance to the emotional triggers that lead to bad investment decisions. Here are a few exercises we regularly do to keep our cool:

1. Memorize this affirmation: “I am an investor; I am not a speculator.” All together now: “I am an investor; I am not a speculator.” As investors, we:
 - Buy stock in solid businesses. We expect to be rewarded over time through share price appreciation, dividends, or share repurchases.
 - Don’t time the market. And we certainly don’t speculate when we buy stocks. Speculation is what day traders do.
 - Focus on the value of the businesses we invest in. We try not to fixate on the day-to-day movements in stock prices.
 - Buy to hold. We buy stocks with the intention of holding them for long haul. (That said, we are willing to sell for reasons we outline in a few pages.)

We recognize that believing your affirmation is sometimes easier than living it. To avoid behaving like a speculator...

2. Tune out the noise: Put down the newspaper, turn off CNBC, and stop clicking that. And that. And, yes, that too. None of it is doing you any good.

Fixating on the market’s minute-to-minute news won’t help you make your next brilliant financial move. At best, all the hours, days, and weeks spent soaking in sensational stories will yield some talking points for your next office happy hour. Mostly, though, it’s

noise, and it's costing you a serious amount of sound sleep — and maybe even some actual money.

3. Spread out your risk: In order to get some quality Zs, you need a solid asset-allocation plan — meaning a portfolio with a bunch of investments that don't always move in the same direction. You need to diversify. (We'll get into the details of diversification in a bit.)

Putting an assortment of eggs in various baskets isn't the only way to spread your risk. You can also avoid the risk of investing in a company at exactly the wrong time. Say you're interested in buying shares of Scruffy's Chicken Shack (ticker: BUKBUK), but you just don't know when to pull the trigger. The answer? Take a bunch of shots!

Practically speaking, you do this through dollar-cost averaging (remember, as we discussed, this means accumulating shares in a stock over time by investing a certain dollar amount regularly, through up and down periods). So every month for three months you purchase \$500 of Scruffy stock regardless of the stock price. The beauty of this system is that when the stock slumps, you're buying more, and when it's pricier, you're buying less.

You are under no obligation to read or watch financial news. If you do, you are under no obligation to take any of it seriously.

Buying in thirds is another way to average in to an investment: Simply divide the total dollar amount you want to devote to a particular investment by three, and pick three different points in time to add to your position.

4. Stay strong, think long! For Fools, investing success is not measured in minutes, months, or even a year or two. We pick our investments for their long-term potential. So resist the urge to act all the time. Make decisions with a cool head after letting new information sink in. Sometimes the best action to take is no action at all.

5. Distract yourself with something useful: If you're going to obsess about your investments, use your time productively and review your investment philosophy and process. For example, pick any investment that's interrupting your sleep. Write down why you bought the business in the first place. Ask yourself: Has any of that fundamentally changed? This exercise underscores that short-term ups and downs in the stock market have little relevance to winning long-term investments and wealth generation.

Action: Get in touch with your inner investor. Do you know your time horizon and tolerance for risk and loss? Do you want to research stocks? Start an investing journal. Every time you think about buying or selling one of your holdings, make a note of why, how you are feeling at the time, and what would have to go differently for you to change your mind.

Step 6

Discover Great Businesses

When you buy a stock, you're purchasing a stake in a living, breathing business. Buy shares of your favorite fast-food joint and you own the place. Literally. Every time someone gets fries with that shake, a tiny bit of cash drops to your company's bottom line.

Finding great stock ideas can be as simple as opening your eyes. Your fridge, medicine cabinet, closet, computer: all hotbeds of stock ideas. Behind virtually every successful product or service lies a publicly traded company that's cashing in on that success — and that you can join as a business partner.

Better know a better business

But a great service or product does not a great investment make — just ask anyone who invested in Webvan during the dot-com era. (Never heard of it? Yeah, that's kind of our point.) Again, think of buying shares of a company just like buying a stake in a neighborhood business. Does the business have staying power? How much cash flows in and out? Do you trust the management and employees to do right by you as an outside investor? Hardly questions you'd need a Harvard MBA to spell out for you, right?

"We're all just guessing, but some of us have fancier math."

— Josh Brown

Fools take the same commonsense approach to investing. We're interested in the strength of a business. Not past performance, charts, or whether the shares have split.

Specifically, here are a few things we look for:

- I. A sustainable competitive advantage: Some businesses have unique, lasting competitive advantages that allow

them to earn outsized profits. The more durable a company's competitive advantage, the larger the "moat" that surrounds its financial fortress. ADP's scale and high switching costs, Facebook's network effects, and Johnson & Johnson's intellectual property are all classic examples of sustainable competitive advantages.

2. **Cash aplenty:** Cash is the lifeblood of any business. It pays the bills and covers the tab for new growth projects. Fools look for low-debt, cash-rich balance sheets and steady cash flows. Specifically, free cash flow — the cash left over after funding operations and growth — fuels share repurchases and those sweet dividends that show up in your brokerage account every three months.
3. **Strong leadership:** Is management invested alongside you? Do they have a history of creating value for shareholders? Do they have years of relevant experience? Do they treat outside shareholders (business partners) with respect?

If you stumble across a company that nails all of the above, odds are good that you're looking at a great candidate for your hard-earned cash. So you've done your homework. Now what?

Companies that focus on their stock price will eventually lose their customers. Companies that focus on their customers will eventually boost their stock price. This is simple, but forgotten by countless managers.

Cheat. Yes, cheat.

Today, getting second opinions on stock ideas is as easy as finding the ideas in the first place. Turns out there are legions of investors just like you freely sharing their ideas, thoughts, and research. Here's where you can find them:

4. [Motley Fool CAPS](#): Looking for a second opinion? How about a few thousand of them? CAPS harnesses the power of collective intelligence to provide ratings on just about any stock you could name. Get a quick look at overall sentiment about the company, or spend a little

time to read comments from other investors and see which stocks they think are the best — and worst. Even better, CAPS is full-on free, Fool. (Find it at caps.fool.com.)

5. [Fool discussion boards](#): Back in the day, The Motley Fool took its first steps by connecting like-minded Fools through discussion boards. Today, Fool.com is host to thousands of investing-focused boards. Portfolio Management? Check. Living Below Your Means? Check. Ask a Foolish Question? Another check. And just like CAPS, our boards are 100% free. (Find them at boards.fool.com.)
6. [Fool Premium Services](#): From small caps to dividend payers to growth stocks, The Motley Fool offers a range of premium stock-picking services where we do the heavy lifting for you. (Find them at store.fool.com.)

With so many ideas and resources at your fingertips, you've lost any excuse not to start digging in and rating stocks yourself. Get started today!

Action: Start a watch list in [Scorecard](#), the Fool's online portfolio tracking tool. If you don't already have one, start a watch list so you can keep up with the companies that pique your interest. When preparation meets opportunity, that's when great investments are made.

My Biggest Investing Mistake



The ‘Experts’ Don’t Always Know Best

by Iain Butler

During my young and naïve days, I was prone to taking “surefire” statistical findings at their word.

For example, the “experts” insist that you should “sell in May and go away.” I’m not sure if that axiom is based on anything more profound than the big swingers taking the summer off or a catchy rhyme scheme.

But at some point, I bought into this “market phenomenon” wholeheartedly and decided that every year in May, I’d not only “walk away,” but put some money into an inverse index exchange-traded fund (ETF) that would actually appreciate when the market did its thing and went down over the next six months. Then, in October, I’d sell the inverse ETF and put the proceeds not just into a long index ETF, but into a double-long index ETF (to get twice the market’s return—that’s how sure I was) to hold from November until the next May... at which point I’d repeat the process.

Inverse ETF in May, double-long ETF in November—I was ready to be rich! What a brilliant plan, no?

NO!

I don’t recall how many times I went through the cycle, but it wasn’t

many. And when it came time again to rotate from short to double-long, my inverse ETF was down by an amount that made me not want to sell it. I justified to myself that it'd be wise to hang on just a bit longer, as that year had to be an anomaly and a correction would surely be just around the corner.

I never bothered to sell, and that correction never happened. I still hold that position as a constant reminder to never do anything harebrained again, even if all the experts swear by it.

Buy great companies, hold them for long periods of time. That's the only investing gimmick you need to know.

Step 7

Buy Your First Stock

You've paid off your credit cards. You've saved up an emergency fund. You've opened a brokerage account. You've done your research, compared notes with like-minded Fools, and found the stock of your dreams. Let the guns blaze!

Whoa, there, pardner!

We're just as excited as you are that you're ready to be a stock owner. But before you go knocking on Mr. Market's door, bearing cash and gusto, let's keep some perspective.

The S&P 500 gained 27% in 2009 — a phenomenal year. Yet 66% of investors thought it fell that year, according to a survey by Franklin Templeton. Perception and reality can be miles apart.

First, this is just one of many investments you'll end up owning. You want to invest in sips, not gulps. Your first purchase should be as petite in size as it is bold in spirit. Second, don't forget that your first investment is possibly more valuable to you as a learning experience than as a way to boost your net worth. As any craftsman will tell you, there's no better way to learn than by doing.

A journey of a thousand miles begins with a single step. And that's what we recommend to you: Buy a single share of your favorite stock. Just one. This one share will teach you more about life as an investor than we could ever hope to teach you here. Follow it. Get to know it. Read the quarterly earnings releases, listen to the conference calls, and see how the stock's daily fluctuations affect you. For future stock purchases, you should keep trading costs and commissions to less than 2% of your total purchase amount, but you can let that slide on your first buy.

But there's something else we want you to pick up while you're making a stop at your friendly broker: A stake in an index fund.

The passive investor's best friend

How many times have you heard someone ask, "How'd the market do today?" But what exactly is "The Market?" And how do we know how it did? Usually, the answer reflects the performance of an index — such as the Dow Jones Industrial Average or the Standard & Poor's 500 — rather than the market as a whole.

Twenty-five hedge fund managers took home \$21.2 billion in 2013 for delivering an average performance of 9.1%, versus the 32.4% you could have made in an index fund. It's a great business to work in — not so much to invest in.

What's the S&P 500?

The Standard & Poor's 500 is an index of 500 of the premier companies in America, as measured by market cap. If the companies as a group rise in price, the S&P 500 index rises, too. This is an excellent benchmark for investors, and it's what we often like to measure our returns against.

What's the Dow?

The Dow Jones Industrial Average measures the performance of the overall stock market by using a group of 30 American multinational conglomerates, including Walt Disney, General Electric, and Procter & Gamble. The Dow stocks represent some of the cream of American big business, and when the media refers to the market being up today, they're often referring to the S&P 500 or the Dow.

What all indexes have in common is that the value of the index changes proportionally to the value of the stocks in the index. So

when the index goes up, the aggregate value of the stocks in the index has grown by a proportional amount, and vice versa.

And you can invest in those indexes — through index funds. These funds don't look to beat the market — they look to match it as closely as possible. That might not sound enticing at first blush, but consider that index funds offer:

1. Instant diversification: When you invest in an index fund, in one fell swoop you've spread your dollars across industries, markets, currencies, and countries, substantially lowering your risk in the process.
2. Low costs: Index funds have much lower expenses than actively managed mutual funds. The average actively managed U.S. fund charges its investors 1.4% for the privilege of owning shares. The Vanguard 500 Index (VFINX) fund, meanwhile, carries an expense ratio of only 0.16%.
3. Superior returns: According to the Fool's own research, only 42% of actively managed domestic mutual funds beat the S&P 500 over the past 10 years ending September 2014. And we're not alone; numerous studies show that you're likely to underperform by investing in a typical Wall Street fund. And as we just pointed out, you'll pay a lot more for that privilege.

Little wonder that we think index funds should be the foundation of your portfolio (more on that soon). But for now, we simply recommend that for every dollar you put into individual stocks, you roll the same amount into an index fund.

But about that stock

Yes, we Fools love index funds, but we also believe everyone should own at least one stock — and eventually, at least 15 to reduce your risk and increase your odds for success. Why? Well, it's fun

(really!). By owning a stock, you have your own little piece of history, and you get to witness firsthand the power of capitalism and entrepreneurship at work.

But just as important, if you want to beat the market, you simply can't do that by investing only in index funds. In fact, your goal for every stock you buy should be to outperform the index. So get out there and start having some fun on your way to market-beating returns.

Action: Invest in an index fund, and buy your first stock!

Step 8

Invest Like the Masters

Growth, value, international. Which style is right for you? If you're a Fool, you happily blend together all three! Join us, though, as we walk through three distinct yet Foolish styles of investing, and see if you can figure out which way you tilt.

Growth investing, starring Peter Lynch

Peter Lynch is a legend around the halls of Fool HQ. Quotes of his adorn our walls — “Never invest in any idea you can't illustrate with a crayon” and “Although it is easy to forget sometimes, a share is not a lottery ticket... it's part-ownership of a business.” We've even named a conference room in his honor.

Saying “I'll be greedy when others are fearful” is easier than actually doing it.

So what makes Lynch so great? A wildly successful investor, Lynch truly stole our hearts with his books *One Up on Wall Street* and *Beating the Street*, both of which were

resounding calls for the empowerment of small investors. By sharing his commonsense and replicable philosophy in a plain-spoken fashion, Lynch convinced a generation of investors that they didn't need an MBA or a white-shoe stock broker to invest in the stock market.

The core drivers of Lynch's growth-centric strategy are pretty straightforward: Invest in growing, unheralded, easy-to-understand companies. Here's how it goes:

- I. Buy what you know: Lynch believes that the average investor knows more than they think. Not only do you consume an array of products and services on a daily basis, but you've developed unique career insights that can

give you a leg up on the Street. Put them to use! Invest in what you know, understand, and are comfortable with, and leave the rest for the “pros.”

2. **Seek hidden gems:** Lynch highlights that individual investors have a huge opportunity when it comes to small- and micro-cap stocks. Most Wall Street research houses can't afford the time or staff to cover small- and micro-cap stocks, and most mutual funds are too large to comfortably trade in and out of them. The end result is that small caps are frequently mis- and under-priced, leaving enterprising investors the chance to buy into small, growing businesses on the cheap.
3. **Diversify:** Lynch's Magellan Fund held an incredible 1,000+ stocks when he finally handed off the reins in 1990. For perspective, that's roughly five times the average number held by U.S. equity funds. Lynch spilled coffee on the Ivory Tower of Modern Portfolio Theory by proving you can comfortably crush the market despite being incredibly well diversified. How? By choosing small, growing, well-managed companies and letting them run.

Value investing, starring Warren Buffett

No offense to the father of value investing, Benjamin Graham, but his pupil Warren Buffett is The Man when it comes to the practice and theory of value investing. Value investing is the art of buying stocks for less than their fair, or “intrinsic,” value.

For Buffett and his legion of value-investing disciples, the craft involves three steps:

1. **Buy great businesses:** Buffett looks for businesses that boast strong brands, management teams, cash flow, and staying power. Serious staying power. The kinds of businesses that you think will outlive you — names like Coca-Cola, Procter & Gamble, and Johnson & Johnson.

Once he finds these great businesses, he looks to buy them when they're out of favor, and then patiently holds on for years upon years as these beauties compound wealth.

2. **Be contrarian:** It takes some nerve to buy stocks that everyone else is down on, but Buffett has made a living by going against the grain. As he's been wont to say, "Be fearful when others are greedy, and greedy when others are fearful."
3. **Invest for the long haul:** As Buffett once said, "Our favorite holding period is forever." And if you can't tell from our section on investor temperament, we feel the same way!

What's Value Investing?

By Ron Gross

In its simplest form, value investing is based on the concept of buying a stock for less than you think it's actually worth. Since no rational investor would willingly pay more than a stock is worth, all investing can be considered value investing to some degree.



However, one of the main differences between value and growth investors is how much the investor is willing to pay for future growth. The typical value investor doesn't want to rely too heavily on a future that, by definition, is unknowable. Rather, a value investor will attempt to value a company using conservative assumptions about the future and then attempt to buy that company for less than the value they've determined. Since valuation is often imprecise, value investors seek to pay significantly less than their estimated value to build in a margin of safety.

Value investors tend to gravitate toward fundamental analysis and

research rather than technical or momentum-based analysis. Value investors prefer balance sheet-based metrics, such as book value, and free cash flow-based valuation tools, such as a discounted cash flow analysis, to help them determine a company's true or intrinsic value.

International investing, starring Sir John Templeton

As with Lynch and Buffett, we celebrate Sir John Templeton's philanthropy, intellectual curiosity, and Foolishness. Templeton's success was not the result of a proprietary trading scheme, inside information, massive amounts of leverage, or complicated derivatives. Rather, like Lynch and Buffett, Templeton succeeded because of sound, fundamental research and the patience and discipline to hold stocks for years.

"Success is a lousy teacher," Bill Gates once said. "It seduces smart people into thinking they can't lose."

His philosophies have become widely adopted today because they work and because people realize that in a global economy, it no longer makes sense to be provincial about investing. But many individual investors continue to try to time the markets and trade with a short time

horizon.

His success also reflected a willingness to look where other investors would not. Appreciate Templeton for all we've said, but also for:

- I. Going abroad: In a time when conventional wisdom demanded that investment houses set up on Wall Street, in Boston, or in London, Templeton instead fled to the peace and quiet of the Bahamas. He was one of the first foreign investors to focus on Japan, and he strode early into Russia.

2. Investing consistently: Templeton didn't chase a lower-case fool's errand by trying to time the market. As he once said, "The best time to invest is when you have money. This is because history suggests it is not timing the markets that matters, it is time."

John meets Warren meets Peter

Again, the perfect Foolish portfolio blends the traits of all these master investors: A business-focused, diverse portfolio of growth and value stocks, both foreign and domestic. But your exact mix is a matter of personal style and risk tolerance.

What About Options?

By Jeff Fischer

After a Foolish investor saves, invests, and grows their portfolio of stocks to least about \$50,000, they might want to consider the benefits of adding options to the portfolio. Stock options can be used to buy new stocks at lower prices, sell existing stocks at higher than market prices, and generate steady income — an especially powerful way to consistently use options. Stock options also allow a Foolish investor to protect key stocks, or their portfolio, by using options as hedges, and much more.

Why do we generally recommend having at least \$50,000 in stocks first? A stock option represents 100 shares of the underlying stock, so your portfolio needs to be able to potentially invest in 100 share blocks to use most (though not all) options strategies. Options also work with, and complement, your stocks. So, we believe it's important to have a strong stock portfolio, one that's set up to compound over the years, before you consider adding options to your toolbox.



How Options Work

A stock option gives its owner the right to buy (with a “call” option) or sell (with a “put” option) an underlying stock at the strike price of the option by the option’s expiration date. You can either “buy to open” an option, paying the option’s premium (or price), or “sell to open” an option, where the option’s premium is paid to you. Selling to open options is how many investors generate steady income.

Common option strategies include writing covered calls. This is where an investor owns 100 shares or more of a stock, and sells to open calls on those shares (“covered calls”), collecting income in the process. If the stock rises above your call strike price by expiration, you’re agreeing to sell your shares at your strike price (and you still keep the income). If the stock doesn’t rise above the strike price, the call simply expires as income, and you can write (meaning sell) another call for more income. This conservative income strategy is commonly used by retirees.

Using Options Foolishly

Other powerful options strategies include selling puts for income or to buy a stock cheaper; buying call options to profit on long-term upside in a stock with little money at risk; or buying put options to protect a stock you own, or profit when a stock (or the market) declines. You can also use option “spreads” to earn 100% or more on your capital if a stock simply goes nowhere or up 5% in a few years. Options can complement your stocks in many ways. Once your portfolio is built to last, you can consider this extra Foolish tool.

Action: Now that you’re building your portfolio, keep track of it with Scorecard, our free tool at the scorecard link at scorecard.fool.com. You can enter your holdings securely, and if you choose to do so, we’ll even send you updates whenever there’s news about one of your companies.

My Biggest Investing Mistake



The Best Time to Sell

by Tom Gardner

Back in 1995, when I had much more hair on my head — but much less investing experience under my belt — I discovered a promising little company that fit all my investing criteria. Although this company was young, it boasted a strong balance sheet, impressive free cash flow, and tremendous growth potential. Best of all, the company — I'll reveal its name in a moment — was run by a dedicated founder/CEO who also happened to be the single largest shareholder.

I happily bought shares, then even more happily sold a few months later, pocketing a tidy 25% profit. It was a textbook value investing success.

It was also the biggest investing mistake I've ever made.

How in the world I could consider a 25% gain the biggest investing mistake of my career? Rest assured, my experience with Dell was more painful than suffering a dozen bankruptcies.

That's because after I sold my shares, Dell went on to increase 45 times in value over the next 10 years. The company eventually had its ups and downs and has since gone private, but the increases I could have banked at many points along the way were the kind of multi-bagger return that can make an investing career — or fund the retirement of your dreams, if you don't share my aspirations of being a master investor.

Fortunately, my Dell experience wasn't a complete waste. In fact, I learned a key lesson that has helped me identify other long-term winners and prevented me from selling them when they still had room to run.

The world's greatest investor, Warren Buffett, teaches us that the best time to sell a great company is never. I couldn't agree more.

And that is the invaluable lesson I learned from my Dell experience. When you have identified a company with the three keys to greatness — customer focus, strong financials, and high insider ownership — you shouldn't let short-term valuation concerns scare you away from multi-bagger returns.

Step 9

Don't Sell Too Soon

When should I sell? This is one of the most frequent questions we hear. Our glib (yet truthful!) answer: Never. We'll come back to that shortly, but in the meantime, here are five reasons we do sell stocks.

"The big money is not in the buying or the selling, but in the sitting."

— Jesse Livermore

Reason No. 1: Better opportunities

Sometimes there's nothing wrong at all with a company or its stock: There are simply better opportunities elsewhere that will bring more bang for your bucks. We will consider selling a less attractive stock (even at a loss) if we think we can get a better deal elsewhere.

Reason No. 2: Business changes

There's no way around it: Businesses change — sometimes significantly. We could be talking about a major acquisition, a change in management, or a shift in the competitive landscape. When this occurs, we incorporate the new information and re-evaluate to see if the reasons we bought the company in the first place still hold true. We will consider selling if:

- The company's ability to crank out profits is crippled or clearly fading.
- Management undergoes significant changes or makes questionable decisions.
- A new competitive threat emerges or competitors perform better than expected.

We'll also take into account unfavorable developments in a company's industry. Here, it's important to delineate between

temporary and permanent changes. In a downturn, financial figures may suffer even for the best-run companies. What's important is how these businesses take advantage of the effects on their industry to improve their competitive position.

Investor Nick Murray once said, "Timing the market is a fool's game, whereas time in the market is your greatest natural advantage." Remember this the next time you're compelled to cash out.

Reason No. 3: Valuation

We're all for the long-term here, but sometimes Mr. Market shows our stock too much love. We will consider selling if a stock price has run up to a point where it no longer reflects the underlying value of the business.

Reason No. 4: Faulty investment thesis

Everyone makes mistakes. Sometimes, you'll just plain miss something. You should seriously consider selling if it turns out your rationale for buying the stock was flawed, if your valuation was too optimistic, or if you underestimated the risks.

Reason No. 5: It keeps us up at night

It is tough to put a dollar value on peace of mind. If you have an investment whose fate has whirled such that it now causes you to lose sleep, it could be time to move your dollars elsewhere. We save and invest to improve our quality of life, after all, not to develop ulcers. Adding insult to injury, stressing about a stock might cause you to lose focus and make rash decisions elsewhere in your portfolio. Remember, there's no trophy or prize for taking on risk in investing. Stick within your comfort zone.

Know when to hold 'em

So that's when you fold 'em. But what about holdin' 'em? Remember, we're long-term investors, not weak-kneed speculators.

Over the course of what will be a prosperous investing career for you, the market will rise and fall. Recessions and booms will happen. And all the while, you must stay focused on the long term. Fear is never a reason to sell.

Action: Put it in writing. Remember that investing journal you started a few steps back? Use it! For each stock in your portfolio, write down why you bought it, your expectations, and what would make you sell. (Then save it as a pitch in Motley Fool CAPS and get the benefit of some collective wisdom.) Refer to it frequently — and before you decide to give your stock the heave-ho.

Step 10

Retire in Style

And now, ladies and gentlemen, the inflation-adjusted million-dollar question: Can you afford the retirement of your dreams?

While you ponder that, it's likely that a few other questions will come to mind:

- How much money will I need when I retire?
- What kind of lifestyle will I be able to afford?
- What will my current savings be worth by then?
- How much can I afford to take out every year?
- Will I need to adjust my plan?
- Does anyone have a brown paper bag? I'm feeling lightheaded.

Relax. We're going to tell you almost everything you need to know about retirement, right now, in less than five minutes. Ready? Here goes.

1. Contribute to the right accounts.

If you've read this investing primer in order and took the time to complete the action items, then this part is done.

Just to review: If your boss matches your contributions to your retirement plan at work (your 401(k), 403(b), 457, or other employer-sponsored plan), save at least enough to take full advantage of that benefit. Remember, contributions reduce your taxable income, and the investments grow tax-deferred.

The next step in the retirement account hierarchy is to fund an IRA

(either a Roth or traditional variety). If you're not eligible for the Roth, contribute to the traditional IRA only if contributions are tax-deductible. If not, stick with your 401(k) (unless it really, really stinks) because you'll get the tax deduction.

2. Choose the right investments.

A lot of people get tripped up on this one. But don't let it stop you from putting a plan into motion. We've shown you how to construct a well-balanced retirement portfolio with a whole day's supply of vitamin D.

Study successful investors, and you'll notice a common denominator: they are masters of psychology. They can't control the market, but they have complete control over the gray matter between their ears.

The "right" investments for you will change over time as you near the point where you stop investing new money and start spending what you've saved.

But it's important to remember that retirement is not your investing finish line. After all, you hopefully still have many years of productive life ahead of you after you retire. While the income and safety of bonds and Treasury bills may seem appealing, approximately half of your portfolio must still be invested in stocks to ensure you can maintain purchasing power and avoid the devastating effects of inflation.

3. Save enough.

With life expectancy increasing by leaps and bounds, if you give notice at the traditional age of 65, you may want to think in terms of a 30-year retirement. That's a lot of electricity bills and all-you-can-eat buffet brunches.

So, how much do you need to save? As much as you can.

A more specific answer can be found in the following table, which assumes you have not yet started to save for retirement:

Your Age	Percentage of Income to Save
20s	10% - 15%
30s	15% - 20%
40s	20% - 30%
50s	30% - 40%
60s	40% - 50%
70s	50% - 60%
80s	Vegas, baby!

4. Run your numbers to see if you're on track (and then run them again).

Are you saving enough to retire when you want? Are you withdrawing too much in retirement? There's one way to find out: Run your plan through a good retirement-savings tool.

Since each will give you a different answer, try at least three. (Yes, that seems like a lot of effort, but your retirement is worth it.) First, try our [suite of retirement calculators](#). You also might find some good tools on your broker's website or as part of your personal-finance software.

At The Motley Fool, we firmly believe that saving for tomorrow is not about sacrificing today — it simply requires striking the right life-money balance.

If you start pricing it out now, you won't experience sticker shock when your ticker isn't quite as strong. Our post-retirement expense calculator will help you figure out how much that round-the-world trip, fishing cabin, or class in paperclip art will cost.

The good news is that many expenses decline or disappear completely in retirement. Once you've retired, you no longer have to pay Social Security or Medicare taxes, you no longer divert money to 401(k)s or IRAs, and retirement income is often taxed at lower rates.

5. Stop paying for other people's retirements.

Unless the person managing the money in your mutual funds is bound to you by matrimony or blood relation, you probably don't intend to contribute to their bank accounts.

Too many investors overpay for underperforming investments, ponying up 1.4% in management fees (a typical expense ratio) for funds that barely keep up with their benchmarks.

"Do nothing" are the two most powerful — and underused — words in investing. The urge to act has transferred an inconceivable amount of wealth from investors to brokers.

Your generosity is not properly appreciated. By choosing lower-cost but better-performing funds, you can add 1% to 2% a year to your portfolio returns. Compounded over many years, we're talking tens of thousands of dollars.

So keep a sharp eye on fees. Below is a pocket guide to what we Fools think is reasonable to pay:

Financial Service or Product	Reasonable Fee
Index funds and ETFs	0.2% or less
Actively managed mutual funds and ETFs	1% or less for domestic funds; 1.25% or less for international funds
401(k) administrative fees	0.25% or less (even better if your employer picks up the tab)
IRA administrative fees	Free, if possible. Many brokers charge no administrative fee for retirement accounts, though they may require a minimum investment
Non IRA / 401(k) Administrative fees	Free, if possible. Many brokers waive administrative fees if you maintain a minimum account balance or sign up for an automatic investment plan
Stock trades	\$10 or less
Financial advice from a Certified Financial Planner	1% or less of assets under management, or an hourly fee of \$150 to \$200

6. Know how to crack your nest egg.

Finally, the big day arrives! You kissed the boss good-bye, and you're ready for a lifetime of... well, whatever the heck you want. It's time to begin tapping your portfolio. Should you start with your traditional IRA, your 401(k), or your regular brokerage account?

This is no small matter. One study found that choosing the right order could extend a portfolio's life expectancy by more than two years. The general rule: Start withdrawing from non-retirement accounts. After that, move on to tax-deferred money, and save your Roth for last. However, there are many exceptions to these rules, so take the time to learn more before you retire.

Live it up today, too!

We'd be remiss if we did not give proper due to a very important period in your life: The here and now.

In the words of John Lennon, life is what happens when you're busy making other plans. At The Motley Fool, we firmly believe that saving for tomorrow is not about sacrificing today — it simply requires striking the right life-money balance. So we'll end this

lesson with your moment of Foolish Zen: Living rich and getting rich are not mutually exclusive.

Action: Find out if you're saving enough for retirement. Well, are you? That's what calculators are for! Our [Foolish retirement calculators](#) can help with the heavy arithmetic. (Check out the "Am I saving enough? What can I change?" calculator in particular.) You will also be able to play "what if" games and see the results quickly, should you decide to vary things like inflation, rates of return, date of retirement, and desired income.

Helping the World



By Alyce Lomax

The investments we make are not simply to pad our brokerage accounts so we can live like royalty. If you're so inclined, it presents you with the opportunity to make a difference in the world.

Yes, there are significant tax benefits to making charitable contributions each year. They can reduce your taxable income and lower your tax bill. But there are far greater benefits.

How do you identify the right philanthropic organizations? At The Motley Fool, we feature an annual fundraising campaign in which we ask our members to contribute financially to a cause selected by a team of employees. And in selecting our Foolanthropic partners, we think of our charitable donations in much the same way we think of investing.

Specifically, we aim to support organizations with long-term,

sustainable goals and transparent, sound finances — the very same thing we would expect from any of our stock picks. The questions we ask when determining Foolanthropy worthiness include:

- Does it offer a long-term, sustainable solution, as opposed to a quick, temporary fix? We favor organizations that have programs that encourage self-sustaining solutions. Rather than simply handing over a pile of cash to needy individuals, we are seeking organizations that help people help themselves to improve their way of life.
- Are its finances transparent and sound? We conduct due diligence on each potential partner organization, and we expect them to have sound financials. The management team should have the background needed to run the organization, for instance, and the board of directors should have qualified experts. We also look at financials, with an eye toward excessive overhead, egregious CEO compensation, and any other red flags that point to a lack of stability within the organization.
- Is the organization small enough for our support to make a difference, yet established and broad-minded enough that we can be certain of its reputation, effectiveness, and appeal? We like to know that we're making a real difference in an organization's ability to operate effectively, but we also want to make sure we choose partners that are established and that have broad appeal to as many Fools as possible.
- And finally, does it educate, amuse, and enrich? As with everything we do at the Fool, we like to have fun while we educate and enrich. Is the charity innovative in its approach to problem-solving? Is it working in a unique way that merits enthusiasm and attention? At The Motley Fool, our core values are: Collaborative, Innovative, Fun, Honest, Competitive, and Motley. For our annual Foolanthropy drive, we seek a company that fits with our ethos and our spirit. We need to like them and be inspired by them.

Overall for our campaigns, we seek out great opportunities to make our dollars really count for missions we believe in, making the path to success a bit easier for deserving people around the world. We're not saying that's the only — or even the best — way to invest the philanthropic portion of your portfolio. But if you haven't already selected the organizations that you want to support in an ongoing basis, we encourage you to create a list of your own guidelines that are important to you. Check a site like Charity Navigator or Guide Star, which provide background information on nonprofits, for your research, and find an organization that matters to you. Then go make a difference.

Conclusion

And that's it.

From shoring up your finances to ensure you're ready to invest, all the way through to a successful, prosperous, and philanthropic retirement, you're now thoroughly prepared to take control of your financial life.

Investing is about creating opportunities — giving your children the opportunity to attend the college of their choice; enjoying the opportunity to see the world with a loved one; exploring the opportunity to chase that dream of launching a startup company without the fear of putting your family's finances in peril.

Following the simple steps we've just laid out puts you in charge of your financial future, opening yourself up for all the opportunities successful investing makes possible. Fool on!

Congratulations, you're now a Fool!

You've armed yourself with all the information you need to make outstanding investment decisions. You are ready to take control of your financial future and open yourself to all the opportunities that entails.

But where to start?

We've given you a bunch of guidance on how to begin your research, but we know that the first step is unquestionably the most difficult. It can seem too monumental, too important, too scary, so we suffer from analysis paralysis. But there is no better day than today to start your investing journey, so we're here to help.

Within this bonus section, we are offering three stock recommendations that we believe represent outstanding prospects for the long haul — set-it-and-forget-it companies that will let you sleep at night. All three companies below were plucked from *Stock Advisor's* list of Starter Stocks – essential stocks are meant to answer the question, “Where do I go first?” And we feel they not only have the strength to ride out downturns, but they're also built for powerful growth.

Before we get to them, a few caveats that you can apply to all your investment thinking:

- Don't simply buy based on our (or anyone's) word. Use any and all stock recommendations as starting points for your own research. Do you believe in the thesis? Do you like the company? Is it right for your portfolio?
- Something could happen that affects our investment thesis. Make sure you collect all the relevant and timely information on any company you're planning

to buy (we're partial to www.fool.com).

- This is just the start. Ideally, you'll begin with three Starter Stocks that form the foundation for a portfolio of at least 15 companies. Such an array provides the diversification necessary for any healthy portfolio.

With no further ado, here are three stocks for the long run.



Starbucks (Nasdaq: SBUX)

Green Circle: Nobody sells coffee like Starbucks. But mix a few ingredients together in 20 or 30 different ways and give people a “third place” to spend their time, and you’ve got an easy-to-understand, hard-to-duplicate business model. It’s not just the coffee that brings people back (though that helps), it’s the knowledge that you could settle in with your laptop or simply sit and watch the

world go by in a pleasant atmosphere. Simple. Effective.



Walt Disney (NYSE: DIS)

Track Record: Disney came to *Stock Advisor* through its acquisitions of Marvel and Pixar. The operations we’ve seen and the gains we’ve enjoyed since then make us happy to hold on. David often says that past performance is usually a good indication of future returns, as successful companies tend to remain successful. With so many ways to compete for our entertainment dollars, that’s Disney.



MasterCard (NYSE: MA)

High Conviction: No investment is priceless, but global payments processor MasterCard comes pretty darn close. Accepted in more than 210 countries with the fastest network available, MasterCard has a 45-year track record of leading its market — and, since it went public, beating Mr. Market. And MasterPass, its digital wallet platform, is quickly gaining speed as electronic payments skyrocket.

With a stellar CEO and strong shareholder value creation, MasterCard is a great addition to your portfolio today.

And thus begins your journey as an investor. But we want to ensure that you continue ever forward. So, as a reader of this book, we'd like to offer you an opportunity to maintain your momentum, putting to use over time all the lessons, tips, and strategies.

Just turn the page for a special free offer. It's 30 free days of *Stock Advisor*, so you can explore all the picks the team has made, including their Starter Stocks and Best Buys Now. It's the ideal next step for you on your journey to financial freedom. And if you don't think it's right for you, just cancel within 30 days and you'll get a full refund.

Don't wait to get started. Your biggest asset is time, but it's ticking. Fool on!

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