Welcome to the Marriott School of Management project on personal finance. At Brigham Young University’s Marriott School we are concerned about the financial literacy of individuals both inside and outside the university. A solid understanding of basic financial principles and the ability to manage finances wisely are important factors in the well-being of individuals and families. This project is one of our many efforts to increase the financial literacy and self-reliance of our own students as well as of families and friends outside the university.

As you work through this course, I hope you will take the time to do three things. First, read and study the material. Each chapter offers valuable information that will enrich your understanding of personal finance. The chapters have been carefully reviewed by our faculty and staff in the Marriott School. We think they are informative and clearly written. They are organized to be useful to young people with little financial knowledge, people who have extensive experience in financial matters, and everyone in between.

Second, as you read, focus on the principles taught in the course. We emphasize principles because principles don’t change over time. Types of financial assets, investment vehicles, and even financial theories may change, but principles do not. This focus will help you stay on course as you make financial decisions for yourself and your family.

Finally, apply these principles to your life by developing your own Personal Financial Plan. Spencer W. Kimball has counseled, “To be sure your life will be full and abundant, you must plan your life” (Ensign, May 1974, 86). We strongly encourage you to think through and write down your goals, the things you want to achieve in life. Develop a financial plan to help you accomplish your goals and then work to implement your plan. Such planning may be the single most important tool for achieving your personal and financial goals.

Thank you for your interest in this course. May this be the start of even greater learning and understanding as you work toward greater financial self-reliance.

Sincerely,

Lee Perry
Dean, Marriott School of Management
Brigham Young University
Welcome to this manual (and the accompanying website at http://personalfinance.byu.edu) on Personal Finance. We compiled information on the most important areas of personal finance for students, individuals, and families. We have developed a principles- and applications-based framework that we hope is clear and concise, and that applies the best practices used in the industry. While there may be differences of opinion as to what are the best practices in the areas discussed, this platform was developed to facilitate review and discussion of those practices.

The ideas presented in this manual were written for an audience with a membership in The Church of Jesus Christ of Latter-day Saint (LDS faith); however, the financial principles taught herein can be extended to members of any Christian faith. Readers who are not of the LDS faith may encounter a few unfamiliar terms within this text. While these terms may provide valuable insights to members of the LDS faith, a thorough understanding of these terms is not required to understand the financial principles taught here. If you have questions about any of these terms, feel free to contact me at personalfinance@byu.edu, or visit The Church of Jesus Christ of Latter-day Saints’ website (http://lds.org/topics) for more information.

This manual and website are updated every year for new information, changes to tax laws, and improvements in teaching methodologies. As such, I would appreciate feedback to help make the manual and website better and more useful. While I have tried to present the material in as fair and balanced a framework as possible and am incorporating changes as they become apparent, there may be errors of omission or commission. While this personal finance manual and the website have been approved by Brigham Young University’s Marriott School of Management for distribution, they remain the work of the author. Any errors are solely my responsibility and are not the responsibility of the Marriott School of Management, the faculty, or Brigham Young University.

Bryan L. Sudweeks, Ph.D., CFA

Special Thanks

I express appreciation to the Rollins Center for eBusiness of the Marriott School of Management for its help and support in maintaining the website, the H. Taylor Peery Institute of Financial Services at the Marriott School for its help and support with the content, and the BYU Center for Teaching and Learning for its help with website design and implementation. Thanks also to Laura Lee Sudweeks for the cover photos and design of the printed versions.

I particularly want to thank the wonderful professors and staff who have helped in this process, specifically Grant McQueen, Steve Thorley, Bernell Stone, Scott Sampson, Brent Wilson, Barrett Slade, Andy Holmes, Craig Merrill, Jim Engebretsen, Bruce Burgon, Skip Koller, Mike Pinegar, Steve Nadauld, Dean Longmore, Hal Heaton, Phil Bryson, Jim Brau, Bob Crawford, Keith Vorkink, Brian Spilker, and Joan Young of the Marriott School of Management; Madison
Sowell, BYU Honors Program Director; Craig Israelsen of the School of Family Life; Todd Martin and Marilyn Miner of BYU Financial Aid; Michael C. Johnson, Dave Egbert, Blake Herzinger, Lynne Allred, David Hellewell, Andrea Velasquez, and David Eves of Center for Teaching and Learning; Michael Orme and Steve Sandberg of the BYU Legal Department; Dann Battistone of the BYU Athletic Department; and Melvin Thorne, Laura Rawlins, Kim Sandoval, Taylor Rouanzion, Christina Champenois, Denise Remy, Camille Hartwig, Katie Newbold, and Jennifer McDaniel of the BYU Faculty Editing Service for their help and guidance.

I also appreciate the thoughtful comments of Stan Benfel of Beneficial Life; Claralyn Hill, attorney-at-law; Rick Hutchins of Novogradac; Fred Hockenjos of BJ Associates; Jason Payne of Payne Financial Management; Creed Archibald and Phil Sudweeks of Farmers Insurance; Dan Wilson of the LDS Church; Tyler Vongsawad of Northwest Mutual; and David Clark of Intermountain Healthcare.

I am thankful for all the hard work and suggestions from my many teaching assistants and students who have helped on this project, including Dallin Anderson, Steve Ashton, Josh Ashworth, Hannah Ballard, John Beck, Will Beck, Mark Bohne, Dan Brown, Craig Bench, Jamon Clark, Derek Collette, Mark Cope, Nick Greer, Armando Gutierrez, Joshua Flade, Brian Harris, Sam Hawkins, Matt Herbert, Greg and Heather Hirschi, Lindsay Johnson, Charlotte Larson, April Lindgren Jones, Nathan Mickelson, Megan Palmer, James Pearce, Monte Schaffer, Preston Taylor, Jeff Willson, and Breckyn Wood. I am also very appreciative of the many students who have added ideas and comments that have helped improve this manual and website.

Finally, special thanks goes to my wonderful wife, Anne, and our seven children, Kimberly (and Lane and Logan Aldrich), Natalie (and Taylor and Halle Barrett), Laura, Clinton, Emilee, Ashley, and Kaili, for all their love and support. They have been wonderful to put up with a dad who asks too many questions and makes too many comments on the topic of personal finance. Without them and their love and support, this project would not have been possible.

**How This Course Is Different**

Dave Ramsey, a nationally syndicated radio talk show host, commented, “Personal finance is more personal than it is finance: it is more behavior than it is math” (KNBR, May 23, 2007). Learning about personal finance requires more than learning the languages of finance and math and more than just a change in spending habits—it requires a change in behavior. The three characteristics that make this course different from other courses on personal finance can help effect this change in behavior:

First, we take a different perspective on personal finance. Perspective—the way we look at things—influences our financial self-reliance because it directs the choices we make. Concerning perspective, the historian Will Durant wrote, “We need ‘to seize the value and perspective of passing things. . . . We want to know that the little things are little, and the big things big, before it is too late; we want to see things now as they will seem forever—‘in the light of eternity.’”\footnote{1}
Our perspective in this manual is unique—our perspective is that personal finance is not separate from our Christian lives; rather, personal finance is simply part of our Christian lives, part of living the gospel of Jesus Christ. This perspective is based on four key principles: 1. Ownership: everything we have is God’s; 2. Stewardship: we are stewards over all that God has blessed us with; 3. Agency: the gift of choice is one of God’s greatest blessings; and 4. Accountability: we will be held accountable for the choices we make, including our financial choices. In this course, our perspective on personal finance is based on a long-term view, on knowing what truly matters. This perspective will guide you as you make financial choices.

Second, we take a principles-based approach to personal finance. Unlike investment theory, investment vehicles, and financial assets, principles never change. A sound understanding of the correct principles of personal finance will act as a compass to guide you as you work toward achieving your personal and family goals. Richard G. Scott commented:

[The] inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. . . . Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you. Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice.²

In this course you will learn how principles relate to every aspect of your personal finances. Understanding correct principles makes it easier to follow and apply the concepts discussed in this manual and website to your personal lives.

Finally, we take an applications-based or hands-on approach to personal finance. We learn best when we use the things learn in our daily lives. It is not enough to know what to do—we must do it. Accordingly, the final difference is that we apply the things learned in this manual in the creation of your individual or family Personal Financial Plan.

To help you apply your learning, we offer a companion website, http://personalfinance.byu.edu, which includes PowerPoint presentations, learning tools, and personal finance manuals compiled and developed by the faculty and staff at Brigham Young University. These tools will help you set goals, create a budget, work toward getting out of debt, evaluate different investments, buy a house or a car, invest wisely, save for retirement, and more. You will also receive extensive instructions for developing your own Personal Financial Plan, including helpful examples of completed financial plans.

I believe that changing your perspective, learning the principles that support successful financial management, and applying this knowledge to your own life through the tools we’ve provided will increase your financial literacy and help you achieve the goals that are most important to you and your family. Best of luck to you as you begin this journey toward increased financial self-reliance.
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We have prepared this manual, course, and website as free resources to help students, faculty, and families both inside and outside the university become more financially self-reliant. As such, we encourage use of these materials under the fair use clause of the 1976 Copyright Act (See Section 107 of Chapter 1 of the Copyright Law of the United States of America). Unless otherwise noted, the individual images, text and objects from the website are available for non-profit and educational purposes, such as research, teaching, and private study. For these limited purposes, you may reproduce (print, download, or make copies of) these materials without prior permission.

We also encourage the free use of these materials by educational, non-profit, and other institutions. Please feel free to download and copy these personal finance manuals, Learning Tools, PowerPoint presentations, and all other materials from the website as needed for your schools and colleges. We have also included lesson plans and PowerPoint presentations on the website that are used here at Brigham Young University’s Marriott School of Management to help in the teaching of these materials.

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Author’s Note

1 The Story of Philosophy, New York: Simon and Schuster, 1927, 1
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1. Personal Finance: Introduction and Another Perspective

Introduction

Personal finance: Those two words can bring either fear or excitement into the heart of the reader. Why such varied responses to a simple two-word phrase? There are many different reasons.

One of the most prevalent is a lack of education. It is hard to make important decisions when you feel you are in unchartered territory. Other responses have been due to “misguided” information. Some individuals and companies have used personal finance as a tool to earn huge commissions on selling insurance and investment products without regard to the needs of the investors they supposedly serve, resulting in poor performance for the investors and uncertainty over missed goals. Still others have made unwise decisions based on solely acquiring assets and investments, but to the detriment of their spouses, families, and real success. While they may have acquired financial security, they have lost the things that will bring them what they desire most, which is happiness and joy. Others have learned their available options, determined their key doctrines and principles, followed those principles and applied them to their financial habits and goals, and have accomplished the goals that they have set for themselves and their families, including happiness in this life and in the world to come. The purpose of this manual and the accompanying website is to help you come to understand the process of personal finance or financial planning for yourself and those you love.

Personal finance in this manual is a five-step process. It is decide, educate, commit, believe, and achieve.

Decide. First, you must decide the “why” behind why you are doing this. Why do you want to learn personal finance? This is not as simple as some think. What is the real reason? What do you expect personal finance to bring into your life? What do you hope it will help you accomplish? What problems will it help you avoid? Too often, people get into the “how” of personal finance without knowing the “why,” and it leads to major problems later.

Educate. Second, you must educate yourself to your available options. This is the “what” of personal finance. This is where we come to understand and prioritize the principles. It is not a simple process to become educated in this area. There is much to be learned in this area. Students have commented that education in this area (which includes using this manual) is similar to “drinking out of a fire hose.” Not only is there a lot of information, but much of this information changes every year, including tax rates, tax tables, contribution limits for retirement, contribution limits for education savings, estate tax limits and percentages, etc. The challenge then is how do we keep up with both the large
body of knowledge as well as the information that changes yearly? Notice that this personal finance manual is updated annually to take into account the changing nature of both types of information as I grapple with this same problem.

Commit. Third, once we know the “why” of our actions and the “what” that we need to do, it comes down to choice. We need to determine the goals that will most likely take us to where we want to be. But the challenge for most people is not setting goals. The challenge is how do we commit to really accomplish the goals that we have set? How do we help ourselves and others to set and accomplish the goals that will take us toward what we really want? How do we take responsibility for our choices? We will help address those issues.

Believe. Fourth, we must believe that we can accomplish the things we set out to accomplish. We must have the vision to know that we can accomplish these things if we are willing to put in the effort, work, and prayer. I believe that we who believe in God have an added benefit. If we seek God’s help in setting and committing to our personal and family goals, and then trust in His promises to us, He will help us accomplish them. Not only will we accomplish our goals, but they will be the right goals for ourselves and our families.

Achieve. Finally, we must work to achieve the goals that we have set. We must be willing to make the necessary sacrifices. But we must also be sure that we keep balance in our goals, ensuring that we accomplish our identity, integrity, and temporal goals in a consistent manner.

This course will work to help you accomplish each of these areas.

With “Decide,” we will discuss the critical doctrines and issues in this first chapter. This first chapter discusses the “whys” of learning more about personal finance. These are critical to understand before we begin any other part.

With “Educate,” the purpose of the entire manual is to help you to become educated to the information, data, and sources of information so you can be a wise consumer of financial information. Key in the education process is to understand the principles of each of the respective areas, the “what” of personal finance. If we can understand the key principles, we will be able to do much better in determining what goals we need to set and why. Read each chapter carefully with an emphasis toward how the principles relate to what you want to accomplish.

“Commit” will help us as we determine which goals we wish to accomplish and as we commit to those worthy goals. This is the “how” of personal finance. This is how we are going to get from where we are now to where we want to be. We must decide what is important and then make plans to help ourselves and our families reach these important milestones in our lives. Our second chapter will be instrumental in this area.

With “Believe,” we must believe we can accomplish what we want. We must have the faith of
prophets of old who said: “I will go and do the things which the Lord has commanded, for I
know that the Lord giveth no commandment unto the children of men save he shall prepare a
way for them that they may accomplish the things which he commandeth them.”¹ Throughout
this series, we will be sharing not just the temporal application of information to help you in your
goals, but also the spiritual side which can be an even greater source of power.

Finally, with “Achieve,” we must be willing to go and do the work necessary to achieve what we
set out to do. We will be giving ideas throughout the course to help you in this area. Specifically,
look for the application area of each chapter, including the case studies. These were specifically
developed to help you as you apply the principles to specific situations in your lives.

**Objectives**

A. Understand the “whys” of personal finance  
B. Understand the importance of perspective  
C. Understand our perspective for this course  
D. Understand the principles upon which that perspective is based  
E. Understand the implications of that perspective

**Understand the “Whys” of Personal Finance**

Before we can decide about wise money management, we must understand and answer two
critical questions. The first is: “Why does the Lord want us to learn personal finance or wise
money management?”

While there are likely many different “whys”, let me share a few thoughts on doctrines of Christ
for why I believe God wants us to learn personal finance.

1. **Personal finance can help bring us to Christ.**

   The ultimate purpose of everything we do, and God does, is to bring us to Christ. C. Max
   Caldwell said:

   Whatever the problem may be in a person’s life—failure to pay tithing, breaking the Word of
   Wisdom, casual church attendance, [or, I add, poor financial habits, the]—real issue is faith in
   Jesus Christ. If we can help people obtain the gift of faith in Christ, good works will follow. The
   end purpose of any law of God is to bring us to Christ. And how well will the law work? It
depends on what we think of the Author of the law.²

   We have also been commanded by prophets and the scriptures to be financially wise.

   [We] have been counseled for many years to prepare for adversity by having a little money set
   aside. Doing so adds immeasurably to security and well being. Every family has a responsibility
to provide for its own needs to the extent possible. . . .
Chapter 1. Personal Finance: Introduction and Another Perspective

If you have paid your debts and have a financial reserve, even though it be small, you and your family will feel more secure and enjoy greater peace in your hearts.

May the Lord bless you in your family financial efforts.³

Whether we view this counsel on being financially wise as a nice thing to do or a commandment of God will provide a great difference in our motivation.

2. Personal finance can help us accomplish our divine missions

We all have divine missions to perform here on earth, and personal finance can help us learn the lessons and develop the skills we need to accomplish those missions. Gene R. Cook said:

I bear testimony of the fact that if you keep the commandments, He nourishes you, strengthens you, and provides you means for accomplishing all things necessary to faithfully finish your divine mission here on earth.⁴

We are all at an important time in our lives, regardless of our age. Ask yourself: Do I really believe that I have a mission here on earth to perform and am I performing it?

3. Personal finance can help us return with our families back to Heavenly Father’s presence

Personal finance helps us keep our priorities in order. We show our love for our Savior as we pay our tithing. We are examples to our children as we put the Lord first and sacrifice through service, hard work, church and temple attendance, tithing, fast offerings and other contributions.

David O. McKay reminded us: “No other success can compensate for failure in the home.”⁵

We will be disappointed in life if we gain the world’s riches and lose our spouses and families. We must learn to better apply personal finance in the Lord’s way, using His plan and obeying His commandments.

4. Finally, personal finance can help us become wiser stewards

Personal finance helps us learn to be wiser financial stewards over the things God has blessed us with. Joe J. Christensen said: “Our resources are a stewardship, not our possessions. I am confident that we will literally be called upon to make an accounting before God concerning how we have used them to bless lives and build the kingdom.”⁶

For some, a critical question at judgment day from our Savior will be: “How well did you use the resources I blessed you with in the service of your fellow men?”

Understand the Importance of Perspective

The dictionary defines perspective as “one’s point of view, the choice of a context for opinions, beliefs, and experiences.”⁷ The historian Will Durant wrote of the human need “to seize the
value and perspective of passing things. . . . we want to see things now as they will seem forever—"in the light of eternity."'

The challenge then is to see things as they will seem forever. Neal A. Maxwell wrote of those without this perspective:

Living without God in the world brings a functional lack of consistent perspective. If there were no eternal truths, to what principles would mortals look for guidance? If not accountable to God, to whom are we ultimately accountable?

Our perspective—how we look at things—makes a difference in the choices we make. Do we recognize our difference in perspective as we look at the world around us? Do we recognize the implications of our differences in outlook, the differences of our eternal perspective as we go about our daily lives?

The purpose of this section is to articulate “another” perspective on wealth, this eternal perspective. This perspective is critical for us to understand, and it has a major influence on how we make choices.

In this manual and website I take a different view from the world. I disagree with the belief that “money buys happiness.” The media continues to bombard us with the illusion that we have to spend money to be content or that to be happy, a person must be beautiful, sexy, thin, rich, or whatever it is they are selling at the moment.

Most of us are not conscious of the effects of our perspectives on our everyday lives. When we have a proper perspective on life, there is pattern, beauty, and purpose instead of senseless, unconnected fragments. Along with that knowledge of the purpose of life, it is important that we understand correct principles so that we can make good choices.

On the subject of choices, Spencer W. Kimball said:

We hope we can help our young men and young women to realize, even sooner than they do now, that they need to make certain decisions only once . . . We can make a single decision about certain things that we will incorporate in our lives and then make them ours—without having to brood and re-decide a hundred times what it is we will do and what we will not do…. My young brothers [and sisters], if you have not done so yet, decide to decide!

The purpose of this series is to help you in your understanding of perspective as it relates to personal finance and then to help you “decide to decide” to be wise in the management of your personal finances. When we have an eternal perspective, we understand things differently, view events differently, and make choices differently with respect to our families, friends, and our personal finances.

Understand our Perspective for this Course
Our perspective is simple. It is this: *Wise money management is simply living the gospel of Jesus Christ.* It is putting Christ first in our lives, not our pocketbooks. “But seek ye first the kingdom of God, and his righteousness; and all these things shall be added unto you”.  

David A. Bednar talked of doctrines and then related them to principles. He said:

> Principles are doctrinally based guidelines for what we ought to do. Therefore if there is a doctrine of the Atonement, then the first principle of the gospel is faith in the Lord Jesus Christ. Brothers and sisters, doctrine answers the why questions of our lives. Principles provide us with direction about the what and the how.12

So if money management is simply a doctrine of Christ, are there principles upon which wise money management is based? Let me propose a few principles that are the foundation upon which this perspective is based. I call these my “Principles of Finance.”

**Understand the Key Principles on which Our Perspective is Based**

Correct principles are fundamental laws or doctrines, which, if understood, will allow us to live or act according to truth. While easy to find, correct principles may not be easy to live. Richard G. Scott commented:

> [The] inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. You will find correct principles in the teachings of the Savior, His prophets, and the scriptures. While easy to find, true principles are not easy to live until they become an established pattern of life . . . Yet, as you resolutely follow correct principles, you will forge strength of character available to you in times of urgent need.13

What are those principles to which we must adhere? Let me propose a few principles that relate to understanding and using wealth wisely. These principles have made a major difference in my life and the life of my family.

**Principle 1: Ownership**

The Psalmist wrote: “The earth is the Lord’s, and the fullness thereof; the world, and they that dwell therein.”14 The apostle Paul, writing to the Corinthians, stated the same message: “For the earth is the Lord’s, and the fullness thereof.”15

We know from scriptures that the Lord was the creator of the earth16, the supplier of our breath17, the giver of our knowledge18, the provider of our life19, and the giver of all we have and are.20

Nothing we have is our own—it is all God’s. As such, there should be no feeling of pride for the things we have or are. These things do not belong to us, but are on loan from a loving Heavenly Father and His Son, Jesus Christ.
There should be no feeling of pride for the things we have, who we are, or who we will become. Rather, these things are blessings that should encourage us to demonstrate greater obedience to God’s commandments. As we realize that all we have and all that we have become are gifts from a generous Heavenly Father and Son, we will find gratitude and obedience rather than pride.

Principle 2: Stewardship

A steward is one who actively directs the affairs of another. The apostle Paul stated: “Let a man so account of us, as of the ministers of Christ, and stewards of the mysteries of God. Moreover it is required in stewards, that a man be found faithful.”21 The Lord stated, “It is expedient that I, the Lord, should make every man accountable, as a steward over earthly blessings, which I have made and prepared for my creatures.”22

Being blessed with material things in life should not be seen only as a blessing but also as a responsibility. We will be required to give an account of our stewardship to Heavenly Father. In order for us to be wise stewards, it is our responsibility to learn everything we can about our stewardship so we can manage it to the best of our abilities. The purpose of this manual and website is to help you understand and manage your stewardship better as it relates to personal finance.

Principle 3: Agency

The prophet Joshua counseled the people about agency, which is the ability to choose, when he said: “Choose you this day whom ye will serve; . . . but as for me and my house, we will serve the Lord.”23

We were given our agency by a Father in Heaven who gives us our own free will to choose our course in life. This freedom and power to choose is one of the most important stewardships that we have.

David O. McKay wrote: “Next to the bestowal of life itself, the right to direct that life is God’s greatest gift to man. . . . Freedom of choice is more to be treasured than any possession earth can give.”24

We should do everything in our power to thank God for this wonderful right to choose, and then use that agency as wisely as we can.

Principle 4: Accountability

We have been blessed with the wonderful gift of agency, but we will also be held accountable for its use. The Lord counseled, “For it is required of the Lord, at the hand of every steward, to render an account of his stewardship, both in time and in eternity.”25

The blessing of agency is an unconditional gift of God, and how we use that gift shows how much we love Him and His Son Jesus Christ. The first three principles outlined above are God’s gift to us. The fourth principle is our gift to God. We can, through our wise choices, show our
Chapter 1. Personal Finance: Introduction and Another Perspective

Heavenly Father how much we love Him by obeying His commandments and striving to become more like His Son.

These four principles establish a spiritual foundation for understanding wealth that is based on our dependence on God and our need for financial self-reliance to fulfill His purposes. Everything we have is God’s, and the things we receive are all blessings from Him. They are not ours, but they have been given to us as a stewardship for which we can make choices. We should choose well, as we will be held responsible for what we do.

Understand the Implications of That Perspective

The purpose of this section is to help understand the implications of an eternal perspective, which are many and varied, but make a big difference in how we live our lives.

**Implication 1. Life is about others**

Some believe the statement “it’s all about me.” They think life is only about them, that they are the center of the universe, that they decide what they should do, that what they want is right, regardless of what it is, and that they can do whatever they want, because they don’t have to account to anyone. Thoughtful consideration causes us to think about who created us, what our purpose is on earth, and where we can find the most joy.

The more we think deeply, the more we realize that this life is not about us, it is about what we do with our life. Life is a test, a training period or probationary time to show where our heart and our will really are. I believe that if we put Christ first in our lives, we will live eternally with God and our families. If we fail to put Christ first in our lives, in the end it really doesn’t matter what or who we put first.

**Implication 2. It’s About Faith**

Some feel personal finance is all about money. Money is the answer to all our problems. Someone commented: “If you can solve it with money, it is not a problem.” But is it really about money?

In most cases, financial problems are behavioral problems, not money problems. We all know what we should do: live on a budget, spend less than we earn, not go into debt, build a reserve, etc. But other things (ignorance, carelessness, compulsiveness, pride, and necessity) get in the way.

For most, it is not a question of knowledge, but of motivation. How do we motivate ourselves (and others) to do the things we know we should?

Boyd K. Packer answered this when he said: “True doctrine, understood, changes attitudes and behavior. The study of the doctrines of the gospel will improve behavior quicker than a study of behavior will improve behavior.”
Moreover, the Lord admonished: “But no temporal commandment gave I unto him, for my commandments are spiritual; they are not natural nor temporal.”

The lesson for us then is to understand doctrine. Then we can apply it to help us do what we should. The “doctrine” is we have been commanded in the scriptures and by living prophets to:

- Live within our means
- Get out of debt
- Build a reserve
- Save for long-term goals, and
- Teach our children.

From this perspective, we see that financial problems are not problems of money, but rather, problems of faith.

**Implication 3. We Can Have God’s Help**

Some think that they have to do all this work on their own to educate themselves about personal finance. They have to figure it out by themselves and they have to do it all themselves.

There are resources that are available that can be helpful in fulfilling this responsibility in personal finance. They key is to choose your help carefully. Ensure they are not trying to sell products or services. Make sure the principles taught are consistent with the principles of the gospel. This manual and website are good resources to help.

Most importantly, as you work and study, seek the help of the Spirit to guide you. Remember since the Lord has commanded us to be wise financially, He will help us to do it.

Our leaders have counseled: “Whatever our calling, regardless of our fears or anxieties, let us pray and then go and do.”

**Implication 4. Finances are a Spiritual Matter**

Many think money matters are only temporal matters. They feel that how they manage their money has nothing to do with their spirituality. They feel that scriptures talk only of spiritual things and not temporal issues such as financial matters. I consider money matters as spiritual matters for four reasons:

a. **All things are spiritual.** In the scriptures the Lord says, “All things unto me are spiritual, and not at any time have I given unto you a law which was temporal.”

b. **Money is a medium of exchange.** Sterling W. Sill said: “We can build temples with money, we can send out missionaries with money, we can erect educational institutions, operate hospitals, and pay our tithing with money. … In many ways we can build up the kingdom of God with money.”
c. There is no true freedom without financial freedom. Many think they are totally free, even when they are in debt to others. They think that it is OK to be in debt. After all, it builds their credit score, doesn’t it?

Ezra Taft Benson said: “No man is truly free who is in financial bondage.”

d. Money is a tool to teach gospel principles. Money is a tool to teach us many things, including the following gospel principles.

1. Seeking the kingdom of God first. By paying our tithes and offerings first, we show we love God more than material things.

2. The spiritual and physical creation. Money teaches and reinforces both the spiritual and physical creation, as we develop goals and budgets and work toward them.

3. The Law of the Harvest. We learn this as we invest for retirement and other long-term goals. We cannot cut corners with this law.

4. Christ-like characteristics. We learn Christ-like characteristics of charity as we save for our goals, learn and practice giving, serve and sacrifice for others, and as we give up things now for things greater in the future.

Implication 5. We are Responsible for our Choices and our Finances

Some feel that they are not responsible for their financial lives. It is someone else’s responsibility, their parents, the government, their children, etc. They should not have to think and labor for the things they receive.

We are responsible for all our choices, including our financial choices. We cannot spend our way into financial security. We must learn to and save for our own retirement. We must learn to and save for our long-term goals. If we choose, we must learn to and save to help our children with their missions and education. If we want to serve missions later on in life, we must learn to manage our finances wisely and save.

After children become adults, they are responsible for their finances. Parents are not responsible for their adult children’s finances—the adult children are. Likewise children are not responsible for their parent’s finances. Evidence is apparent that parents who continually support their children financially will find their children will always need support. Please note that it is hard for children to learn financial responsibility if they are continually rescued from their poor financial choices or if they do not have to work for what they get.

Others think money matters are a male responsibility for married couples. Some think if wives become knowledgeable about financial matters, their husbands will be upset. Others reason that since the husband makes the money, husbands get to decide where it goes.
Couples are jointly and equally responsible for their finances. The Proclamation on the Family states:

> By divine design, fathers are to preside over their families in love and righteousness and are responsible to provide the necessities of life and protection for their families. Mothers are primarily responsible for the nurture of their children. In these sacred responsibilities, fathers and mothers are obligated to help one another as equal partners.32

Control of money by one spouse as a source of power or failure by a partner to be a part of financial management are both incorrect attitudes. Marvin J. Ashton said:

> Management of family finances should be mutual between husband and wife in an attitude of openness and trust. Control of the money by one spouse as a source of power and authority causes inequality in the marriage and is inappropriate. Conversely, if a marriage partner voluntarily removes himself or herself entirely from family financial management, that is an abdication of necessary responsibility.33

When culture or other traditions go counter to this equality, it must be changed. Husband and wife are equal partners in the Lord’s view.

**Implication 6. Consumer Debt is an Addiction**

Some consider it is OK for them to go into debt for things, especially things they really want. You can’t have a car without a car payment, can you? It is OK to borrow, if you really want it, isn’t it?

Consumer debt is bad. It stops growth and savings, and is expensive, both economically and spiritually. James E. Faust stated: “Over the years the wise counsel of our leaders has been to avoid debt except for the purchase of a home or to pay for an education. I have not heard any of the prophets change this counsel.”34 Sadly, consumer, auto, and credit card debt not paid off monthly are not included in that short list.

Perhaps the debt problem is more a problem of pride than it is of money? Don’t think of it as “I am going into debt.” Think of it as “I’m spending my children’s mission and education money” or “I am disobeying the teachings of my Savior.” Putting these financial decisions in this perspective may be helpful in making better choices.

**Implication 7. Every Family Should have a Budget**

Some feel that living on budgets is only for college students and those that need to be careful with their money, not more “mature” people like ourselves. We do not need to have a budget because we know where the money goes (it goes to pay our bills).

Spencer W. Kimball counseled:
Chapter 1. Personal Finance: Introduction and Another Perspective

Every family should have a budget. Why, we would not think of going one day without a budget in this Church or our businesses. We have to know approximately what we may receive, and we certainly must know what we are going to spend. And one of the successes of the Church would have to be that the Brethren watch these things very carefully, and we do not spend that which we do not have.35

Implication 8. We Cannot Judge or Compare

Some judge others by the outward appearance, by how much money they have, how they are using that money, or by the assets they own or control. They think that appearances are more important than the heart and that they have all the facts necessary to judge.

In the parable of the talents,36 the Lord gave different talents to different people. They each took the talents given them, took responsibility for those talents, and they used the talents to the best of their abilities. They each made different returns on their talents. But the end result was the same wonderful blessing: “Enter thou into the joy of thy lord,”37 regardless of the amount given.

None are in a position to judge based on the talents (or blessings) given them by God. We have been commanded: “Judge not, that ye be not judged. For with what judgment ye judge, ye shall be judged: and with what measure ye mete, it shall be measured to you again.”38

Some, such as parents, bishops or other Church leaders must make judgments as part of their stewardships. The counsel to them is equally important, that they should judge by the “light of Christ.” The counsel is equally strong: “And now, my brethren, seeing that ye know the light by which ye may judge, which light is the light of Christ, see that ye do not judge wrongfully; for with that same judgment which ye judge ye shall also be judged.”39

Just as we are in no position to judge others (or even ourselves) based on what we perceive based on financial blessings, we are in no position to judge or compare with others. Judgment and comparisons are Satan’s tools, not Christ’s. They come from, and lead to, pride, self-aggrandizement, and feelings of being better (or worse) than others. These are not part of Christ’s gospel where “all are alike unto God.”40

Implication 9. We Must Learn to be Financially Wise

The prophet Malachi said: “Bring ye all the tithes into the storehouse, . . . and prove me now herewith, saith the Lord of hosts, if I will not open you the windows of heaven.”41 Doesn’t it say that if I pay my tithing, the windows of heaven will open and I will get all the financial blessings that I need, regardless of any learning, education, thought, application, hard work or effort on my part?

The prophet Malachi promised that God will open the windows of heaven. However, there is no promise that the windows of heaven will be financial blessings or that paying tithing will eliminate all our financial problems. We still are stewards over what we have and are, and must learn to live in this increasingly challenging financial world. There are still more commandments
which relate to finances in addition to just paying your tithing, i.e., living with your means, avoiding debt, teaching your children, building a reserve, preparing for retirement, missions, etc.

Here are some interesting statistics:

- Average per household debt in the U.S. is $14,500 excluding mortgage debt in 2007
- Credit card users pay 12–20% more than cash users
- 40% of American families spend more than they earn
- The typical family pays $1,200 per year in interest
- About 60% of all active credit card accounts are not paid off monthly
- Most couples indicate that finances are a major stress on their marriages

Over the remaining chapters in this book and through the tools, PowerPoints, and videos available on the website at http://personalfinance.byu.edu, we will work together to share what you can do to become more financially wise and better financial stewards, to help you to “decide” and “educate” so that you can “commit,” “believe,” and “achieve.”

Summary

We have talked about many things regarding another perspective on wealth as it relates to personal finance. While we haven’t talked about the real “nuts and bolts” yet, we have talked about critical concepts. The most critical question is why does God want us to learn personal finance? I believe it is due to four reasons:

1. Personal finance can help bring us to Christ.
2. Personal finance can help us accomplish our divine missions.
3. Personal finance can help us return with our families back to Heavenly Father’s presence.
4. Finally, personal finance can help us become wiser stewards.

Perspective is important in studying personal finance. Our perspective is simple. It is that personal finance is simply living the gospel of Jesus Christ; it is putting Christ first in our lives. Our view of the Savior, the way we look at life, at ourselves and others will have an important impact on how we utilize the blessings we have been given by God. It is critical that we have a correct perspective, as perspective impacts our choices.

Four key principles constitute the principles on which this perspective is based. They are:

1. Ownership.
2. Stewardship.
3. Agency.
4. Accountability.

Finally, it is our responsibility to be financially wise. The purpose of this manual and accompanying website, PowerPoints and learning tools is to help you accomplish that purpose.
Assignments

Financial Plan Assignments

Think about the things we have discussed regarding the purpose of wealth in our lives. The world has a different perspective on wealth – generally an incorrect perspective. To become truly wealthy, we must first have a correct perspective and understand the key principles for using wealth wisely. The scriptures state: “For God so loved the world, that he gave his only begotten Son, that whosoever believeth in him should not perish, but have everlasting life.” This is the true kind of wealth. Think about what is necessary to have this correct perspective on wealth.

Read and discuss the following three important chapters that help us with perspective on wealth and our understanding of its key principles: 1 Timothy 6, Jacob 2, and Doctrine and Covenants 6. These chapters are available online at http://scriptures.lds.org/.

Learning Tools

The following Learning Tool will also be helpful as you prepare your Personal Financial Plan:

1. Personal Financial Plan (PFP) Table of Contents

This is a recommended table of contents for your Personal Financial Plan.

Review Materials

Review Questions

1. Why is it important to “decide to decide” now? What problems can it help us avoid?

2. Why does God want us to learn wise money management?

3. What is our perspective and why is it important?

4. What are the four key principles on which that perspective is based? Why are they important? What can we do to incorporate these principles into our lives now?

5. Some have asked, “If wealth is so bad, should we seek for riches?” What did Jacob say about this question in Jacob 2:18–19? What should we seek for first?

Case Studies

Case Study 1

Data
Chapter 1. Personal Finance: Introduction and Another Perspective

Brenda came from a family that had few worldly goods, but there was a lot of love in the home. She has come to talk with you about her finances because she respects you for the wonderful example you have set at work.

Application

She asks you, “What is the purpose of wealth in our lives?”

Case Study 1 Answers

You have lots of good ideas, but you share the following: Jacob shared with us one view of the purpose of wealth in our lives. He counseled us that if we seek wealth, we should do it for the right reasons, and it is OK to do so only after we seek the kingdom of God. The purpose of wealth is not to build ourselves up, and its possession does not allow us to think we are better than other people. Rather, it is to help us bless our families, serve our fellow men, and build the kingdom of God.

Case Study 2

Data

Brenda continues to ask you questions regarding your perspective and principles for using wealth wisely. She is intrigued by your thoughts and answers. She asks if there are principles that you know and have lived that have made a difference in your life.

Application

Share the four key principles for using wealth wisely discussed in this chapter. Why is each principle important? What can we do now to incorporate each principle into our lives now?

Case Study 2 Answers

There are several good answers for these questions. You might respond with:

Our perspective is simple. It is that personal finance is simply living the gospel of Jesus Christ. That perspective is based on four key principles:

1. Ownership: Everything we have or are is a gift from God.
   - It is important because the things we have are not ours but are on loan from a loving Father in Heaven.
   - We can incorporate this principle into our lives by learning that when we share with others, we are only giving back to God what was His in the first place.

2. Stewardship: We are stewards over the things the Lord has blessed us with.
• It is important because we must learn to be better stewards over our blessings because we will be held accountable for what we do with these blessings.
• We can incorporate this into our lives by learning as much as we can about the things we need to do so we can become the best stewards we can over the blessings our Heavenly Father shares with us.

3. Agency: The gift of “choice” is man’s most precious inheritance.
• It is important because we need to use this gift wisely so we can return and live with God eternally.
• We can incorporate this into our lives by studying all areas of our decisions and decision-making processes so we can have the information needed to make the best decisions possible.

4. Accountability: We are accountable for our choices.
• We are the final decision-makers in life.
• It is important because we must learn to choose wisely.
• We can incorporate this into our lives by setting good goals and then by making wise choices to help us attain those goals—goals that our Heavenly Father would have us seek for.

1 1 Nephi 3:7.
7 In en.wikipedia.org/wiki/perspective, May 1, 2007
8 The Story of Philosophy, New York: Simon and Schuster, 1927, p. 1
9 “Take Especial Care of Your Family,” Ensign, May 1994, 88
11 Matt. 6:33.
12 David A. Bednar “Teach them to Understand,” Ricks College campus Education Week Devotional, June 4, 1998, Rexburg, Idaho.
14 John 1:3
15 Acts 17:24-25
16 Moses 7:32
17 Acts 17:28
18 Mosiah 2:21
20 Joshua 24:15.
21 Conference Report, Apr. 1950, p. 32; italics added.
22 Doctrine and Covenants 72:3.
24 D&C 29:35.
Chapter 1. Personal Finance: Introduction and Another Perspective

29 D&C 29:34.
36 Matthew 25:14-30
37 Matthew 25: 21, 23.
38 Matt 7:1-2.
39 Moroni 7:18.
40 2 Nephi 26:33.
41 Malachi 3:10.
42 John 3:16.
2. Beginning Investing 1: Principles

Introduction

The previous chapters have been successful if they have helped you put personal financial management into perspective. These chapters have taught you to live on a budget, keep track of where your resources are going, manage your cash and cash equivalents wisely, protect yourself from loss by owning insurance, and make big-ticket purchases wisely. Now we begin a discussion on long-term investing.

Please be aware that this class approaches the subject of investments differently than other textbooks approach this subject. Most books take an asset-based approach: in other words, they talk about stocks, bonds, mutual funds, and other assets. These assets will change over time as new assets are developed and sold. I take a principles-based approach to discussing investments because the principles will not change over time.

Objectives

When you have completed this chapter, you should understand the key principles of investing including:

1. Investment basics
2. What to do before you invest (the top of the “investment hourglass”)
3. Investing factors you control
4. The ten principles of successful investing
5. Understand what you invest in (asset classes)

Properly prepare yourself to invest and understand what you will be investing in before you begin your investment program; these are important keys to success.

Investment Basics

It is important that we understand the key principles of investing. Richard G. Scott commented:

Joseph Smith’s inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. . . Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you. Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice.¹

What are the correct principles when it comes to investing? Let me share a few ideas.
Principle: Everyone invests

Perhaps to start, we should define investing. Most would agree it is the giving up of something important to us now in order to get something better in the future. Now think about sacrifice. How would you define that term? Again, most would agree that it is the giving up of something important to us now in order to get something better in the future. Notice that these terms are nearly identical. We all invest, in terms of giving up our time, our talents, and our resources for things better in the future. Let’s not be too narrow in our view of investing.

Principle: There is a purpose to investing

Spencer W. Kimball said:

Many people spend most of their time working in the service of a self-image that includes sufficient money, stocks, bonds, investment portfolios, property, credit cards, furnishings, automobiles, and the like to guarantee carnal security throughout, it is hoped, a long and happy life. Forgotten is the fact that our assignment is to use these many resources in our families and quorums to build up the kingdom of God.”

I believe that God wants us to learn to invest, and we should want to learn as well. From the Lord’s view, the purpose of investing are:

• To bring us to Christ
• To help us achieve our divine missions
• To help us return with our families back to His presence, and
• To teach us to be “wise stewards.”

From our view, the purpose of investing is:

• To show by our choices what we really believe
• To accomplish our short- and long-term personal and family goals, and
• To steward our resources to be able to serve and bless our families and others.

Principle: There is a priority of investments

There is a priority of investments. Below are mine (see Picture 1). Do not be too narrow in your view of investing and investments.

Principle: Investing is not gambling

Some have wondered the difference between investing and gambling. They think that investing in the stock or bond markets are simply gambling. Perhaps we can share some thoughts on the difference between investing and gambling. They are:

Investing: The odds are in your favor
• There is a favorable risk-return tradeoff
• It is part of a long-term plan
• You have done your homework
• It involves the creation of wealth

Picture 1. My Most Important Investments

Gambling: The odds are in another’s favor

• There is no favorable risk-return tradeoff
• There is no long-term plan
• There is no homework, only chance
• It is a zero-sum game—no wealth is created

So the difference is in the risk-return tradeoff, the planning, the work, and the creation of wealth.
What to Do Before You Invest

Following are some other important questions to ask yourself before you start investing:

- Are there certain products or services you feel you should never do without? Should you have health and life insurance before you begin investing?
- Is there a better use for your money than investing? Are there bills or debts you should pay before beginning your investment program? What should you do about your high-interest debts such as credit cards and consumer loans? Does it really make sense to earn 8 percent annually on an investment when you are paying 24 percent annually for credit cards and other forms of debt?
- How does investing fit in with your personal goals and budget? Do you have a plan for investing?

As I have worked with families and students, I have developed a helpful framework for teaching investing. I call this framework “the investment hourglass.” This tool helps relate priorities and risks to the goals you want to accomplish.

The investment hourglass is divided into two parts: the top of the hourglass, which represents questions you should consider before you invest, and the bottom of the hourglass, which represents how you should invest.

The hourglass is designed to help you prioritize your goals and objectives. Since investing is a means to an end—and not an end in itself—you should base your investment decisions on your priorities and personal goals. If you can answer each of the questions listed in the top of the hourglass affirmatively (see Chart 1), you are ready to invest. If you cannot agree with any of these statements, you have important steps to take before you begin investing.

The top of the hourglass teaches about priorities. What are your most important priorities, and how do we make sure we put first things first? First and foremost, your most important priority is being “square” with the Lord, who I believe is your most important creditor. Before you invest, ask yourself if you have paid your tithes or other contributions to your local church or religious organization consistent with your belief in God.

Your second priority is your family. If something were to go wrong with your health, or if you were to die, who would take care of your family? Make sure you have adequate life insurance and health insurance in place before you begin investing. Disability or death is not a valid excuse to stop providing for the needs of your family.

Your third priority is yourself. Personal responsibility has two parts: the first involves getting out of credit card and consumer debt. When there is no guarantee that you will make a return on your investments in the stock market, it does not make sense to pay 24 percent interest on credit cards. The second part of personal responsibility involves living by your budget, knowing your personal and family goals, and having an Investment Plan. Figuratively speaking, before you drive to a new location, you must understand where you are, where you want to be, and how to
get there. Your budget represents where you are, your goals represent where you want to be, and your Investment Plan represents how to get there.

**Chart 1. Top of the Investment Hourglass—Before You Invest**

1. Are your priorities in order and are you “square” with the Lord?
2. Do you have adequate health and life insurance?
3. Are you out of high-interest credit card and consumer debt?
4. Have you written down your personal goals, do you live on a budget, and do you have a well-written investment plan?

If you can answer “yes” to each of the questions from the top of the investment hourglass, you are ready to invest. This hourglass can help you keep your priorities in order: God first, family second, and personal responsibility third.

**Factors Controlling Investment Returns**

Reinhold Niebuhr in the Serenity Prayer wrote, “God grant me the serenity to accept the things I cannot change; courage to change the things I can; and wisdom to know the difference”\(^3\) (see Picture 3).

There are six factors that control investment returns. Five of those factors are within your personal control, while only one is outside of your control. The five factors you control are:

- How much you save,
- How long your investments grow,
- Your mix of investments, i.e., your asset allocation,
- How much you pay in expenses, and
- How much you pay in taxes.

The only factor you do not control is
If you want to do well on your investing, spend your time and efforts on the things you can control! Focus on:

- Saving money each week or month by reducing your spending and sticking to your budget
- Keeping your investments in the market at your risk level,
- Your asset allocation mix, compounding, and diversification, and
- Reducing fees, expenses, transactions costs, and taxes.

Successful investors spend their time on the areas that are within their personal control while spending a minimal amount of time on areas outside their personal control. In the area of investment returns, some investors use passive management/indexing as an investment strategy to minimize risk and give them some control over their investment returns. On the other hand, most novice investors spend their time on areas they cannot control and fail to be concerned with areas they can control.
This chapter will give a brief review of the process for selecting investment vehicles. It will then briefly discuss the major asset classes and their risk and return history.

Recognize the 10 Principles of Successful Investing

If you understand the “correct principles” that relate to successful investing, you will be able to “govern,” or manage, your investment portfolio better. Dallin H. Oaks said:

We live in a complex society, where even the simplest principle can be exquisitely difficult to apply. I admire investors who are determined not to obtain income or investment profits from transactions that add to the sum total of sin and misery in the world. But they will have difficulty finding investments that meet this high standard. Such complexities make it difficult to prescribe firm rules. We must rely on teaching correct principles, which each member should personally apply to govern his or her own circumstances.4

Once you are ready to invest, you must recognize that there is not just one right way to invest. There are multiple methods of investing, depending on your budget, personal goals, and Investment Plan. The key to successful investing is to know yourself and what you are trying to accomplish.

An important question to ask about investing is “how have most investors done?” By answering this question, it can help us to see if the current methods used by most investors have been successful in helping them attain returns in excess of their benchmarks—what they could accomplish with an indexing strategy.

To understand how most equity investors have done in investing, you must compare their returns to their benchmarks or indexes. One of the longest surveys of how investors have done is provided by Dalbar (Dalbar.com). Each year DALBAR puts out an annual survey called Quantitative Analysis of Investor Behavior (QAIB), which discusses how the average investor in equities, fixed income and asset allocation funds have done compared to his or her benchmarks over the past 20 years. It covers returns over the past 20 years and it is updated every year.

Interestingly, with all the information available at our fingertips via the internet and with our abilities to buy and sell stocks instantaneously, most investors have not had very high returns in comparison to their benchmarks (see Table 1). For example, over the 20 year period from 1993 to 2012, the average equity investor’s returns were 4.3% versus the equity benchmark returns of 8.2%, resulting in a shortfall or difference of 4.1%. While the good news is the difference is declining, the bad news is that it is still significant.

Have bond investors done any better in comparison to their bond benchmarks? Sadly, the returns were even less and the difference between the average bond investor’s return and the bond benchmarks was even greater (see Table 2).
What about those who participate in an asset allocation strategy (actively moving between equity markets and bond markets based on which seems most attractive)—how have they done? Again, the results are not overly encouraging (see Table 3).

### Table 1. Historical Analysis of Equity Investor’s Return

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor Period</th>
<th>Investor* Returns</th>
<th>Benchmark Returns</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>1987–2006</td>
<td>4.3%</td>
<td>11.8%</td>
<td>-7.5%</td>
</tr>
<tr>
<td>2008</td>
<td>1988–2007</td>
<td>4.5%</td>
<td>11.8%</td>
<td>-7.3%</td>
</tr>
<tr>
<td>2009</td>
<td>1989–2008</td>
<td>1.9%</td>
<td>8.4%</td>
<td>-6.5%</td>
</tr>
<tr>
<td>2010</td>
<td>1990–2009</td>
<td>3.2%</td>
<td>8.2%</td>
<td>-5.0%</td>
</tr>
<tr>
<td>2011</td>
<td>1991–2010</td>
<td>3.8%</td>
<td>9.1%</td>
<td>-5.3%</td>
</tr>
<tr>
<td>2012</td>
<td>1992–2011</td>
<td>3.5%</td>
<td>7.8%</td>
<td>-4.3%</td>
</tr>
<tr>
<td>2013</td>
<td>1993–2012</td>
<td>4.3%</td>
<td>8.2%</td>
<td>-4.1%</td>
</tr>
</tbody>
</table>

* DALBAR 2007–2013

### Table 2. Historical Analysis of Fixed Income Investor’s Return

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<tr>
<th>Year</th>
<th>Investor Period</th>
<th>Investor* Returns</th>
<th>Benchmark Returns</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
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<td>2007</td>
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<td>1.7%</td>
<td>8.6%</td>
<td>-6.9%</td>
</tr>
<tr>
<td>2008</td>
<td>1988–2007</td>
<td>1.6%</td>
<td>8.0%**</td>
<td>-6.4%</td>
</tr>
<tr>
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<td>1989–2008</td>
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<td>7.4%</td>
<td>-6.6%</td>
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<tr>
<td>2010</td>
<td>1990–2009</td>
<td>1.0%</td>
<td>7.0%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>2011</td>
<td>1991–2010</td>
<td>1.0%</td>
<td>6.9%</td>
<td>-5.9%</td>
</tr>
<tr>
<td>2012</td>
<td>1992–2011</td>
<td>0.9%</td>
<td>6.5%</td>
<td>-5.6%</td>
</tr>
<tr>
<td>2013</td>
<td>1993–2012</td>
<td>1.0%</td>
<td>6.3%</td>
<td>-5.3%</td>
</tr>
</tbody>
</table>

* DALBAR 2006–2012, ** Estimate, not given in report

### Table 3. Historical Analysis of Asset Allocation Investor’s Return

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor Period</th>
<th>Investor* Returns</th>
<th>Benchmark Returns**</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>1986–2005</td>
<td>3.3%</td>
<td>11.0%</td>
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<tr>
<td>2007</td>
<td>1987–2006</td>
<td>3.7%</td>
<td>10.5%</td>
<td>-6.8%</td>
</tr>
<tr>
<td>2008</td>
<td>1988–2007</td>
<td>3.5%</td>
<td>10.1%</td>
<td>-6.7%</td>
</tr>
<tr>
<td>2009</td>
<td>1989–2008</td>
<td>1.7%</td>
<td>8.0%</td>
<td>-6.3%</td>
</tr>
<tr>
<td>2010</td>
<td>1990–2009</td>
<td>2.3%</td>
<td>7.7%</td>
<td>-5.4%</td>
</tr>
<tr>
<td>2011</td>
<td>1991–2010</td>
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<td>8.2%</td>
<td>-5.7%</td>
</tr>
<tr>
<td>2012</td>
<td>1992–2011</td>
<td>2.3%</td>
<td>7.5%</td>
<td>-5.92</td>
</tr>
</tbody>
</table>

* DALBAR 2006–2013 ** Estimate of 60% equity and 40% fixed income benchmarks

As the saying goes, “If you do what everyone else does, you will get what everyone else gets.” Based on the DALBAR studies, it seems that whatever people are doing regarding investing is not working very well for equity or fixed income investors. Perhaps there are better ways to invest than what others have done in the past.

How have most actively managed mutual funds performed compared to their benchmarks? If they have performed better, we could conclude that the active managers are adding value over and above the return that an investor could receive by investing in a low-cost, tax-efficient index fund or ETF.
In general, actively managed mutual funds have not beaten their benchmarks over the long term. While in some years actively managed funds outperform their index fund counterparts, the support for actively managed funds for longer periods of time is low.

Another paper that examined mutual fund performance on both a total return and after-tax basis reported:

In general, we find that index funds outperform actively managed funds for most equity and all bond fund categories on both a total return and after-tax total return basis, with the exception of actively managed small company equity and international funds. These results should be viewed with caution, however, as there is evidence that actively managed funds outperform the index funds during periods when the economy is either going into or out of a recession.\(^5\)

**Chart 2. Percentage of Actively Managed Funds That Failed to Beat Their Benchmarks\(^6\)**

Recent experience is not much different. In the last 10 years, the percentage of actively managed funds that failed to beat their benchmarks was in excess of 55-65%, depending on asset class (see Chart 1).

Whatever you decide to invest in, and whatever phase of investment you are in, it is critical that you adhere to correct principles. Following are 10 principles that I believe, if followed, will help you to minimize that difference between investor returns and benchmarks and will likely help you to have a successful portfolio.
Chapter 2. Beginning Investing 1: Principles

Principle 1: Know Yourself

Investing is not an end in itself; rather, it is a means of reaching your personal and family goals. Consequently, you need to know yourself as an investor. You should have well-written and well-thought-out goals; goals are critical because they help you determine what you want to accomplish with your investment program. For help on writing your goals, see Chapter 2. Creating Your Personal Financial Plan and Setting Personal Goals.

You also need to know your budget. A critical part of successful investing is having a well-planned budget; a percentage of your income should be earmarked for savings and investment. You cannot invest without funds, and you should not invest with borrowed money. For help on budgeting, see Chapter 3. Budgeting and Measuring Your Financial Health.

You also need to understand your ability to tolerate risk. You want to develop a “sleep-well portfolio”—a portfolio that is planned so that even when investments go wrong, as they often do, you can still sleep well at night.

Beware of overconfidence in your portfolio. One sign of overconfidence is frequent trading. A study found that men trade 45 percent more often than women trade and that men’s annual returns were, on average, 2.7 percent lower than women’s annual returns. The study also found that single men trade 60 percent more often than single women trade and that single men’s annual returns were 1.4 percent lower than single women’s annual returns.

You must be especially wary of overconfidence when trading online. The same study showed that the same group of investors beat the market by 1.9 percent before online trading. However, when the same group of investors switched to online trading, the group underperformed by 3.6 percent. While online trading may appear to give you more control, it can result in lower overall returns if it leads to more frequent trading.

Principle 2: Understand Risk

Risk is inherent in all investment activities. Some risks include inflation risk, business risk, interest-rate risk, financial risk, market risk, political and regulatory risk, exchange-rate risk, call risk, and liquidity risk. The key to managing risk is to understand the different types of risk and to invest at a risk level that is comfortable for you. Often, taking a risk tolerance test will help you discover the level of risk that is right for you. One such risk tolerance test is included in the Learning Tools section of this website in Learning Tool 16: Risk Tolerance Test.

Principle 3: Stay Diversified

Diversification is your best defense against risk. Diversification does not mean simply investing in 10 different banks; rather, to be properly diversified, you should invest in different companies, industries, and perhaps even countries that won’t be subject to the same economic factors or risks. Make sure you understand the risks of each of your investments.
Many people review the portfolio returns from various asset classes over the last 10, 20, or 50 years to get an idea of an asset class’s performance history. However, these people often invest in only one or two single assets instead of in a portfolio of 500 or more stocks and are often disappointed when they do not get the returns they expected. Remember, the returns from asset classes are from portfolios of hundreds of assets—not from individual assets. To see the effects of diversification, see Learning Tool 23: Return Simulation for Asset Classes in the Learning Tools directory of this website.

**Principle 4: Make Low-Cost and Tax-Efficient Investments**

Watch your investment costs carefully, including costs for transaction fees, management fees, and taxes. Remember that when investing, a dollar saved is worth more than a dollar earned.—you have to pay taxes on every new dollar you earn, but every dollar you save is already taxed and can earn interest on income. Be aware that frequent trading incurs significant transaction and tax costs; avoiding this will help you keep your costs low.

Defer or eliminate taxes as much as possible. Mutual funds are required by law to distribute 90 percent of all capital gains, dividends, and interest to their shareholders each year. That means you must pay taxes on the distributions from your mutual funds each tax season, even though you may not have sold a single share. Mutual funds are pass-through accounts for tax purposes, which means that the tax consequences of the mutual fund are paid by the investor, not the mutual fund. The portfolio manager’s decisions can have a significant impact on your tax bill.

Make tax-efficient investments to avoid paying more taxes than necessary. Remember, it is not the amount of money you make but the amount of money you keep after taxes and inflation that makes you wealthy.

**Principle 5: Invest for the Long Run**

Invest for the long run; this is how you will achieve your goals. There are no “get-rich-quick” schemes that work.

Avoid short-term trading. Short-term trading is expensive and incurs transaction costs and taxes. Be sure to keep at least part of your funds in the market for the long run—taking money out of the market may not only slow your progress but could stop it altogether. A recent study found that those who traded more often, using the turnover ratio as a proxy for trading, had lower returns than those who traded less often and used a buy-and-hold strategy (see Chart 2).

**Principle 6: Use Caution If You Are Investing in Individual Assets (which I do not recommend)**

If you want to invest in individual assets (which is not necessary for a successful portfolio), do your homework and know what you are investing in and who you are investing with. Learn about the company, its financial statements, its management, its short- and long-term strategies, its domestic and global industry, and its competition. It takes many hours of diligent, careful
research to investigate a company thoroughly. Do not take others’ word for it: do the research yourself. Of course, finding a great company is not enough—the stock must also be priced right. A great company whose stock is overpriced can still be a lousy investment.

Chart 2. Trade More, Make Less

![Chart showing transaction costs and returns for different types of traders.]

If you do not have time to research individual companies, invest in mutual or index funds that contain many individual assets. If your mutual fund has 10 stocks, you need to know those 10 stocks well. However, if your mutual fund has 500 or more stocks, you do not need to know those 500 stocks as well because each stock has such a small impact on your total portfolio.

**Principle 7: Monitor Portfolio Performance against Benchmarks**

Thomas S. Monson stated, “Where performance is measured, performance improves. Where performance is measured and reported, the rate of improvement accelerates.”

How can you know how your investments are doing if you do not monitor their performance? To understand the performance of your investments, you will need to learn how to use benchmarks. Benchmarks are passively managed portfolios of financial assets that indicate how well your financial assets are performing. Set your own portfolio benchmarks and then monitor your portfolio performance on a monthly, quarterly, and annual basis.
If you choose to invest in actively managed mutual funds, compare the assets’ after tax performance against the benchmarks you have set. If the return on these assets is consistently lower than the benchmarks, consider investing in no-load (no sales charge), low-fee index funds, which are discussed later in this course. The returns on index funds are generally more consistent in matching the performance of selected benchmarks than actively managed funds.

**Principle 8: Do Not Waste Too Much Time and Energy Trying to Beat the Market**

It is difficult, expensive, and time-consuming to try to beat the market, or gain returns in excess of the returns on the major asset classes. While it may be possible on a short-term basis, it is difficult to consistently beat the market on a long-term basis. You are competing against hundreds of thousands of professional money managers with much more time, money, and access to information than you have.

If you want to try to beat the market, try for a short period of time and compare your returns after taxes to your benchmarks. Do not waste too much time and energy trying to beat the market because you will be able to match the market return with little or no effort through no-load, low-fee index mutual funds or exchange traded funds (ETFs).

If you feel you must trade actively, try to trade efficiently in terms of taxes. Trade in tax-deferred or tax-eliminated retirement accounts such as a 401(k), Roth IRA, or traditional IRA accounts so your taxes are eliminated or deferred until you take the money out at retirement.

**Principle 9: Invest Only with High-Quality, Licensed, Reputable People and Institutions**

When you need help, do not be afraid to ask for it. However, be sure to get help from good people whose actions and beliefs are consistent with the principles discussed in this chapter. Good help from qualified, licensed, and experienced financial planners, financial advisors, and brokers may help you with your Investment Plan.

Make sure you invest with mutual fund companies that have a tradition of meeting the needs of their investors. Work with good companies that offer good products. Be careful with your money and invest it wisely.

Use the best resources available to help you invest, but be aware of how much you pay to use those resources. In addition, make sure your advisors are licensed to counsel you on the broad range of investment assets you are (or should be) considering. Work only with licensed and registered advisors. In some circumstances, fee-only financial planners or advisors may be a better choice than financial planners or advisors that are paid on commission.

**Principle 10: Develop a Good Investment Plan and Follow It Closely**

Develop a good Investment Plan that is consistent with your goals, your budget, and the principles discussed in this chapter. Follow this plan closely. An Investment Plan is a detailed road map of your investment risk and return, constraints, investment strategy, and reporting and
evaluation methodology. For an example of an Investment Plan, see Learning Tool 5: Investment Plan Example in the Learning Tools directory of this website.

Your Investment Plan should outline the amount of return you are seeking and the risk level you are comfortable with for investments. This plan documents constraints—such as taxes, liquidity, and time horizon—that affect your portfolio. It details which asset classes you will or will not invest in and includes your view on active versus passive management. It lays out your plan for the percentage of gross income you will invest each month, the amount you will invest in each of your chosen asset classes, the maximum percentage of your assets that you will invest in any single new investment, and the ways your strategy will change as you get older. Finally, your Investment Plan details how often you will rebalance your portfolio and how often you will report the portfolio performance to others.

Think of your Investment Plan as a road map to successful investing. Your plan should be consistent with the principles discussed in this course. If you plan wisely and invest accordingly, you will save yourself from heartache and problems in the future, and you will likely achieve your personal and family goals.

Understand What You Invest In

Investing entails risk, which means different things to different investors. Risk could mean the possibility of losing all your money. It could also mean the possibility of losing principal. Risk could also entail the possibility of not achieving a specific holding-period return.

Risk is measured in many different ways. In the past, the main risk of investing was considered “default risk,” or the risk that a company would not be able to pay back an investment due to default or bankruptcy. Government securities were considered risk-free investments because investors knew the government could always print money.

In more recent years, analysts began to use variance, or standard deviation, to better measure risk; using this measurement, they found that even government securities are risky. This measure of risk is not concerned with the possibility of default but with the volatility of the investments—the risk that the investment’s return may be lower than expected. Currently, investors also use a metric known as “beta,” which measures the way a specific stock moves in relation to a specific market or benchmark.

Generally, most investors prefer to use variance or beta to measure risk. Both are measures of how volatile a stock is—how much it moves both up and down. In the case of beta, risk is also measured by how much the stock moves in comparison to a specific benchmark. A lower variance indicates that the price does not move very much. A higher variance indicates that the price moves a lot in comparison to the benchmark. A beta higher than one indicates that the stock is more volatile than the market; a beta less than one indicates that the stock is less volatile than the market; a beta of exactly one indicates that a stock moves with the market. When you look at a stock’s returns, you should always look at the variance of the stock as well. Generally, higher returns carry higher risks because investors must be compensated for taking on additional risk.
There are a few important concepts you should understand related to risk:

- **Investment risk** is the probability of not achieving some specific return objective.
- The **risk-free rate** is the rate of return that will definitely be obtained.
- The risk premium is the difference between the expected return and the risk-free rate.
- **Risk aversion** is the reluctance of an investor to accept risk.

### The Importance of Asset Classes

Understanding asset classes is critical if you are to invest. You should invest at a level of risk that you are comfortable with and that will help you to achieve your personal and financial goals. The way you manage risk is by managing the amount of your portfolio in the respective asset classes (or baskets of investments).

Asset classes are broad categories of investments with specific and similar risk and return characteristics. They are distinguished by characteristics specific to particular groups of securities, such as type of financial instrument, market capitalization, maturity, geographic location, etc. The major asset classes are cash and cash equivalents, fixed income, and equities. We will discuss each asset class simply to help you understand the benefits and risks of the specific asset class.

**Cash and Cash Equivalents.** The major goal of this asset class is liquidity and to preserve capital. This asset class includes Certificates of Deposits (CDs), money market funds, T-bills, and commercial paper, etc. For an individual investor, it would also include your savings, checking account, money market deposit accounts. It offers a fixed rate of return.

Cash includes money market funds which seek to preserve the value of your investment and still offer a somewhat competitive return. Short-term interest-bearing investments includes Treasury bills and Savings Bonds, loans to the U.S. Government, and commercial paper, loans to corporations.

The advantages of cash and cash equivalents is liquidity and stability of principal. You can turn these securities into cash quickly and easily. They are generally low risk. There is little risk of losing principal since the borrowers have good credit and loans are for short periods of time. These are good investment assets for money you plan to use in less than 3-5 years and don’t want to take risks with losing principle.

The disadvantages is that they are less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with inflation.

Four final thoughts on cash:

1. Cash is great for liquidity—especially for your Emergency Fund.
2. Returns on cash are unlikely to keep up with taxes and inflation.
3. Cash assets are generally fully taxable—make sure you take taxes into consideration.
4. Use cash for liquidity and some diversification, but realize that this asset class will add little to performance over time.

**Fixed Income (or Bonds).** The major goal of fixed income is to provide income and to hopefully earn returns in excess of inflation. There are many different types of fixed income assets including taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae); tax-free bonds include revenue or general obligation bonds issued by local or state governments and agencies. Such bonds are generally free from federal and state taxes on income.

Short-term bonds (or short term bond mutual funds) include bonds that mature in less than five years. Short-term bonds are less vulnerable to interest rate risk than long-term bonds as there is a shorter time period before the bonds mature. Short-term bonds are generally considered good investments for anyone needing a dependable stream of income (dividends) in an environment where interest rates are not likely to rise.

Intermediate-term bonds/bond funds are bonds with a maturity of 3–10 years. Because of their longer maturity, they are more susceptible to interest rate risk, the risk that interest rates rise during the period you own the bonds.

Long-term bonds (or junk bonds or bond mutual funds) are bonds with a maturity of 10 or more years. These bonds generally have the highest yields, but are the most vulnerable to interest rate volatility.

Inflation protected securities are securities whose yield is linked to the rate of inflation as measured by a specific inflation index. These bonds have the benefit that when interest rates rise, the yield on the bond rises as well.

The U.S. Government also sells savings bonds to investors whose earnings fall within specific income limits. I Bonds (or inflation linked bonds) have their interest rate linked to inflation that changes every six months. EE Bonds pay a fixed interest rate over a specific period of time.

Bond mutual funds are different from buying individual bonds. Mutual funds buy and sell bonds before they mature. Investing in a bond mutual fund means you are buying a share in thousands of different bonds in a changing portfolio, and so you are more diversified than in buying an individual bond. The income from a fixed-income mutual fund fluctuates as mutual funds buy and sell bonds. The market value of the mutual fund changes depending on whether the fund is selling bonds at a loss or gain. The longer the maturity of the bonds (see the average maturity) the more dramatically your principal will gain or lose value as interest rates change.

The advantages of fixed income investments is that they offer greater potential return than cash, but at greater risk. They are a good diversification tool when holding a diversified portfolio of assets, as bonds generally move differently than stocks.
The disadvantages are that returns have been historically lower than stocks. They are very susceptible to interest rate and other risks. Generally, fixed income assets alone are not good long-term investments because they don’t provide enough growth to beat inflation over long periods of time. The should be part of an overall diversified portfolio.

**Equities (or Stocks).** The major goal of this asset class is to provide growth and earn returns in excess of inflation. Over long periods of time, the stock market historically has been the only major asset class to consistently outpace inflation.

An equity share is ownership in a businesses’ earnings and assets. You get a proportionate share of the profits by receiving dividends, and also benefit from increases in the company’s share price as well. Mature companies are a likelier source of dividends (rapidly growing companies often prefer to reinvest profits).

Equity asset classes are generally delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), or geographic area. The benchmarks for each asset class tend to change over time, but equity asset classes can be generally defined as follows:

Market capitalization is one measure of the size of a company. It is calculated by multiplying the market price of the stock by the number of shares (i.e. ownership pieces) outstanding. The greater the capitalization, the larger the company. It is used to weight companies in various benchmarks by the size of the company, i.e. large-capitalization (or large cap), mid-capitalization (or mid-cap), or small-capitalization (or small-cap) firms.

Large caps are stocks with a market capitalization greater than $10 billion in the US, and smaller capitalizations for international companies. These are the generally the largest, most well established companies in the US, with a history of sales and earnings as well as notable market share which has allowed them to grow and expand. Traditionally, large cap was synonymous with "dividend-paying company," but this is no longer a standard for classification. These are generally mature corporations with a long track record of steady growth and dividends.

Mid-cap or mid-capitalization stocks are stocks with market capitalization between roughly $2 billion and $10 billion. These stocks tend to grow faster than big cap companies, and are generally less volatile than small cap companies. Mid-caps generally perform somewhere between small-cap and the large-cap asset classes. For asset-allocation purposes, mid-caps are generally not considered a major asset class.

Small-cap or small capitalization stocks are companies with a market capitalization less than $2 billion. These are smaller, sometimes newer, US and global companies that are still developing and may have a smaller market share than their large-cap counterparts. Small-cap stocks are subject to greater volatility and may fail more frequently than companies in other asset categories, but are generally expected to grow faster than bigger companies.

Within the equity stock categories are three separate types of stocks: growth, value and blend.
Growth stocks are companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things.

Value stocks are companies which are inexpensive in terms of the market (in terms of low PE and low P/BV ratios). These are companies that have potential for good long-term return through both appreciation and dividends.

Blend stocks are stocks that include part of both value and growth components.

International/Global/Emerging Market stocks are stocks of companies based entirely outside the U.S. or throughout the world. These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world. Funds that contain a mixture of U.S. and foreign holdings are called global funds.

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Stock mutual funds are funds that own stock in specific groups or types of companies. When you buy a mutual fund, you are buying a share in multiple companies which change over time depending on the fund manager’s decisions. You are responsible for paying taxes on all distributions by the mutual fund, which are taxed at your level—not the fund level.

Mutual funds are delineated by investment objective, which can be any of the equity asset classes discussed above.

The advantages of equities is that when purchased as part of a diversified portfolio they offer highest return of the major asset classes. Growth and value stocks tend to perform in alternating cycles—it makes sense to own both types. Stock generally are a good investment for long-term investing—they have consistently beat inflation over the long-term

The disadvantages of equities are they offer less stability of principal than other asset classes, and subject to short-term price fluctuations. Equities are risky for short-term investments. If you’re investing for less than 3-5 years, only a small portion (if any) of your investments should be in stocks due to their volatility.

**History of Asset Class Returns**

It is important to understand how the various asset classes have performed historically. Remember that an asset class is a group of financial assets with similar risk and return characteristics. From a historical analysis, we can learn much about a particular asset class (see Chart 3).
I believe it is important to study history, including the history of investments and investment returns. Some have questioned the importance of learning an asset class’s performance history because they reason that the future will not be like the past. Gordon B. Hinckley stated the following regarding this notion: “All of us need to be reminded of the past. It is from history that we gain knowledge which can save us from repeating mistakes and on which we can build for the future.”

What have been the characteristics of risk and return historically? Chart 4 and Table 4 show that from 1927 to 2012, large-capitalization stocks (as represented by the S&P 500) have yielded a return of about 9.5 percent per year and have a standard deviation of 19.2 percent. Small-capitalization stocks have yielded a return of about 12.0 percent per year and have a standard deviation of 29.1 percent. T-bonds have yielded a return of 5.6 percent per year and have a standard deviation of 8.4 percent. T-bills have yielded a return of about 3.6 percent per year and have a standard deviation of about 0.9 percent. Note that while different asset classes have different risk and return relationships, there is generally a positive relationship between risk and return (see Chart 3). Moreover, these numbers will change every year.

Chart 5, which shows the S&P 500 annual return since 1925, shows that the annual return appears to be very volatile—there are many years of high returns and many years of negative returns. However, looking at the return in terms of 5-year periods instead of 1-year periods shows that there are only a few major periods of time on the chart that show a negative return (see Chart 6). If you follow the return trend over a 10-year period, you will likewise see that there have been very few times when the 10-year return was not positive (see Chart 7).

We will now look at risk, or standard deviation. Table 4 shows the geometric return and the standard deviation for each of the major asset classes. As you look at the large-cap (the Standard
and Poor’s 500 Index) return and risk, note that over 5, 10, 25, 50, 75, and 85 years, the return was volatile, yet over longer periods has been around 7 to 10 percent. The standard deviation has ranged from approximately 15 percent to 20 percent.

Chart 4. Annual Risk versus Return

![Chart 4. Annual Risk versus Return from 1927-2012](chart4)

Chart 5. S&P 500 Annual Returns

![Chart 5. S&P 500 Annual Returns from 1926 - 2012](chart5)

If you look at small-cap returns over the same periods of time, you will see that same volatility, particularly in recent years. Though over longer periods the return has been between 10 to 14 percent, notice that the risk levels of small-cap returns (the standard deviation) are between 20 percent and 30 percent.
If you look at fixed-income investments (T-bonds), you will see that they have, on average over longer periods, yielded a return ranging from 5 percent to 9 percent; the variance for T-bonds during this time period was between 8 percent and 12 percent.

If you look at T-bills on the chart, you will see that they have yielded a range of approximately 0.1 to 5 percent interest over the various periods of time; T-bills have had a standard deviation of between 0.1 and 0.9 percent.
Inflation (as measured by the CPI) has been between 1.5 and 4.1 percent with a standard deviation of between 0.5 and 1.9 percent.

In order to invest successfully, you must understand the risks and benefits of each of the major asset classes. This chapter has attempted to share some risk and return history over the past 85 years.

Table 4. Geometric Return and Risk over Specific Time Periods (Ending 2012)

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<tr>
<td>Compound Return</td>
<td>16.0%</td>
<td>1.7%</td>
<td>7.1%</td>
<td>9.7%</td>
<td>9.8%</td>
<td>10.9%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>10.1%</td>
<td>18.9%</td>
<td>14.9%</td>
<td>14.8%</td>
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<td>Compound Return</td>
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<td>3.7%</td>
<td>10.3%</td>
<td>11.5%</td>
<td>13.4%</td>
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<td>Standard Deviation</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Compound Return</td>
<td>1.8%</td>
<td>9.0%</td>
<td>7.3%</td>
<td>9.2%</td>
<td>7.5%</td>
<td>5.8%</td>
<td>5.6%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>9.0%</td>
<td>13.8%</td>
<td>12.0%</td>
<td>9.9%</td>
<td>10.3%</td>
<td>8.8%</td>
<td>8.4%</td>
</tr>
<tr>
<td><strong>T-bill</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compound Return</td>
<td>1.0%</td>
<td>0.6%</td>
<td>1.7%</td>
<td>3.7%</td>
<td>5.2%</td>
<td>3.9%</td>
<td>3.6%</td>
</tr>
<tr>
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<td>0.1%</td>
<td>0.2%</td>
<td>0.5%</td>
<td>0.7%</td>
<td>0.9%</td>
<td>0.9%</td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Compound Return</td>
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<td>-4.3%</td>
<td>3.8%</td>
<td>8.5%</td>
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<td></td>
<td></td>
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<tr>
<td>Standard Deviation</td>
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<td>25.8%</td>
<td>18.4%</td>
<td>17.8%</td>
<td></td>
<td></td>
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<td></td>
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<td>Compound Return</td>
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<td>15.2%</td>
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<td></td>
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<td>24.3%</td>
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<td></td>
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<td><strong>REITs</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compound Return</td>
<td>13.9%</td>
<td>4.9%</td>
<td>13.0%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>23.0%</td>
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<td>27.6%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>CPI</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compound Return</td>
<td>1.6%</td>
<td>1.9%</td>
<td>2.4%</td>
<td>2.8%</td>
<td>4.1%</td>
<td>3.8%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>1.0%</td>
<td>1.6%</td>
<td>1.5%</td>
<td>1.1%</td>
<td>1.2%</td>
<td>1.6%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>


**Summary**

I approach the topic of investments differently than other textbooks. Most books take an asset-based approach. I take a principles-based approach because the principles of good investing will not change over time. There are important investing principles that, if followed, will result in a quality
investment plan and lead to a successful investment portfolio. We must understand investment basics, the purpose of investing, the priority of our investments, and investing versus gambling.

We must understand what we should do before we invest, which is to:

1. Be square with the Lord,
2. Have adequate health and life insurance to care for the needs of your family in the event that something were to happen to you,
3. Be out of high-interest credit card and consumer debt, and
4. Write down your goals, be living on a budget, and have a well-written and well-thought-out investment plan.

These steps help you prepare a “priorities-based” investment plan. There is no better way to start investing than to have your priorities in order.

We discussed the six factors that control investment returns. Five of these factors are within our control, and only one is outside of our control. We should work on the factors that we can control: how much you save, how long your investments grow, your mix of investments, i.e., your asset allocation, how much you pay in expenses, and how much you pay in taxes. We should not be as concerned with the factor we cannot control which is investment returns.

We shared the 10 principles of successful investing. These are critical if you are to achieve your goals. We shared how most investors have done with their investments, which isn’t positive. That is why the principles are so important. They are:

1. Know yourself.
2. Understand risk.
4. Invest low-cost and tax-efficiently.
5. Invest for the long run.
6. Use caution if you must invest in individual assets.
7. Monitor portfolio performance against benchmarks.
8. Don’t waste too much time and energy trying to beat the market.
9. Invest only with people and institutions that are high-quality, licensed, and reputable.
10. Develop a good investment plan and follow it closely.

Follow these principles and you will have a much better chance of having a successful portfolio.

We continued with discussions of asset classes. We used history to help us understand the risk and return characteristics of the various asset classes.
Financial Plan Assignments

Understanding yourself is a critical part of investing. It is important that you understand not only your personal view of investing, but also your family view of investing.

Review the top of the investment hourglass. Where are you on the top of the hourglass? Are your priorities in order? Do you have adequate health and life insurance? Are you out of high-interest consumer and credit card debt? Have you written down your goals, are you living on a budget, and are you ready to begin writing your investment plan? Determine where you are and the steps you must take before you begin investing.

Review the principles of successful investing. Why do you think these principles are important? What can principles help us do to be better investors?

Review the risk and return history of the major asset classes. What asset classes would you include in your personal asset allocation?

Optional Reading Assignments

To help you understand what steps you must take before you invest, please read the following articles in the Readings directory of this website:


Learning Tools

The following Learning Tools may be helpful to you as you prepare your personal financial plan:

16. A Risk-Tolerance Test

This document is a simple risk-tolerance test to help you determine a suitable level of risk for your investments. It has eight questions, and it explains how each question can help you understand your tolerance for risk. It also gives a few recommendations for asset-allocation targets, based on your answers to the eight questions.

21. Key Questions on Money in the Family

This document asks questions regarding how your views on money were shaped. It asks nine simple questions related to money; the answers to these questions can help you gain important insight about the events that shaped your views on money.
Review Materials

Review Questions

1. What are the ten principles of successful investing?

2. What questions should you ask before you begin investing?

3. Why is it important to ask these questions first?

4. Why is it important to understand the key principles of investing first before you begin investing?

2 Kimball, Spencer W. Ensign, June 1976, p. 4
7 Carla Fried, “The Problem with Your Investment Approach,” Business 2.0, Nov. 2003, 146
9 “Reach with a Rescuing Hand,” New Era, Jul. 1997, 4
3. Beginning Investing 2: Application

Introduction

You have an understanding of key investment principles, why you invest, factors you control, how most investors have done with their investments (performance has not been good compared to benchmarks), and asset classes. You understand what you should do before you invest, and you have reviewed the principles of successful investing. You understand asset classes and you have reviewed the risk and return characteristics of the various asset class. These principles we discussed are critical to understanding, developing, and implementing a successful investment portfolio. In addition, you have reviewed the investment hourglass, a learning tool to help you understand that investing is a means to an end, not an end in itself. Investing is a way to achieve your personal and family financial goals.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand how to apply the key principles to your personal investing including:
   1. Building an investment portfolio
   2. Selecting investment vehicles carefully
   4. Investing at your risk level, i.e., determining your asset allocation
   5. Wisely selecting assets, and
   6. Final cautions for investing

Building an Investment Portfolio

Strategies for developing investment portfolios differ among individual portfolio managers and institutions. The strategy each investor prefers depends on the way he or she views the market; an investor’s strategy also depends on his or her goals, budget, and experience in investing. It is impossible to discuss the strategies that every portfolio manager uses to build each portfolio; however, as I have reviewed successful portfolios, I have found that several critical phases of investment remain the same.

The top half of the investment hourglass detailed the steps you should take before you begin investing. Like the way we live our lives and decide on our goals, the way we invest should be based on our priorities.

The bottom of the investment hourglass contains a pattern of successful portfolios that I have seen in my experience as I have worked with students, families, and institutions (see Chart 3).
Chart 3: The Investment Hourglass Bottom

The bottom of the investment hourglass is divided into four levels, representing four phases of investment. The first level, or base, of the hourglass represents the phase in which you develop your emergency fund and food storage. I strongly recommend that you start this phase first. Generally, it is recommended that you have the larger of three to six months of income or expenses in very liquid cash or cash equivalents (i.e., savings accounts, internet savings accounts, money market mutual funds, short-term CDs, checking accounts, etc.) for your emergency fund. For information on cash management vehicles, see the chapter on **Cash and Liquid Asset Management**.

The second level represents the phase in which you develop your portfolio’s core, or broad exposure. This level generally gives you exposure to the least risky of all the equity asset classes, mainly large-capitalization mutual funds. When you first begin investing, I strongly recommend that instead of purchasing individual stocks and bonds you follow the principles of investing discussed earlier and instead invest in low-cost, no-load index mutual funds. Doing so will give you broad diversification (I prefer a minimum of 500 securities per fund), market returns, and tax-efficient investments. For information on mutual funds, see chapter on **Investments 6: Mutual Fund Basics**.

The third level represents the phase in which you further diversify your portfolio by broadening and deepening your asset classes. If your core allocation is large-capitalization stocks, to deepen your portfolio you might include mutual funds which invest in small-capitalization or mid-capitalization stocks. If you were to broaden your asset classes, you might look to add no-load, low-cost, tax-efficient mutual funds which gave you exposure to new asset classes such as international (companies listed on stock exchanges located outside the United States), emerging markets (companies listed on stock exchanges located in the developing countries), or Real Estate Investment Trusts (portfolios of real estate investments that are developed and trade similar to mutual funds). There are many more other asset classes as well.
Finally, the fourth level represents the phase in which you develop your opportunistic assets, such as individual stocks and sector funds. Truthfully, you do not ever need to purchase individual stock or bond assets or sector funds.

Levels two, three, and four are also divided in terms of taxable assets and retirement assets. *Taxable assets* are assets on whose generated earnings you will need to pay taxes each year. *Retirement assets* are assets that you will not need until after you retire and on whose generated earnings you do not pay taxes ever or until you take the money out at retirement. The breakdown of your assets between your taxable and retirement accounts will depend on your personal goals and your available retirement vehicles.

The bottom of the investment hourglass illustrates three important principles.

First, it illustrates the importance of keeping risk in perspective. The base of the hourglass encompasses the least risky investments. As you move up the hourglass, you take on higher risk and, hopefully, higher returns.

Second, the hourglass teaches you the “how to” of investing. You should invest in lower-risk assets first and then expand your portfolio to increase its potential for greater risk and more return as the size of your assets increases.

Third, the investment hourglass separates taxable assets and retirement assets. The impact that taxes have on these two types of accounts is not the same, so retirement and taxable assets should be managed differently.

**Select Investment Vehicles Carefully**

Before you can build a successful investment portfolio, you must understand the difference between investment vehicles and investment (or financial) assets. *Investment vehicles* are special types of investment accounts that provide a tax-advantaged framework that allows you to invest in various financial assets. Tax advantages include the deferral of current taxes or the elimination of future taxes on earnings. These accounts are useful because they provide specific tax advantages that are not available when financial assets are purchased individually. Investment vehicles are like shopping carts in the grocery store.

*Investment, or financial, assets* are specific classes of financial securities in which you may invest, including stocks, bonds, mutual funds, real estate, money-market mutual funds, CDs, and so on. As you have learned, these financial assets are grouped into asset classes and are associated with different levels of risk. Investment assets are like the groceries you put in your shopping cart.

There are many types of investment vehicles. Many investment vehicles are geared towards helping you build a retirement account and most are named after a specific line in the Internal Revenue Code. For example, a 401(k) plan is a retirement plan offered to employees of private companies, a 403(b) plan is a retirement plan offered to employees of public companies, a
Simplified Employee Plan (SEP-IRA) is a retirement plan designed for employees of small businesses, and an Individual Retirement Account (IRA) is a retirement plan designed for individuals. Table 1 shows characteristics of select investment vehicles for 2012.

### Table 1. Select Investment Vehicles for 2013 (Before Catch-Up)

<table>
<thead>
<tr>
<th>Plan</th>
<th>Tax-Deferred</th>
<th>Tax-Eliminated</th>
<th>Maximum Amount</th>
<th>For Employees of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>401-k</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Businesses w/ Plans</td>
</tr>
<tr>
<td>Roth 401-K</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Businesses w/ Plans</td>
</tr>
<tr>
<td>403(b)</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Non-profit, tax-exempt</td>
</tr>
<tr>
<td>Roth 403(b)</td>
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<td></td>
<td>$17,500</td>
<td>Non-profit, tax-exempt</td>
</tr>
<tr>
<td>457</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>State/Municipalities</td>
</tr>
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<td></td>
<td>$51,000</td>
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</tr>
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<td></td>
<td>$12,000</td>
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</tr>
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<td>IRA</td>
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<td></td>
<td>$5,500</td>
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</tr>
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<td></td>
<td>$5,500</td>
<td>Individuals</td>
</tr>
<tr>
<td>Education IRA</td>
<td>Yes</td>
<td></td>
<td>$2,000</td>
<td>Individual Education</td>
</tr>
<tr>
<td>529 Plans</td>
<td>Yes</td>
<td></td>
<td>$390,000 per child</td>
<td>Individual Education</td>
</tr>
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</table>

Understanding the process can help you identify the tax benefits and other benefits that different investment vehicles offer. The process is divided into three sections: free money; tax-advantaged money; and tax-efficient and wise investments. Understanding the process can help you determine which investment vehicles you should use first in working toward your financial goals.

**Priority 1: Free Money**

The first priority is free money: free money is the money provided by your company when you participate in a company-sponsored retirement plan or a reduction in taxes for investing in specific education vehicles for your children and family. Free money is often provided through a matching plan, in which your company offers to match a percentage of the money you invest in your retirement plan. A matching plan is used as an incentive to encourage employees to remain with the company and to invest in a retirement plan. Some states allow a tax deduction for your contribution to that state’s 529 Plan for education, which is also a form of free money.

Free money is your first priority because it is free and the percentage matched by the company is usually higher than any rate of return you could earn in the market. The risk of investing in a company-sponsored plan is that you are usually required to stay with the company for a certain number of years to become fully vested, or in other words, take full ownership of the free money.

**Priority 2: Tax-Advantaged Money**

There are two different types of tax-advantaged vehicles or accounts: tax-eliminated accounts and tax-deferred accounts. Your choice of which account is better mainly depends on your
current tax rates and your estimation of your future tax rates. If you expect your tax rates to be higher in the future than they are now, you will save a greater amount for retirement if you choose a Roth retirement account versus a traditional. However, if you expect your tax rates to be lower in the future than they are now, you will save a greater amount for retirement if you choose a traditional retirement account. To help you decide which type of IRA is more beneficial for you, see Learning Tool 28: Roth versus Traditional: Which Is Better for You in the Learning Tools directory of this website. It allows you to set an annual contribution, an estimate for a rate of return on earnings, and your current and future tax rates. By changing your future tax rates, you can determine if your balance in the future would be higher or lower, all other areas being held constant.

Tax-eliminated accounts: Tax-eliminated accounts require you to pay taxes on principal before you invest it; however, you do not have to any pay any taxes on the capital gains or earnings in the future. There are several different tax-eliminated investment vehicles and assets that can help you save for retirement (i.e., Roth IRAs or Roth 401(k)) or for education (i.e., 529 funds, Education IRAs and Series EE or I bonds). When tax-eliminated accounts are used for qualified purposes, withdrawals can be made without penalty and without taxes.

With a Roth IRA or a Roth 401(k), you pay taxes on the principal before you deposit the money into your retirement account. Once you reach age fifty-nine and a half, you can take both the principal and interest out of this retirement account without paying taxes on the money. By paying taxes beforehand, you eliminate taxes on all capital gains and earnings in this account. Roth IRAs have an additional advantage: if you need to use the funds in your account before retirement, you can withdraw the principal without penalty because you have already paid taxes on the principal. The disadvantage of a Roth IRA is that, like all retirement accounts, you cannot withdraw your earnings without penalty until you are at least fifty-nine and a half years old.

With many 529 funds and Series EE and I bonds, you are investing with after-tax dollars. If you use your earnings to cover qualified educational expenses for your children, you do not have to pay taxes on the earnings. However, if you do not use the earnings for qualified educational expenses, you must pay a 10-percent penalty on your earnings, as well as federal and state taxes on the amount withdrawal as it is considered ordinary income for tax purposes.

Tax-deferred accounts: Tax-deferred accounts allow you to invest without first paying taxes on the principal; then, when you withdraw money from the account at retirement, you pay taxes on both the principal and the earnings. This type of account is advantageous because it allows you to invest a larger amount of money using a smaller percent of your net income. Examples of tax-advantaged investment vehicles include Individual Retirement Accounts (IRAs); 401(k), 403(b), and 457 plans; and Simplified Employment Plan Individual Retirement Accounts (SEP-IRAs).

Suppose your gross income last year was $45,000, and you invested $3,000 in a traditional IRA. Your adjusted gross income (the income on which you pay taxes) would be $42,000 ($45,000 less the $3,000 contribution). Contributing to an IRA reduces the amount you must pay in taxes today (the amount of your tax savings would be equal to $3,000 multiplied by your tax rate). However, when you retire after age fifty-nine and a half and take this money out of your
reirement accounts, you are not only required pay taxes on your $3,000 investment, but you must also pay taxes on any earnings the IRA investment has produced as well. Note also that although your investments were long-term investments, both earnings and principle are taxed at ordinary tax rates.

The risk of using tax-deferred investment vehicles is that you must be at least age fifty-nine and a half to make withdrawals. If you withdraw funds before you reach this age, you must pay taxes on the funds at your ordinary income-tax rate, and you must also pay a 10-percent penalty fee. Thus, if you make early withdrawals, you may lose up to 50 percent of your investment in taxes (a 10-percent penalty charge plus 40 percent in taxes if you have the highest marginal tax rate possible). Tax-deferred earnings that have remained in your retirement account for more than twelve months are still taxed as ordinary income, which is taxed at a higher rate than capital gains.

**Priority 3: Tax-Efficient and Wise Investments**

The third priority is tax-efficient, wise investments. Wise investors know they will have to pay taxes and transaction fees on any investment they make, so they work to minimize these costs as much as possible. They also monitor their investments’ performances by comparing their returns after taxes and transaction fees to the appropriate benchmarks. The following are five important suggestions for investing tax-efficiently and wisely.

1. **Know the impact of taxes.** As an investor, you must be particularly concerned about the effects of taxes, because taxes are one of the largest expenses you will have to pay when you invest. Every dollar you pay in taxes is a dollar you will not be able to invest. To invest in a tax-efficient manner, you must understand how taxes influence your returns (capital gains, dividends, and interest). You can use the following formula to calculate your after-tax return:

   \[
   \text{Return after tax} = \text{Return before-tax} \times (1 - \text{marginal tax rate})
   \]

   Your after-tax return is equal to your before-tax return multiplied by the result of one minus your marginal tax rate. Your marginal tax rate is the tax rate you pay on your last dollar of earnings. Your marginal tax rate encompasses your federal, state, and local taxes. It is important for you to know your marginal tax rate. Remember that different types of earnings are taxed differently. Bond interest is taxed at your marginal tax rate, stock dividends are taxed at 15 percent or 5 percent, and unrealized capital gains (the capital gains on assets that have not been sold yet) are not taxed at all until the assets have been sold.

   To understand the impact of taxes, you must calculate the estimated after-tax return of each asset you are considering.

2. **Reduce taxes and defer earnings and taxes to the future.** Capital gains are taxed at a much lower rate than ordinary income (15 percent if your marginal tax rate is 25 percent or more, or 0 percent if your marginal tax rate is 15 percent or less). Earn as much of your income as possible in the form of long-term capital gains.
Invest in your qualified and individual retirement plans. This way you are getting a tax break now, and will not have to pay taxes until retirement. You could also invest in Roth retirement vehicles where you pay taxes now, but never pay taxes on the investments ever again.

You can replace ordinary income with capital gains by using a buy-and-hold strategy when you invest. This strategy means that you hold on to your assets for as long as possible and do not trade in your accounts. By holding on to assets for extended periods of time, you defer earnings to the future and avoid paying taxes now.

3. **Minimize turnover and taxable distributions.** Minimize turnover on all assets and minimize taxable distributions on your mutual funds. Every time you sell an asset, you set up a taxable event (a transaction that has tax consequences). By using a buy-and-hold strategy, you minimize the impact of taxes and reduce your transaction costs as well.

The law requires that mutual funds distribute 90 percent of all capital gains and interest to shareholders annually. You will have to pay taxes and fees on these distributions, even if you do not sell your mutual fund. As an investor in a mutual fund, you must sometimes pay taxes because of the actions of the mutual fund’s portfolio manager.

You can minimize turnover and taxable distributions by selecting your mutual funds wisely. Invest in funds that do not have a history of trading actively (i.e., funds that have low turnover or trading). These funds will reduce the amount you must pay in taxes each April.

4. **Replace interest income with stock dividend income.** Because of changes in the tax law in 2004, taxes on dividends from individual company stocks or stock mutual funds were reduced to 15 percent or 0 percent, depending on your marginal tax rate. However, interest earned on bonds or bond mutual funds is taxed at your ordinary income rate. If you put more emphasis on stock dividend income than interest income, you will potentially increase your portfolio’s return and pay less in taxes as well. These steps should only be taken if they are appropriate for your risk-tolerance level.

5. **Invest tax-free.** If you are in a high marginal tax bracket, you can invest in assets that do not require you to pay federal or state taxes. For example, municipal bonds are federal tax-free; they may also be state tax-free if you are a resident of the state that is issuing the bonds. Treasury bonds are state tax-free, and certain government savings bonds, such as Series EE and Series I bonds, are both federal and state tax-free if the proceeds are used solely for qualified educational expenses.

**Using the Process**

Some investment vehicles are preferred over others because they provide tax advantages and other advantages. Unfortunately, some of the investment vehicles that are high money priorities also have lower maximum contribution limits. For example, in 2013 the maximum amount you could contribute to a Roth IRA was $5,500, while there was no limit on how much you could invest in taxable individual financial assets.
Although some investment vehicles have limitations, it is still a good idea to adhere to the process discussed. You should first invest money in vehicles that are the highest priority on the list. When you have reached the maximum amount you can invest in these vehicles, or when you have invested as much money as your company is willing to match, then you should invest in the next highest priority. Continue to invest until you have utilized all of your available investment funds.

When selecting financial assets to include in your retirement account, remember that you will not have to pay taxes on the principal or earnings until you take the money out, or not at all. If you own financial assets that are actively traded or that generate a lot of income, these assets should be held in your retirement accounts; you will not have to pay taxes on the assets until you take them out at retirement, if at all. Assets that you may want to hold in your retirement account include actively traded accounts, taxable bonds, and high-turnover mutual funds.

Financial assets that you are managing with a buy-and-hold strategy should be kept in taxable investment accounts. Such assets include tax-free bonds, tax-efficient indexes and mutual funds, and other financial assets that you do not plan to sell for a long time. Although you may be required to pay taxes on these funds each year for dividends and other short-term distributions, it is usually tax efficient to hold these assets for extended periods of time. The taxes that you must pay on these funds will add little to your yearly tax bill.

**Invest at Your Risk Level (your asset allocation)**

One of the key challenges of investing is to invest at a risk level you are comfortable with. Different investors can accept different levels of risk as they work to achieve their personal and family goals. This view and understanding of risk is not an easy thing to determine.

If you choose to invest at lower risk levels, you will have a greater probability of not losing money, yet because of the lower risk, your returns are likely to be lower as well. There is a tradeoff between risk and return. If your risk level is too low, you will need to save more money for retirement and other goals as your returns will likely be less.

If you take too much risk in your investing, there are concerns as well. With higher risk, you have higher volatility and hopefully higher returns. However, if you invest at a higher risk level than you are comfortable with, you will be very concerned every time the market declines.

Interestingly, most investors are torn between “fear” and “greed.” When the financial markets decline, the “fear” kicks in. We think we should take our investments out of the market, and that we will know and be able to put them back in before the market goes up again (this is called market timing). I personally know of no investor that can consistently time the market.

Likewise, when the markets are going up, the “greed” kicks in. We think we should put all our assets into one or two “sure things”, which are anything but sure.
Our challenge then is to find a median point between fear and greed, so that we can build a portfolio that will give us the amount of risk that we are comfortable with and that will help us to achieve our goals. That is where risk tolerance comes in.

**Risk Tolerance.** Risk tolerance is an investor’s willingness to accept risk. It is related to the holdings of the investor’s investment portfolio or their expected holdings in their investment portfolio, particularly their asset allocation or asset mix. Generally, a higher risk tolerance indicates a willingness to take on more risk, while a lower risk tolerance indicates a willingness to take on less risk.

Your risk tolerance is determined in two main ways: 1. It can be derived from an investor’s age and their current portfolio holdings, i.e., an implied risk tolerance, or 2. It can be estimated by an investor answering specific questions regarding investor demographics including age, characteristics, spending habits, history, and investment experience.

When we define risk in the determination of risk tolerance, risk in this case is generally considered the volatility of investment returns. Investors with a lower risk tolerance will have more assets in less risky or less volatile asset classes such as bonds and cash. Investors with a higher risk tolerance will have more assets in more risky or more volatile asset classes such as equities or stocks including small caps, international, REITs, etc.

Some have wondered if risk tolerance is more an absolute number or a general category. For the purposes of this class and lecture, risk tolerance is considered more a general category. In this class, we divide risk tolerance into five general categories: very conservative, conservative, moderate, aggressive, and very aggressive.

The purpose of risk tolerance is to enable an investor to determine an appropriate asset allocation or investment mix based on the investor’s willingness to accept risk. This allocation is critical because it determines the amount of risk an investor is willing to accept. A lower risk tolerance should lead to a lower risk portfolio, with more invested in bonds and cash. A higher risk tolerance should lead to a higher risk portfolio with more equities.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Annual Return*</th>
<th>Standard Deviation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Small Cap</td>
<td>12.0%</td>
<td>29.1%</td>
</tr>
<tr>
<td>US Large Cap</td>
<td>9.5%</td>
<td>19.2%</td>
</tr>
<tr>
<td>Treasury Bonds</td>
<td>5.6%</td>
<td>8.4%</td>
</tr>
<tr>
<td>Treasury Bills</td>
<td>3.6%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Inflation</td>
<td>3.1%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

Source: Calculated from Ibbotson Data, 2013. Note that each of these asset classes are portfolios of financial assets, not individual assets.

The challenge of risk tolerance is that it is not an exact science, and can mean different things to different people. Risk tolerance varies from one individual to another.
Please note that there are many different risk tolerance tests and categories that may lead to slightly different results. There are lots of different risk tolerance tests available online, many of which are more to sell investment products than to really help people understand how they should invest their assets. Luckily, we are not selling anything with this manual or this website.

**Asset allocation.** Asset allocation it is the process of determining how the assets of a portfolio are divided, mainly into which asset classes. A well-diversified portfolio should have broad diversification across many asset classes to reduce overall portfolio risk. A broadly diversified portfolio is an investor’s key defense against risk, a key to a “sleep-well portfolio,” one that is not torn between fear and greed.

**Table 3. 10 Year Return and Volatility of Asset Classes from 2002 to 2012**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Annual Return*</th>
<th>Standard Deviation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other: US REIT</td>
<td>13.0%</td>
<td>27.6%</td>
</tr>
<tr>
<td>Equity: Emerging Markets</td>
<td>15.2%</td>
<td>24.3%</td>
</tr>
<tr>
<td>Equity: US Small Cap</td>
<td>10.3%</td>
<td>20.8%</td>
</tr>
<tr>
<td>Equity: International</td>
<td>3.8%</td>
<td>18.4%</td>
</tr>
<tr>
<td>Equity: US Large Cap</td>
<td>7.1%</td>
<td>14.9%</td>
</tr>
<tr>
<td>Government Treasury Bonds</td>
<td>7.3%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Government Treasury Bills</td>
<td>1.7%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.4%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Source: Calculated from Ibbotson and MSCI 2013. These are portfolios of financial assets, not individual assets

Asset allocation is important for two reasons:

1. Research has shown that most of the returns from financial assets are mainly a function of returns from the specific asset class decision, and not from the individual stock selection decision. Asset class choice influences returns.

2. In the process of selecting your asset allocation, you are selecting your risk level for your overall portfolio. Selecting asset classes is selecting the risk or risk level for your portfolio.

While we cannot know which asset classes will be the most risky over the upcoming years, we can use historical data to determine the most risky asset classes over the past 85 years ending December 2012 in terms of volatility (or standard deviation). The higher the standard deviation the more volatile the asset class (see Table 2).

As you know, time periods change. What were the most risky asset classes over the past 10 years ending December 2012 (see Table 3)

Notice that generally the higher risk asset classes had the higher return, but it was not necessarily the case.
So if risk tolerance is important then the challenge becomes the process of determining your asset allocation. How do we do that?

Asset allocation is a three-step process:

**Step 1:** Set your initial bonds and cash allocation to equal your age as a percent of your overall portfolio allocation. For example, if you are 40 years old, you should have 40% of your portfolio in bonds and cash, and 60% in equities.

**Step 2:** Take this risk tolerance test. Based on your results, you will adjust that allocation to take into account your individual risk tolerance and come up with an risk-appropriate asset mix. If you are more conservative you will increase your bonds and cash allocation and decrease your equity allocation. If you are more aggressive, you will do the opposite.

**Step 3:** Determine your preferred asset classes based on risk within your major asset classes. If you are a conservative investor, you will likely have many different bond asset classes (short-term, long-term corporates, governments, municipals, etc.), but likely only large cap equities, and perhaps a small amount of other equity asset classes. If you are more aggressive, you will do the opposite, have more small cap, international, emerging markets, REITs, etc. and less allocation to bonds and cash.

To come up with your asset allocation, I recommend you take our risk tolerance test from the website. **Learning Tool 16: A Risk Tolerance Test** is a tool we developed to help students understand and determine their asset allocation and risk tolerance. The process is:

1. Read through the entire test to familiarize yourself with what you are doing (it is included below).
2. Review each of the 8 questions and answer each of the questions carefully based on your views, experience and opinions.
3. Then add up your points from each question. There are five potential responses to each question, worth 1 to 5 points.
4. Add up the point next to the correct response and sum your total points from each of the 8 questions.
5. From your total points, we will have recommended actions for your asset allocation.

**Question 1: Demographics. What is your age currently?**
1. 65 and over
2. 45 to 64
3. 35 to 44
4. 25 to 34
5. 24 and under

**Question 2: Time Horizon. What is your investment time horizon for this money?**
1. 1 year
2. 2-5 years
3. 5-10 years  
4. 10-20 years  
5. 20 years or longer

**Question 3: Investment Goals. What is your primary objective for this money?**  
1. Preservation of Principal  
2. Current Income  
3. Growth and Income  
4. Conservative Growth  
5. Aggressive Growth

**Question 4: Expected Personal Earnings: Regarding your current income, do you expect it to:**  
1. Decrease dramatically in the future  
2. Decrease a slight amount in the future  
3. Stay about the same  
4. Increase with the pace of inflation  
5. Increase dramatically

**Question 5: Emergency Funds: What amount of money do you have set aside for emergencies? (This does not include borrowings or credit lines, but does include money you can access quickly)**  
1. None  
2. Enough to cover three months of expenses  
3. Enough to cover six months of expenses  
4. Enough to cover nine months of expenses  
5. Over twelve months of expenses

**Question 6: Investment Experience: What is your personal investment experience?**  
1. I have never invested any money in any financial market or instrument.  
2. I am relatively new investor,--only a few years.  
3. I have invested in IRAs and employer sponsored retirement plans (401 (k)) for some time, but now I am ready to develop additional investment strategies outside of that plan.  
4. I have invested for quite some time and am fairly confident in my investment decisions.  
5. I have invested money for years and have a definite knowledge of how financial markets work.

**Question 7: Investment Risk: Regarding your view of risk, which investment would you be more comfortable making?**  
1. I am comfortable investing in savings accounts, CDs, and other short-term financial instruments.
2. I invest in savings accounts/CDs, but I also own income-producing bonds and bond mutual funds.
3. I have invested in a broad array of stock and bond mutual funds, but only the highest quality.
4. I have invested primarily in growth stocks and growth stock mutual funds.
5. I like to pick out new and emerging growth companies and aggressive stock mutual funds.

**Question 8: Investment Preference:** Which investment would you be more likely to invest in? The investment has:

1. A 20-year average return of 0-2%, with infrequent downturns and no years of negative returns.
2. A 20-year average return of 3-4% with mostly positive returns but less than a year of negative returns.
3. A 20-year average return of 5-6% with a few downturns and more than one-year of negative returns.
4. A 20-year average return of 7-8% with several periods of negative returns
5. A 20-year average return of 9% or greater with several periods of substantially negative returns.

You should now have your total score. From your total score, it can help you understand what type of investor you are: Very conservative, Conservative, Moderate, Aggressive, and Very aggressive. Each score will have a recommended action regarding increasing or reducing risky assets (see Table 4).

The challenge is to get from your risk tolerance to your asset allocation. Table 4 below helps you do that. Match your beginning allocation, which is your age in bonds, with your recommended action. Once you perform the recommended action, you will have your asset allocation or asset mix consistent with your preferred level of risk.

Investors are free to shift between the cash and bond allocations without any change in effectiveness of the test. I personally prefer to always have, at minimum, a 1-5% allocation to cash.

So how does this scoring work? For example, if you scored 35 points, you would be considered a “aggressive” investor. This is your risk tolerance or type of investor you are.

To get to your asset allocation or asset mix, you need to start with your age in bonds. For example, assume you are age 40 so assume 40% in bonds.

Next, do what the Asset Allocation Recommendations suggest. For an “aggressive” investor, you would add 10% to equities and subtract 10% to your bond and cash allocations from the above charts. Your asset allocation at age 40 would be 30% bonds and cash, and 70% equities.
You are likely wondering if you can have two individuals with similar asset allocations yet with different risk levels? The answer is yes. This is due to their different ages. For example, three investors each have a 60% equity and 40% bond allocations. Investor A is age 50 and is Aggressive; Investor B is age 60 and is Moderate; and Investor C is age 40 and is Very aggressive. Their overall allocations of 60% equity and 40% bonds the same. However, their allocations within the equity and bond allocations will likely be very different. Aggressive investors will have more small cap, international, and other risk equity asset classes. Conservative investors will have more in savings accounts, bonds, government securities, and municipal bonds.

### Table 4. Asset Allocation Results from the Risk Tolerance Test

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Asset Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset Classes:</strong></td>
<td><strong>Recommendations:</strong></td>
</tr>
<tr>
<td>Very Conservative</td>
<td>8 to 12 points</td>
</tr>
<tr>
<td>Cash</td>
<td>+5%</td>
</tr>
<tr>
<td>Bonds</td>
<td>+15%</td>
</tr>
<tr>
<td>Stocks</td>
<td>-20%</td>
</tr>
<tr>
<td>Conservative</td>
<td>13 to 20 points</td>
</tr>
<tr>
<td>Cash:</td>
<td>+0%</td>
</tr>
<tr>
<td>Bonds:</td>
<td>+10%</td>
</tr>
<tr>
<td>Stocks:</td>
<td>-10%</td>
</tr>
<tr>
<td>Moderate</td>
<td>21 to 28 points</td>
</tr>
<tr>
<td>Cash</td>
<td>0%</td>
</tr>
<tr>
<td>Bonds</td>
<td>0%</td>
</tr>
<tr>
<td>Stocks</td>
<td>0%</td>
</tr>
<tr>
<td>Aggressive</td>
<td>29 to 36 points</td>
</tr>
<tr>
<td>Cash</td>
<td>-5%</td>
</tr>
<tr>
<td>Bonds</td>
<td>-5%</td>
</tr>
<tr>
<td>Stocks</td>
<td>+10%</td>
</tr>
<tr>
<td>Very Aggressive</td>
<td>37 to 40 points</td>
</tr>
<tr>
<td>Cash</td>
<td>-5%</td>
</tr>
<tr>
<td>Bonds</td>
<td>-15%</td>
</tr>
<tr>
<td>Stocks</td>
<td>+20%</td>
</tr>
</tbody>
</table>

### Wisely Select Individual Assets

Once you have the “whys” of investing, understand your principles of successful investing, are ready to invest (meaning your priorities are in order, you are out of credit card and consumer
debt, have adequate health and life insurance, and know your goals, budget, and have a well written investment plan), and know your target asset allocation, the next challenge is to choose your financial assets. What type of assets should you choose?

The answer to this question depends on the size of your investment portfolio. Many wonder when and if they should pick individual stocks?

I recommend most investors avoid picking individual stocks and bonds. For those who really want to do this, then I recommend waiting until your portfolio is sufficiently large (i.e., $500,000 or more) to make this feasible. You can have a successful portfolio without purchasing individual stocks and bonds. Why is this the case?

There are five major reasons why I do not recommend picking stocks when your portfolio is small, and these all relate to our principles of successful investing.

1. Principle 3: Stay Diversified. Picking single stocks violates the principle of diversification, especially when you are just beginning to build your portfolio. With a small portfolio, it is difficult to achieve acceptable diversification with limited numbers of stocks.

2. Principle 4: Invest Low Cost. Investing in stocks when you have a small portfolio is very expensive. Transactions costs for purchasing stocks are among the highest of any major asset class.

3. Principle 6: Know What You Invest In. Picking stocks when you have not developed the knowledge base necessary to evaluate stocks is very risky, bordering on speculation or gambling. Most have not as yet put in the time to learn to evaluate stocks nor have developed the tools to make good stock selection decisions. This caution also includes most of my Finance students unless they have taken my Finance 409 Equity Modeling and Valuation and 415 Asset Management classes which specifically address the selection process.

4. Principle 8: Don’t spend too much time trying to “Beat the Market.” Picking stocks is very difficult and challenging. There is so much more to be learned about valuation that can’t be taught in a single presentation or class on investing. I have given only the very basics in this chapter.

5. Stock selection is not required to have a successful investment portfolio. While it is intellectually challenging to select stocks, you can generally improve returns and reduce risk more by properly selecting asset classes and buying no-load mutual funds, index funds and exchange traded funds (ETFs). You may never need to buy an individual stock unless you really want to. I personally have no individual stocks in my portfolio except with what I do with the students in my classes.

I recommend students use no-load mutual funds, index funds and ETFs to get exposure to the asset classes they are considering.
Index funds and ETFs are mutual funds which hold specific shares in proportion to those held by an index. Their goal is to match the benchmark performance. They came about because investors were concerned that most actively managed mutual funds have not been able to beat their benchmarks after all fees, taxes and costs on a consistent basis.

Index funds have become the standard against which other mutual funds are judged. If an active manager cannot beat the benchmark after all fees and costs, then investors should just invest in the index fund or ETF. They know they will get the return of the index without the additional costs active management entails.

The principle becomes simply. If an actively managed mutual fund cannot perform consistently better (after taxes and fees) than a low cost index fund from the same asset class, then investors should invest in index funds. Research has shown that investors who invest in low-cost funds can have significantly more resources in retirement than those who invest in high-cost investments.1

Remember the Dalbar study discussed earlier.2 Investor’s have significantly underperformed the performance of the benchmarks (see Dalbar 2007-2012).

Index funds and ETFs grown quickly over the past years, as they have outperformed most actively managed funds after fees, taxes and expenses.

Remember that winners rotate. There is no correlation between last year’s winners and this year’s winners for actively managed funds. Actively managed funds reduce performance through excessive trading and high fees. Experience has shown it is very difficult to beat index funds on a consistent basis after all fees and taxes.

Jason Zweig, a senior writer for Money Magazine commented:

> With an index fund, you're on permanent auto-pilot: you will always get what the market is willing to give, no more and no less. By enabling me to say "I don't know, and I don't care," my index fund has liberated me from the feeling that I need to forecast what the market is about to do. That gives me more time and mental energy for the important things in life, like playing with my kids and working in my garden.3

Warren Buffet commented about index funds:

> By periodically investing in an index fund, the know-nothing investor can actually outperform most investment professionals. Paradoxically, when 'dumb' money acknowledges its limitations, it ceases to be dumb.4

While it is exciting to buy individual stocks and actively managed mutual funds, most actively managed funds will generally under-perform index funds in the long run after all taxes, costs and fees.5 The competition in stock-market research is intense and will get more competitive going forward, making markets more efficient and indexing even more attractive. Buying an index...
fund or “passive investing” is a free-ride on the competition. Passive investing takes very little
time and has generally outperformed most actively managed funds over time.

Remember, since analyzing companies is not likely going to be many of your jobs, it will be in
most of your best interests to develop a “sleep-well portfolio” plan and follow it. This is done
by:

Living on a budget and saving monthly. It is not what you earn but what you save and invest
that makes you wealth.

Investing regularly for your personal and family goals. “Let the solemnities of eternity rest on
your mind.”

Staying diversified and investing low cost and tax efficiently through index funds consistent with
your level of risk.

Writing and following your Investment Plan.

Enjoying your family and friends.

Doing well in your day job, church responsibilities and community

**Final Cautions on Investing**

Let me share a few final thoughts on Investing:

Do not go into debt to invest. This includes taking equity out of your home, buying on margin,
or short-selling assets. Investing has enough risks of its own. Do not compound that with
leverage.

Beware of financial advisors who recommend shifting assets from one vehicle to another. I hear
of advisors who recommend to don’t shift assets from a 401k retirement account, having you pay
penalties, and then putting you into another asset, usually an insurance product. Do not move
your investments from one investment vehicle to another unless you fully understand all the
costs and benefits.

Beware the agency problem. Some advisors sell products based on their commissions, not what
is best for you. Watch your turnover in your portfolio. A high turnover usually indicates
problems and leads to lower returns.

Listen to the spirit. If it seems too good to be true, it probably is. Beware of members of your
local congregation, friends, and others who will try to use associations to have you buy their
products. There are no guaranteed returns. If it sounds too good to be true, it likely is a scam.

Finally, remember the wise counsel of M. Russell Ballard who said:
There are no shortcuts to financial security. There are no get-rich-quick schemes that work. Do not trust your money to others without a thorough evaluation of any proposed investment. Our people have lost far too much money by trusting their assets to others. In my judgment, we never will have balance in our lives unless our finances are securely under control.7

Summary

We discussed in the earlier chapter the important investing principles that, if followed, will result in a quality investment plan and lead to a successful investment portfolio. We also discussed the investment hourglass and how that helps you understand what you should do before you invest. If you follow these principles, there is a greater chance of a successful portfolio—one that can help you achieve your personal and financial goals.

We discussed how you build an investment portfolio using the bottom of the investment hourglass. As you begin to save and invest, review the bottom of the investment hourglass. Start with the basics: build your emergency fund and food storage, then work up the pyramid. As you go up the pyramid, you will be adding risk to your portfolio. When you build your portfolio, it is critical that you take risk into account.

Selecting investment vehicles was next, which is the process of determining which investment vehicles can help you achieve your goals the fastest. It is largely related to understanding the tax advantages of the various investment vehicles, and utilizing the vehicles that can help you get the highest after-tax returns.

We took a risk tolerance test which helped you to understand which type of an investor you are: very conservative, conservative, moderate, aggressive, and very aggressive. This test had two purposes: to help you understand what type of investor you are and to help you understand a recommendation for your asset allocation, how risk is brought into your portfolio. The riskier the assets in your portfolio, the riskier the portfolio.

We discussed how you select financial assets for your portfolio. We discussed why it is a poor idea to buy individual stocks and bonds initially, especially when your portfolio is less than a $500,000. Easier and wiser investments would be no-load, low-cost index and mutual funds which offer immediate diversification, low cost, low taxes, and generally good performance.

We finished with some final cautions. Don’t go into debt to invest. This includes borrowing against your home equity, buying on margin, or selling short. Don’t move assets from one vehicle to another, i.e., take money from your 401k to buy a cash value insurance policy. Be careful of people selling assets—make sure they are licensed and the products are registered. If it sounds too good to be true, it likely is.
Assignments

Financial Plan Assignments

Understanding yourself is a critical part of investing. It is important that you understand not only your personal view of investing, but also your family view of investing. Start by taking the simple risk-tolerance test, found in Learning Tool 16: Risk-Tolerance Test. The test gives simple recommendations for possible asset-allocation targets (asset-allocation targets will be discussed later). Know how much risk you are willing to take. When you have answered these questions, you are ready to start creating your Investment Plan.

First, copy the sample plan found in Learning Tool 5A: Investment Plan Example. Read through this Plan.

Second, complete the introduction to the Investment Plan and add the information on yourself and your spouse if you are married, including your names and ages.

Third, complete the introductions to each of the four sections. In the introduction to Section I, add the different accounts you will use. It is acceptable to include all the listed accounts as you may use many of them during your lifetime. In addition, you must determine two separate time stages for this Investment Plan. Generally, these time stages equate to your time before retirement as Stage 1 and time in retirement as Stage 2. Add this information.

Fourth, after the results of your risk-tolerance test (see Learning Tool 16: A Risk-Tolerance Test), fill out the type of investor you are in Section I.B.

Fifth, using your risk-tolerance test results, develop equity targets, bond targets, and other targets for Stages 1 and 2 in Section III.C.1. and III.C.2. Start first with the general rule of thumb of your age in bonds, then use the results of your risk-tolerance test to adjust those allocations. If you have questions, consult the notes for adjustments to the general rule of thumb at the end of Learning Tool 16: A Risk-Tolerance Test. Later, you will return to this section to determine your allocations within the stock and bond asset classes.

Optional Reading Assignments

To help you understand what steps you must take before you invest, please read the following articles in the Readings directory of this website:


Learning Tools

The following Learning Tools may be helpful to you as you become more financially self-reliant and as you prepare your personal financial plan:

28. Roth versus Traditional: Which Is better?

This spreadsheet gives a simple way of comparing which of the alternatives, a Roth or a Traditional IRA or 401(k) is better for you, based on your assumptions.

23. Return Simulation Spreadsheet

This spreadsheet helps you see the impact of various investment strategies and volatility for different types of asset classes. With selective asset classes, it can also help you to see the historical impact of different asset-allocation decisions.

27. Expected Return Simulation and Benchmarks

This spreadsheet gives a historical perspective on returns and standard deviation (risk) for the major asset classes over the last 1, 5, 10, 25, 50, 75, and 80 years. It also includes some recommended benchmarks for the major asset classes.

Review Materials

Review Questions

1. What is the process of selecting investment vehicles? Why should we learn it?

2. How much can an individual invest in a Roth IRA in 2013 (see Table 1)? In a 401(k)? Are these tax-eliminated or tax-deferred investment vehicles?

3. What are asset classes? What are the three major asset classes?

4. What is the main goal of cash and cash equivalent investments? Fixed income investments? Equities?

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2 DALBAR QAIB 2007-2013.
6 D&C 43:34.
401(k)
An employer qualified retirement plan set up by a private company in which eligible employees may make salary-deferral (salary-reduction) contributions on a before- and/or after-tax basis. Employers may make matching or non-elective contributions to the plan on behalf of eligible employees and may also add a profit sharing feature to the plan. Earnings accrue on a tax-deferred basis.

403(b)
403(b) plans are salary-reduction plans. They are similar to 401(k) plans but are for employees of non-profit, tax-exempt companies and institutions such as schools.

457 Plans
457 plans are salary-reduction plans. They are similar to 401(k) plans but are for state and municipal workers.

529 Savings Plans
529 College Savings Plans are education savings vehicles designed to help save and pay for children, grandchildren, or other children's educations. They are created by state governments (and differ state to state and year to year) to help prepare for the future costs of education (529 Savings Plan) or to prepay tuition costs for a specific in-state university (529 Prepaid Tuition Plan). With a 529 Savings Plan, the control of the funds resides with the contributor, who chooses the investments from among a set of approved alternatives set up by the state. Assets in these plans are not considered assets of the student, which increases the student’s ability to apply for other financial aid. Some states may even offer tax deductions for contributions you make to your local 529 funds (check by state). Earnings on these funds are tax free if principle and earnings are used for approved higher education expenses. With a 529 Prepaid Tuition Plan, parents pay a specific amount, which guarantees that tuition will be paid at some specific point in the future when the child enters college.

Acceleration Clause
An acceleration clause is a loan requirement stating that if the borrower misses one payment, the entire loan comes due immediately.

Accrued Interest
Accrued Interest is interest that has been earned on the bond but has not yet been paid out to the bondholder.

Active Income
Active income is income that comes from wages or a business.

Active Management
Active management is an investment strategy in which investors try to gain returns in excess of their benchmarks by actively buying and selling securities. This strategy requires considerable time and expense to maintain consistent performance.

Adjustable-Rate Mortgage (ARM)
An adjustable-rate mortgage (ARM) is a mortgage loan in which the interest rate charged fluctuates with the level of current interest rates. The loan fluctuates, or is adjusted, at set intervals (say, every 5 years) and only within set limits as specified in the loan agreements.
Adjusted Gross Income (AGI)
Adjusted Gross Income (AGI) is your total income less allowable deductions used in calculating income taxes.

Affinity Card
An affinity card is a credit card issued in conjunction with a specific charity or organization. It carries the sponsoring group's name and/or picture on the credit card itself and sends a portion of the annual fee or a percentage of the purchases back to the sponsoring group.

After-Tax Return
The after-tax return is the actual return you earn on taxable investments once taxes have been paid. It is equal to the taxable return times (1 - your marginal tax rate) + the non-taxable return.

Agency Bonds
Agency Bonds are bonds issued by government agencies other than the Treasury.

Amortized Loan
A loan paid off in equal installments, including both principle and interest.

Annual fee
An annual fee is a fixed charge imposed by a credit card company for the use of its credit card for one year.

Annual Percentage Rate
The annual percentage rate (APR) is the true simple interest rate paid over the life of the loan. It's a reasonable approximation for the cost of borrowing, although it does not take into account compounding. The Truth in Lending Act requires that all consumer loan agreements disclose the APR in bold print. It is calculated as the cost of interest and fees divided by the number of years, all divided by the average amount borrowed.

Annual Percentage Yield
The annual percentage yield (APY) is the simple annual percentage yield that converts interest rates compounded for different periods into comparable annual interest rates.

Annuity
A series of equal dollar payments coming at the end of each time period for a specified number of time periods, generally months or years.

Asset allocation
Asset allocation is the process of determining what percent of investor's assets should be invested in which asset classes to enable the investor to reach his or her financial goals.

Asset Management Accounts
Asset Management Accounts are comprehensive financial service packages offered by a brokerage firm, which can include a checking account; credit and debit cards; an Money Market Mutual Funds; loans; automatic payment of fixed payments such as mortgages; brokerage services (buying and selling stocks or bonds); and a system for the direct payment of interest, dividends, and proceeds from security sales into the MMMF.

Assets
Assets are things that you own. They can be physical (i.e. autos, homes, etc.), financial (stocks, bonds, cash) or intellectual (i.e. knowledge, trademarks or patents).

Automobile loans
A consumer loan that's secured with an automobile. Should the borrower fail to make payments, the lender can repossess the auto.

Average Daily Balance Method
Average Daily Balance Method is a method of calculating the balance on which interest is paid by summing the outstanding balances owed each day during the billing period and dividing by the number of days in the period.

Back-End Load
Back-End Load is a commission or fee that is charged only when the investor liquidates his or her holdings.

Balanced Mutual Fund
Balanced Mutual Fund is a mutual fund that tries to "balance" the objectives of long-term growth with current income and so includes portions of both risky and conservative assets.

**Balloon Mortgage Loan**
Balloon Mortgage Loan is a mortgage with relatively small monthly payments for several years (generally 5 or 7 years), after which the loan must be paid off in full, in generally one large balloon payment.

**Bank Credit Card**
A credit card issued by a bank or large corporation, generally as a Visa or MasterCard.

**Bankruptcy**
A legal process whereby payment to creditors is administered by law.

**Basic Health Insurance**
Used to describe most health insurance, which includes a combination of hospital, surgical, and physician expense insurance.

**Basis Point**
A means of describing costs for a mutual fund or other financial instrument. A basis point is 1/100 of 1% or .01 percent.

**Bear Market**
A stock market characterized by falling prices.

**Beneficiary**
The individual designated to receive specific assets in the case of a will, or the person designated to receive the insurance policy proceeds upon the death of the insured.

**Blue-Chip Stocks**
Common stocks issued by large, nationally known companies with sound financial histories of solid dividend and growth records.

**Bond Funds**
Mutual funds that invest primarily in bonds.

**Bonds**
Bonds are debt and are issued for a period of time. Governments, districts, companies, and other types of institutions sell bonds. When an investor buys bonds, they are lending money.

**Budget**
A budget is a plan for controlling inflows of funds with outflows to pay expenses. Living on a budget is probably one of the single most important things you can do to help get your financial house in order.

**Capital Gain**
An increase in the value of a capital asset (investment or real estate) that gives it a higher value than the original purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.

**Cash Budget**
A plan for controlling cash inflows and outflows. Its purpose is to balance income with expenditures and savings.

**Compound Annuity**
An investment that involves depositing an equal sum of money at the end of each year for a certain number of years and allowing it to grow.

**Compounded (annually, quarterly, daily, etc.)**
The number of periods during the year where interest is calculated. The shorter the compounding period, the higher the effective annual rate of interest.

**Consolidation**
Combining all debts into a single loan to help reduce interest.

**Consumer Loans**
Consumer loans are loans for generally larger valued items such as electronics, automobiles, furniture, recreational vehicles, etc., things that you generally don't need (at least not urgently).

**Convertible Loans**
Convertible loans are loans whose interest rate structure can change. They can begin as a variable rate loan and can
be locked into a fixed rate at some predetermined time in the future.

Credit Bureaus
These are companies that collect and report financial information on individuals or firms. The information is collected from creditors, public records, and a variety of institutions. There are three major credit bureaus: Equifax, Experian, and Trans Union.

Credit Counseling
Performed by agencies who work with individuals and their credit card companies to reduce or eliminate interest payments.

Credit Evaluation
The process potential creditors use to determine an individual's credit worthiness by analyzing specific information, such as personal demographics and credit history, provided by various sources and generally included on credit reports.

Credit History
A record of an individual's personal credit. It includes what credit is open, closed, balances, etc.

Credit Report
A public record of information on a specific individual's credit standing compiled by a credit bureau. Most credit reports include the individual's name, address, credit history, and information from public records such as bankruptcy filings and criminal convictions.

Credit Scores
These are ratings developed by financial institutions as a way of determining which borrowers are more likely to repay their loans. Credit scores are based on specific factors such as credit history, length of credit, repayment history, types of credit owned, and so on. Generally, the higher your credit score, the lower your risk, and the more likely you will repay your loans.

Custodial Account
An investment account where parents hold assets for children until they reach legal age. After legal age, the account becomes the property of the child.

Debt
Money that is borrowed.

Debt Elimination Calendar
A method of reducing debt by using a spreadsheet and listing all debts in order of interest rate from highest to lowest with the intent to pay-off the debt with the highest interest rate first.

Debt Reduction
A method of reducing debt in an acceptable length of time.

Defined Benefit Plan
A defined benefit plan (DBP) is a retirement plan funded entirely by the employer in which the payout amount is guaranteed based on a specific formula set by the company. Employees don’t contribute to the plan, but they receive a promised defined payout at retirement. This payout is generally based on a formula, including formula variables such as age at retirement, average salary level, and years of service.

Defined Contribution Plan
A defined contribution plan is a retirement plan into which the employer contributes a specific amount to the employee’s retirement fund while the employee is working and then has no responsibilities once the employee retires.

Education IRA
The Education IRA is a type of individual retirement account that allows parents to save money to pay for their children's education. Investments accumulate tax free and the account creator determines how to invest the funds and how the funds will be spent. Eligible expenses include elementary, secondary, and college tuition, as well as the purchase of books and supplies. If the money is withdrawn for non-education expenses, federal taxes will be charged to the account holder at the
account holder's regular tax rate plus a 10 percent penalty.

**Effective Interest Rate**
The actual rate (as opposed to the stated rate) received after taking into account the effects of compounding.

**Employer Qualified Plans**
These are retirement plans which comply with government regulations and allow you to place pretax dollars into the retirement plans.

**Employee Stock Option Plan**
An employee stock options plan is a type of defined contribution plan in which retirement funds are invested in company stock. This is a very risky and non-diversified plan.

**Equity**
Ownership of a company or corporation indicated by shares. These shares represent ownership in the corporation's assets and earnings.

**Equity Indexed Universal Life**
A permanent life insurance policy that allows policyholders to tie their cash value accumulation to a stock market index.

**FICO score**
This is the most commonly used credit score; it was developed by Fair, Isaac and Company.

**Fixed expenses**
Expenses you don't directly control, e.g., mortgage, rent, tuition, books, life and health insurance, etc.

**Fixed rate loans**
Fixed rate loans, which are the majority of consumer loans, have the same interest rate for the duration of the loan. Normally they have higher initial interest rates, because the lender could lose money if the rates increase.

**Future Value**
The value of an investment at some point in the future.

**Goal**
A goal is one of the most important factors in accomplishing things in life. It is generally something that is important to you and which you are willing to put effort toward. Goals should be "smart," specific, measurable, achievable, realistic, and time-bound.

**Home Equity Loan**
A debt consolidation loan against value invested in a home.

**Home equity loans**
Home equity loans are basically second mortgages. You can use the equity in your house, the difference between what you paid for the house and what it is worth today, to secure your loan. The benefits are that they normally allow you to borrow up to 80% of the equity in your home. The interest payments are generally tax deductible.

**Index Fund**
A mutual fund which has the goal of matching the performance of a specific benchmark or index.

**Indexes**
Statistical measures of change in an economy, asset class, or securities market. In the case of financial markets, an index (plural indices) is essentially an imaginary portfolio of securities representing a particular market or a portion of it.

**IRA (Individual Retirement Account)**
A retirement vehicle that allows you to set aside money for retirement, while at the same time possibly offering tax advantages. IRA's can be invested in numerous types of investments, including stocks, bonds, mutual funds, etc.

**Inflation**
An increase in the volume of money and credit relative to available goods and services resulting in a continuing rise in the general price level.

**Installment loans**
Installment loans are loans repaid at regular intervals. The payment includes both principal and interest. It's normally used to finance houses, cars, appliances,
and other expensive items.

**Interest**
A charge for borrowed money, often calculated as a percentage of the amount loaned.

**Interest Only Option**
An option on a fixed or adjustable rate mortgage that allows the borrower to make only interest payments for a specific number of years. After the interest only period is over the borrower must pay both principle and interest back within the stated mortgage period.

**Interest rate**
The stated rate that you will receive for investing for a specified time at a specified compounding period.

**Investment**
A current commitment of money or other resources in the expectation of reaping future benefits.

**Investment Constraint**
Investment constraints are factors which must be taken into account as you manage your portfolio. These include factors such as liquidity, investment horizon, taxes, and special needs.

**Investment Plan**
An investment plan is a detailed description of all the major areas of your investment strategy. It will help you understand yourself and sets the framework for every investment activity you will participate in.

**Investment strategy**
Investment strategy is the understanding of how you will invest your assets. It clarifies how to select, manage, prioritize, fund, and evaluate your investments.

**Investment vehicle**
A tax-law defined vehicle that has specific tax advantages, i.e. tax deferral or tax elimination. Examples include IRAs, 401(k) and Keogh plans, or 529 Plans

**Keogh Plan**
A Keogh plan is a retirement plan for small businesses that allows the business to make tax-deductible payments to the retirement plans of employees. This plan is similar to a corporate pension or profit sharing plan. There are three Keogh options that provide for increased flexibility: the profit sharing plan, the money purchase plan, and the paired plan.

**Liquidity**
Liquidity is the speed and ease with which an asset can be converted into cash.

**Marquis Strategy**
A method in which debts are paid off in order of smallest to largest with the intent to pay off as many debts as quickly as possible.

**Money Purchase Plan**
A money purchase plan is a type of defined contribution plan in which the employer contributes a percentage of an employee’s salary each year.

**Mortgage**
A loan to finance the purchase of real estate, usually with specified payment periods and interest rates.

**Mundis Strategy**
A method in which the total amount available to pay off debt is determined and a percentage of that amount pays off each debt.

**Mutual fund**
Mutual funds are pools of money managed by an investment company. These funds offer a variety of goals, depending on the fund and its investment objectives. Funds can impose a sales charge, or load, when investors buy and sell shares, or the funds may be no-load and impose no sales charge. Mutual funds may also be open-end funds, which create new shares on demand, or closed-end funds, which have set shares outstanding.

**Net worth**
The difference between the assets that you own and the debts that you owe to
Nominal Return
This is the return on your investment before taking into account the impact of inflation or taxes.

Open credit
An agreement with a financial institution (for example, a credit card company) that allows you to borrow money up to a specific credit limit with the expectation that you will pay back the loan at a specific interest rate and also pay other attached fees. A credit card is one type of open credit.

Passive management
Passive management is an investment strategy where investors, instead of trying to earn returns in excess of their stated benchmarks, invest in index or exchange traded funds whose purpose is to simply mirror the performance of those benchmarks.

Payday loans
These are loans secured with a postdated check. They have very high interest rates, some in excess of 520% on an annual basis. I do not recommend anyone ever use these loans. They are short loans of one to two weeks.

Personal Balance Sheet
A snapshot of the financial position of an individual or institution on a given date, usually the end of the year or the end of the month. It is a numerical representation of the dollar amounts of what is owed and what is owned.

Present Value
The current value, which is the value in today's value of a future sum of money.

Principal
The money that you have to invest or save, or the stated amount on a bond or deposit instrument.

Profit Sharing Plan
A profit sharing plan is a type of defined contribution plan in which an employer's contributions vary year-to-year depending on the firm's profitability. (The contribution may be zero if the firm is not profitable).

Qualified retirement plans
A qualified retirement plan is a retirement plan that allows a company to make tax-deductible contributions to employees through either a defined-benefit plan or a defined-contribution plan. Some of these plans require no employee contributions and some of these plans require employee contributions that are employer matched.

Real Return
The real rate of return on an investment after removing the impact of inflation. The approximation formula is the nominal return less inflation. The exact formula is \[(1 + \text{nominal return})/(1 + \text{inflation})\] -1. In this class, we will use the exact formula.

Reinvesting
Taking money that you have earned on an investment and investing it again

Retirement planning
The process of planning for your financial future. It entails knowing what you want to accomplish during retirement and how you want to live, and then preparing your finances to allow you to achieve these goals.

Roth IRA
The Roth IRA is a retirement plan that provides no tax deduction for contributions, but does provides a special benefit not available to other forms of retirement savings. All earnings and capital gains are distributed tax free when you retire after age 59½.

Roth 401(k)
A 401k retirement account that allows contributors to make contributions on an after-tax, rather than a pre-tax basis. Then when the contributor turns age 59½ the contributor can withdraw the funds without penalty and without tax.

Roth 403(b)
403(b) plans are salary-reduction plans.
They are similar to 401(k) plans but are for employees of non-profit, tax-exempt companies and institutions such as schools. A Roth 403b retirement account allows contributors to make contributions on an after-tax, rather than a pre-tax basis. Then when the contributor turns age 59½ the contributor can withdraw the funds without penalty and without tax.

**Sacrifice**
A current commitment of money or other resources in the expectation of reaping future benefits.

**Salary Reduction Plan**
In salary reduction plans, an employee contributes before-tax dollars to the employees, thus reducing the employee’s taxable income. The earnings that are accumulated are tax-deferred until retirement.

**Secured loans**
Secured loans are loans guaranteed by a specific asset such as a home equity loan or a car loan. They typically have lower rates, as the security, i.e., the home, car, etc., is considered collateral for the loan.

**SEP IRA**
A SEP-IRA is a Simplified Employee Plan Individual Retirement Account that allows a small business employer to contribute to the retirement of its employees. The employer contributes to each eligible employee’s SEP-IRA, with the same percentage contributed to all employees. Contributions are tax deductible and earnings grow tax-deferred.

**Compound Interest**
Compound interest is where interest is paid on previously earned interest, as well as on the principal.

**Series EE Savings Bonds**
Series EE are savings bonds issued by the United States Government that have a minimum maturity of five year. These are taxable bonds, which can be purchased in any combination of denominations up to specific annual limit. The bonds can be purchased in small denominations (as low as $25) over the Internet, and they have competitive interest rates that change every six months and are calculated at 90% of the average 5 year Treasury yield. If the principle and earnings from these bonds are used for qualified educational expenses, the earnings are tax-free. However, if the bonds are cashed before maturity, there is a three-month interest penalty.

**Series I Savings Bonds**
Series I Bonds are savings bonds issued by the United States Government that have a minimum maturity of five years. These are taxable bonds, which anyone can purchase in any combination of denominations up to specific annual limits. The bonds can be purchased in small denominations (as low as $25) over the Internet, and they have competitive interest rates that change every six months, calculated by computing the rate of inflation over the previous year and adding a real return component. If the principle and earnings from these bonds are used for qualified educational expenses, the earnings are tax-free. However, if the bonds are cashed before maturity, there is a three-month interest penalty.

**Shareholder**
A person or entity which owns equity or shares in a company.

**SIMPLE-IRA**
Savings Incentive Match Plan for Employees (SIMPLE-IRA) is a tax-sheltered retirement plan for small businesses or the self-employed that provides some matching funds by the employer similar to the matching of a 401(k) plan. Employees can contribute up to 100 percent of compensation to a maximum that changes year to year. Contributions are tax deductible, so there is a penalty for early withdrawals.
The employer is required to match employees’ contributions.

**Single payment loans**

Single payment loans are balloon loans. They are sometimes called bridge or interim loans because they're used until permanent financing is arranged. The loan is repaid in one lump sum including interest. Normally it is for short term lending of one year or less.

**Social Security**

A federal program that provides disability and retirement benefits based upon years worked, amount paid into the plan, and retirement age.

**Stock**

Ownership of a company or corporation indicated by shares. These shares represent ownership in the corporation's assets and earnings.

**Student loans**

These are loans with low federally subsidized interest rates used for higher education. Examples are federal direct and plus direct loans, Stafford and Stafford plus loans available to parents and students. These loans may have specific tax advantages. They may have lower than market rates, and payment on federal direct and Stafford loans are deferred until 6 months after graduation.

**Tax liability**

Taxes that are owed but not yet paid.

**Tax-adjusted Return**

This is the return on your investment after taking into account the impact of taxes (both federal and state).

**Tax-advantaged money**

This is money that has special tax advantages, mainly the elimination of all future taxes on capital gains, interest and dividends, or the deferral of taxes until retirement. A good example of a tax-eliminated money is the Roth Individual Retirement Account (Roth IRA). An example of tax-deferred money is the traditional IRA.

**Tax-deferred money**

An increase in the value of a capital asset (investment or real estate) that gives it a higher value than the original purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.

**The Envelope System**

A simplified cash budget system where you put money for each expense in an envelope. When the money is gone, it is gone.

**Thrift and Savings Plan**

A thrift and savings plan is a type of defined contribution plan in which the employer matches a percentage of employee contributions.

**Time value of money**

The basic principle that money can earn interest. Therefore, something that is worth $1 today will be worth more in the future if it is invested wisely. This is also referred to as future value.

**Traditional IRA**

A traditional IRA is a retirement account in which an individual can contribute up to specific limits annually, depending on the contributor’s income level and whether he or she has other retirement savings plans. This money is tax-deferred until retirement; it is taxed as ordinary income on withdrawal after age 59½.

**Universal Life Insurance**

A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in money market investments, and the death benefit, savings, and premiums can be changed at the policyholders option.

**Unsecured loans**

Unsecured loans require no collateral and are generally offered only to borrowers with excellent credit history. However, unsecured loans normally have the highest interest rates, and can
range in cost from 12% to 23%, or even higher.

**Variable expenses**
Expenses you have some control over, e.g., food, entertainment, clothing, etc.

**Variable Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in stocks, bonds, mutual funds, etc.

**Variable rate loans**
Variable rate loans have an interest rate that is tied to an index such as the prime rate 6 month Treasury bill plus some interest rate spread. It adjusts at different intervals such as monthly, semiannually, or annually with a lifetime adjustment cap. Normally they have a lower initial interest rate

**Variable Universal Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in stocks, bonds, mutual funds, etc., and the death benefit, savings, and premiums can be changed at the policyholders option.

**Whole Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in insurance company long-term bonds and mortgages.
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