33A. Principles of Beginning Investing (1)

Introduction

The previous chapters have been successful if they have helped you put personal financial management into perspective. These chapters have taught you the "why's," "what's", and "how's" of personal finance and the creative process of how 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 aspects 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 first start with investment basics. These basics are key foundational information to help you as you begin our discovery of this wonderful experience of investing.

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 to just think it relates to financial markets.

There is a Purpose to Investing

We have already discussed the doctrines of finance. 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 and finance for that matter are the same.

- Spiritual: To bring us to Christ
- Temporal: To help us become wiser stewards
- Family: To help us return with our families back to God's presence, and
- Individual: To help us achieve our divine missions and destiny.

From our view, the purpose of investing is similar:

- Spiritual: To show by our choices and actions what we really believe
- Temporal: To show ourselves wise stewards over the blessings we have been blessed with
- Families: To steward our resources to be able to serve and bless the lives of our families and others.
- Individual: To accomplish our short- and long-term personal and family goals including our personal missions in life.

Spencer W. Kimball reminds us:

> 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."[1]

There is a priority of investments

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

Investing is not gambling

Some have wondered the difference between investing and gambling. They think that investing in the stock or bond markets is 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

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

Picture 1. My Most Important Investments

So the difference between investing and gambling is in the risk-return tradeoff, the planning, the work, and the creation of wealth.

What to Do Before You Invest

Once you have some basic information, there are some other important questions to ask yourself

before you start investing in financial securities. This is important as there is things we should do first before we begin investing for retirement and other goals.

- Are there bills or debts you should pay before beginning your investment program? Are there covenants we have made which help us realize our financial priorities?
- Are there certain products or services you feel you should never do without? Should you have health and life insurance before you begin investing?
- What should you do about your high-interest debts such as credit cards and consumer loans? Does it really make sense to earn 6 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 vision, goals, plans and budget? Do you have a plan for investing? What is that plan?

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 vision, goals and plans. If you can answer each of the questions listed in the top of the hourglass affirmatively (see Picture 2), you are ready to invest. If you cannot answer affirmatively with any of these statements, you have important things to do before you begin your formal investing in securities markets.

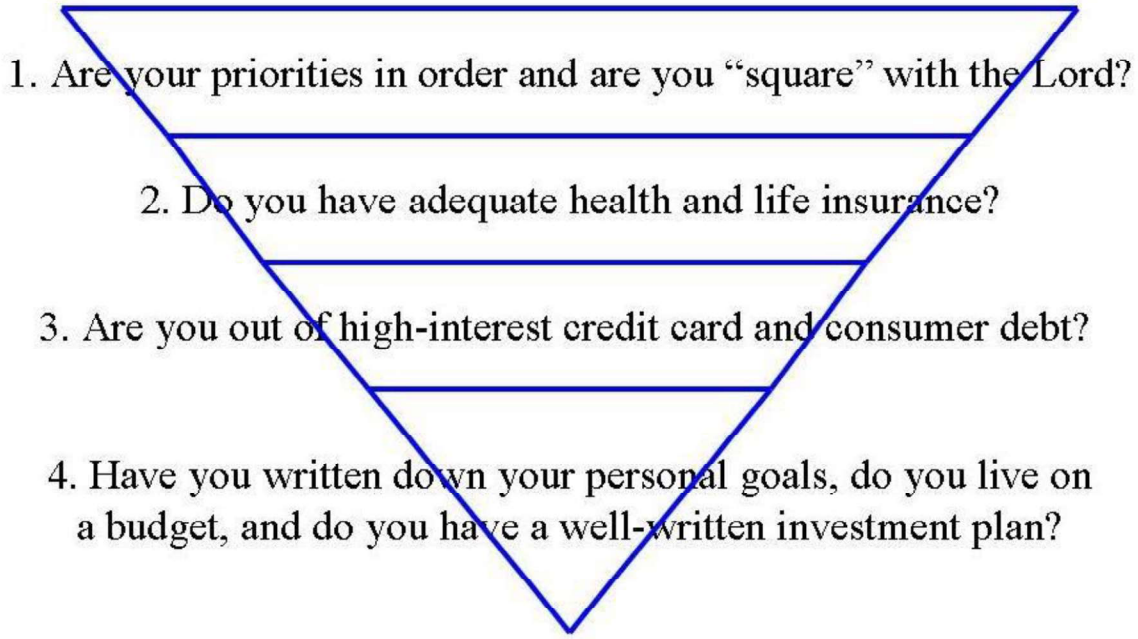
The top of the hourglass teaches about priorities. What are your most important priorities, and how do we make sure we put first things first? First and foremost, your most important priority is being "square" with the Lord, who I believe is your most important creditor. Before you invest, ask yourself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

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 knowing your vision, goals and plans, including living by your budget and 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 vision represent where you want to be, and your Investment Plan represents how to get there.

Picture 2. Top of the Investment Hourglass—Before You Invest



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"[2] (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

- Your investment returns.

Picture 3. Serenity Prayer

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 acceptable risk level. This will allow your investments to compound over time.
- Understanding your risk level, and then keeping your asset allocation, your stock and bond mix, consistent with that risk level.
- Being wise and keeping fees, expenses, and transactions costs at the lowest possible level.
- Being wise and investing so that you minimize taxes and maximize after-tax returns.

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, we recommend the use passive management/indexing as an investment strategy to minimize risk and give some control over their of investment returns. On the other hand, many novice investors spend their time on areas they cannot control and fail to be concerned with areas they can control.

Once you have a basic understanding of investing and the things you can and cannot control, it is necessary to understand how most investors have done and the principles of successful investing.

Recognize the 10 Principles of Successful Investing

The purpose of principles is to give us guidelines to help us manage and accomplish our personal and family vision and goals. 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.[3]

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 vision, goals, budget, and Investment Plan. The key to successful investing is to know yourself and what you are trying to accomplish.

How have Most Investors Done?

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. A benchmark is a yardstick to see how a group or portfolio of assets have performed. 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 1997 to 2016, the average equity investor's returns were 4.8% versus the equity benchmark returns of 8.8%, resulting in a shortfall or difference of 2.9% per year. That is the shortfall per year, not the shortfall over the 20 year period, and it is 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).

Table 1. Historical Analysis of Equity Investor's Return

Year	Investor Period	Investor Returns	Benchmark Returns	Difference
2012	1992–2011	3.5%	7.8%	-4.3%
2013	1993–2012	4.3%	8.2%	-3.9%
2014	1994–2013	3.7%	11.1%	-7.4%
2015	1995–2014	5.2%	9.9%	-4.7%
2016	1996–2015	4.7%	8.2%	-3.5%
2017	1997–2016	4.8%	7.7%	-2.9%

* DALBAR
2012 - 2017

Table 2. Historical Analysis of Fixed Income Investor's Return

Year	Investor Period	Investor* Returns	Benchmark Returns	Difference
2012	1992–2011	0.9%	6.5%	-5.6%
2013	1993–2012	1.0%	6.3%	-5.3%
2014	1994–2013	0.7%	7.7%	-7.0%
2015	1995–2014	0.8%	6.2%	-5.4%
2016	1996–2015	0.5%	5.3%	-4.8%
2017	1997–2016	0.5%	5.0%	-4.5%

* DALBAR
2012 - 2017

Table 3. Historical Analysis of Asset Allocation Investor's Return

Year	Investor Period	Investor Returns*	Benchmark Returns**	Difference
2012	1992–2011	4.4%	7.3%	-2.9%
2013	1993–2012	2.9%	7.5%	-4.5%
2014	1994–2013	1.9%	9.7%	-7.8%
2015	1995–2014	2.5%	8.4%	-5.9%
2016	1996–2015	2.1%	7.0%	-4.9%
2017	1997–2016	2.3%	6.6%	-4.3%

* DALBAR
2012 - 2017

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 encouraging (see Table 3).

As the saying goes, "If you do what everyone else does, you will get what everyone else gets."[4] 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 or are doing now.

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, most actively managed mutual funds have not beaten their benchmarks over the long term (see Chart 1). 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.

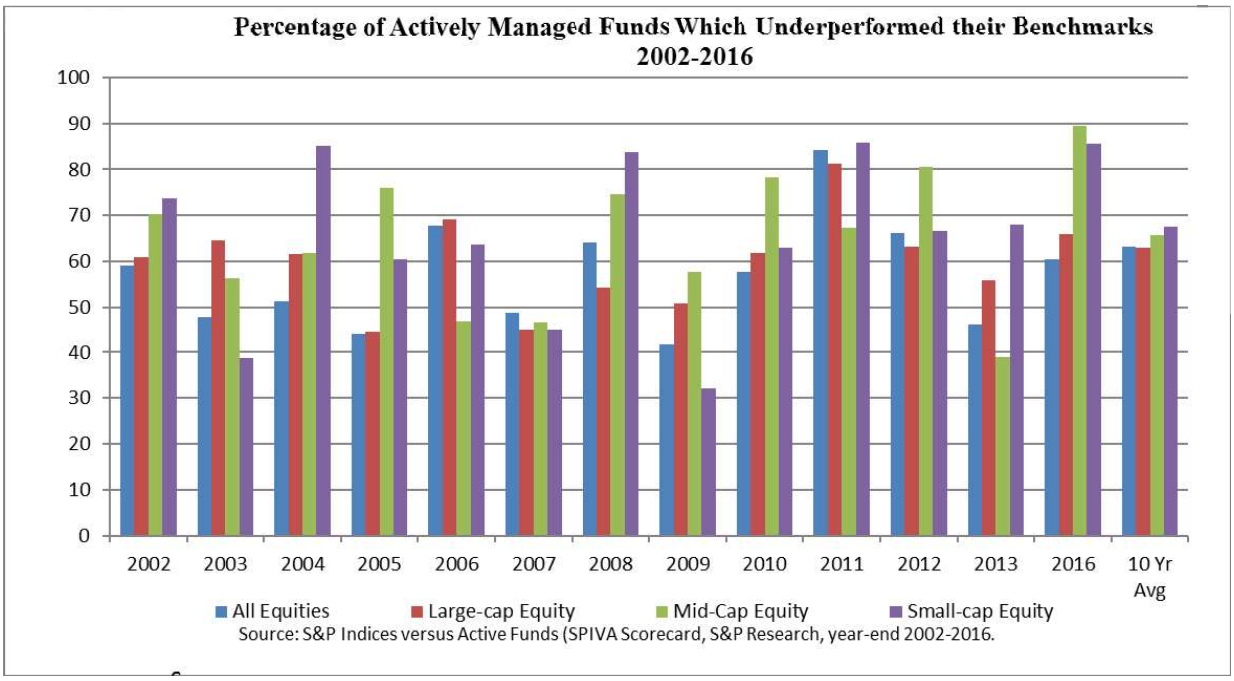
Another paper that examined mutual fund performance on both a total return and after-tax basis reported:

> 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]

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 60-65%, depending on asset class (see Chart 2).

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.

> **1. Know Yourself.** Investing is not an end in itself; rather, it is a means of reaching your vision and your personal and family goals. Consequently, you need to know yourself as an investor. You should have well-written and well-thought-out vision, goals and plans. 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. [7] While online trading may appear to give you more control, it can result in lower overall returns if it leads to greater overconfidence and more frequent trading.

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.**

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.

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.

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).[7]

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.

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.

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."[8]

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.

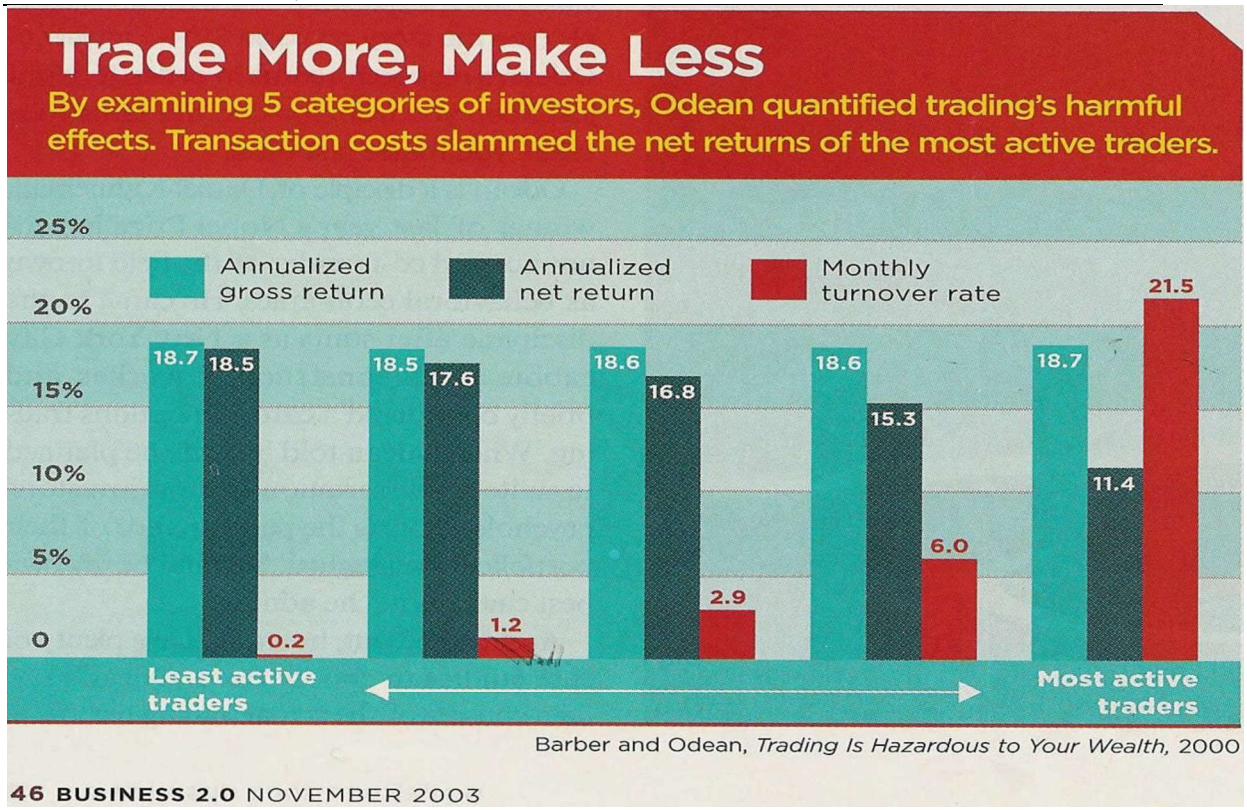
If you choose to invest in actively managed mutual funds, compare the assets' after tax performance against the benchmarks you have set. If the return on these assets is consistently lower than the benchmarks, consider investing in no-load (no sales charge), low-fee index funds, which are discussed later in this course. The returns on index funds are generally more consistent in matching the performance of selected benchmarks than actively managed funds.

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.

Chart 2. Trade More, Make Less



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.

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.

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 through an investment in a short-term government security.
- 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 include 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 taxes and inflation. Cash assets are generally fully taxable—make sure you take taxes into consideration.

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. They 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 but 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 at the mutual 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

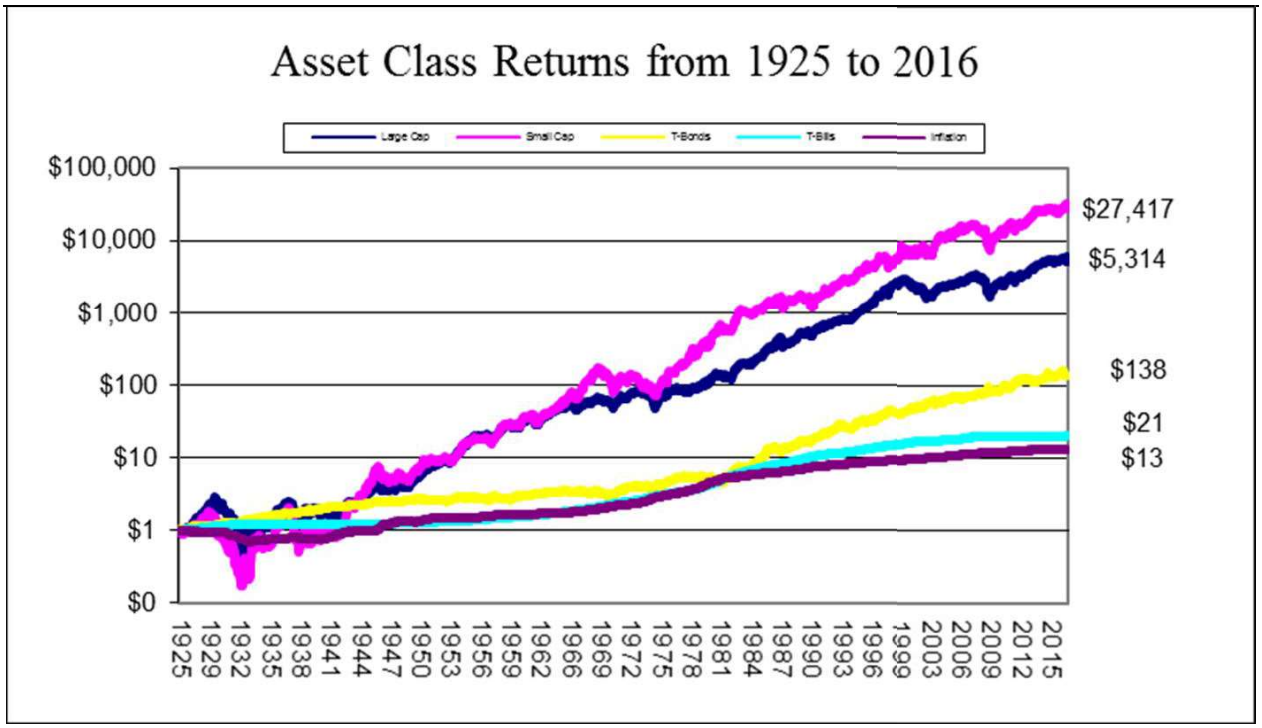
highest return of the major asset classes. Growth and value stocks tend to perform in alternating cycles—it makes sense to own both types. A portfolio of diversified stocks have generally been a good investment for long-term investing—they have consistently beat inflation over the long-term.

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).

Chart 3. Asset Class Returns from 1925 to 2016



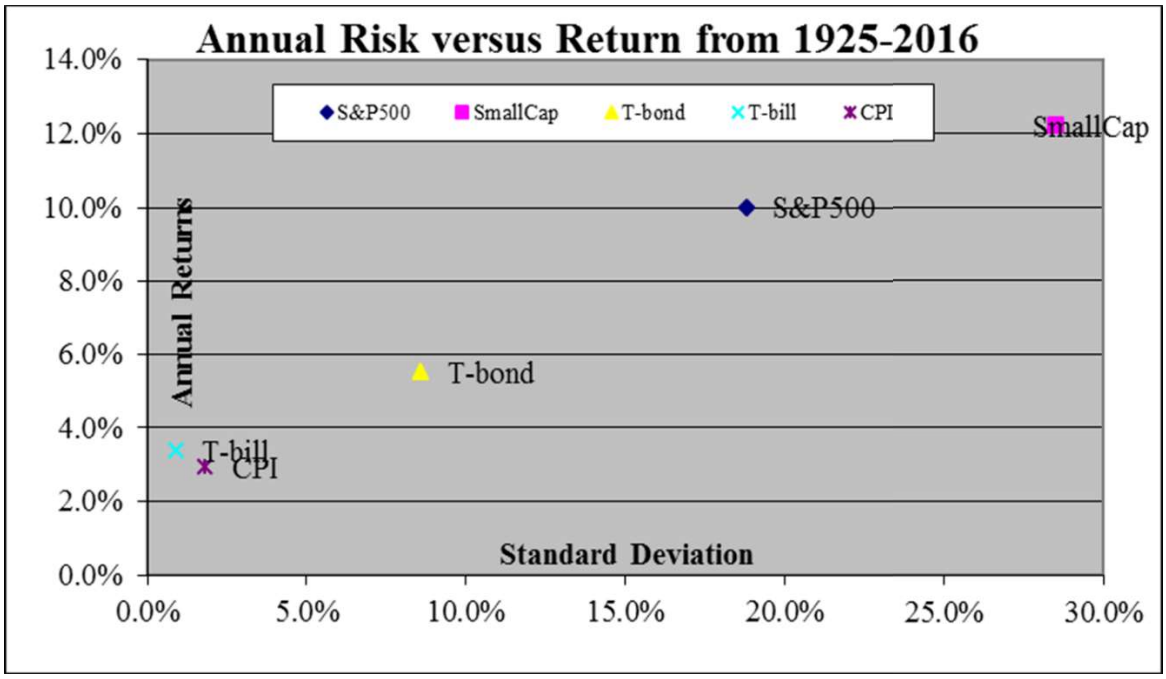
I believe it is important to study history, including the history of investments and investment returns. Some have questioned the importance of learning an asset class's performance history because they reason that the future will not be like the past. Gordon B. Hinckley stated the following regarding 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." [9]

What have been the characteristics of risk and return historically? Chart 4 and Table 4 show that from 1926 to 2017 (90 years), large-capitalization stocks (as represented by the S&P 500) have yielded a return of about 10.0 percent per year and have a standard deviation of 18.8 percent. Small-capitalization stocks have yielded a return of about 12.0 percent per year and have a standard deviation of 28.5 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 3.4 percent per year and have a standard deviation of about 0.9 percent, while inflation has increased 2.9 percent with a standard deviation of 1.8%. 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 1926, 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 which had a negative return. 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).

Chart 4. Annual Risk versus Return for 90 Years



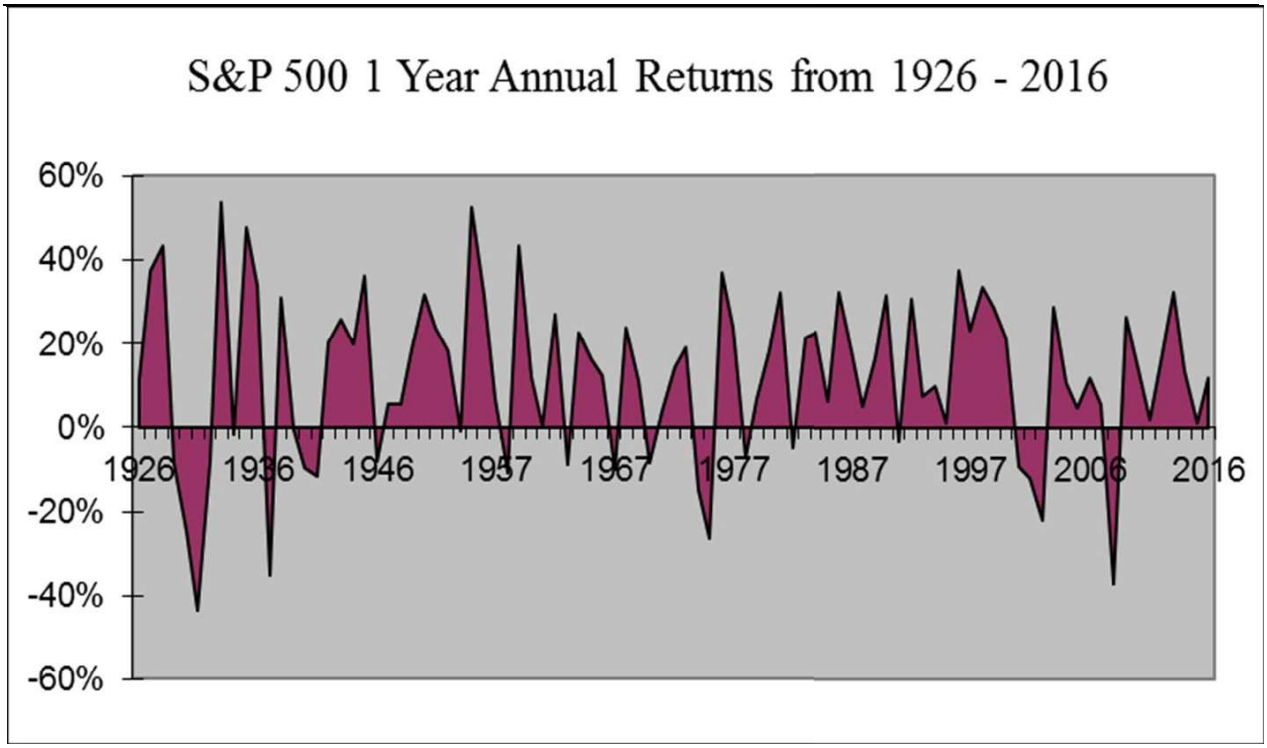
We will now look at risk, or standard deviation. Table 4 shows the *geometric return* and the standard deviation for each of the major asset classes. As you look at the large-cap (the Standard and Poor's 500 Index) return and risk, note that over 5, 10, 25, 50, 75, and 90 years, the return

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.

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.

Chart 5. S&P 500 Annual Returns



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.

Chart 6. Five-Year Annual Returns

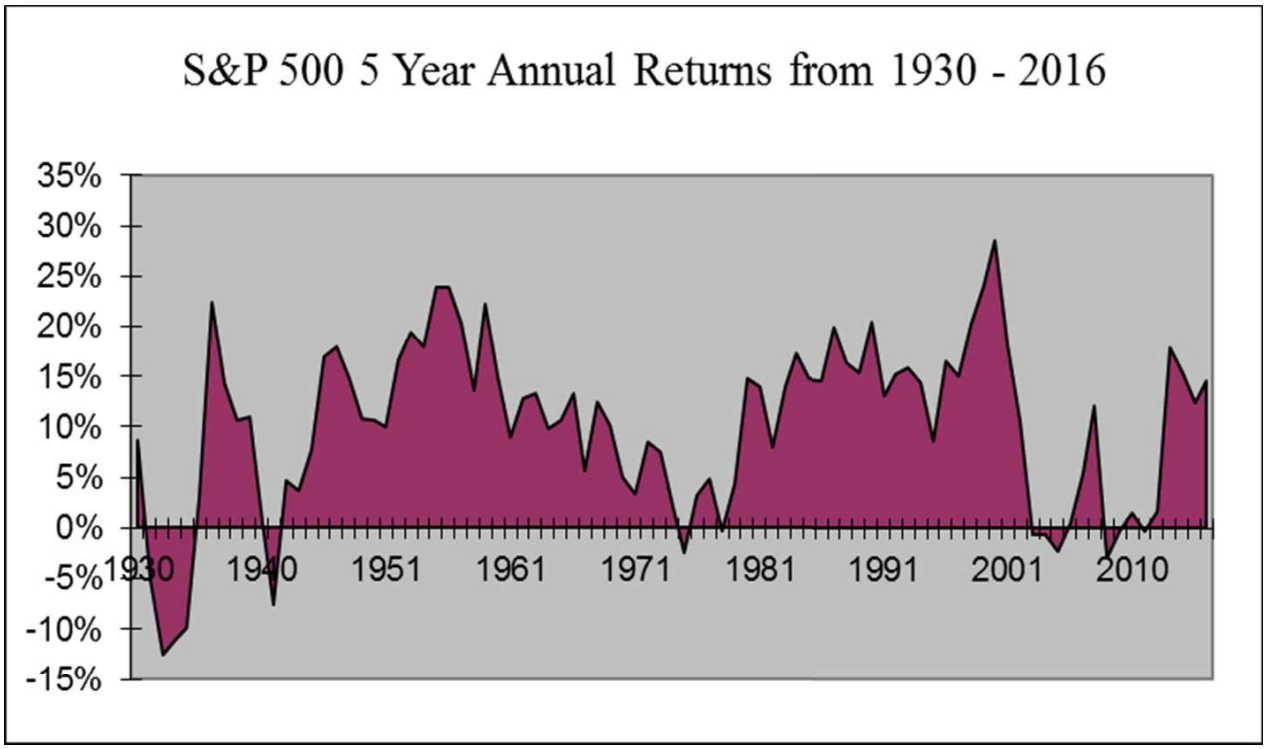
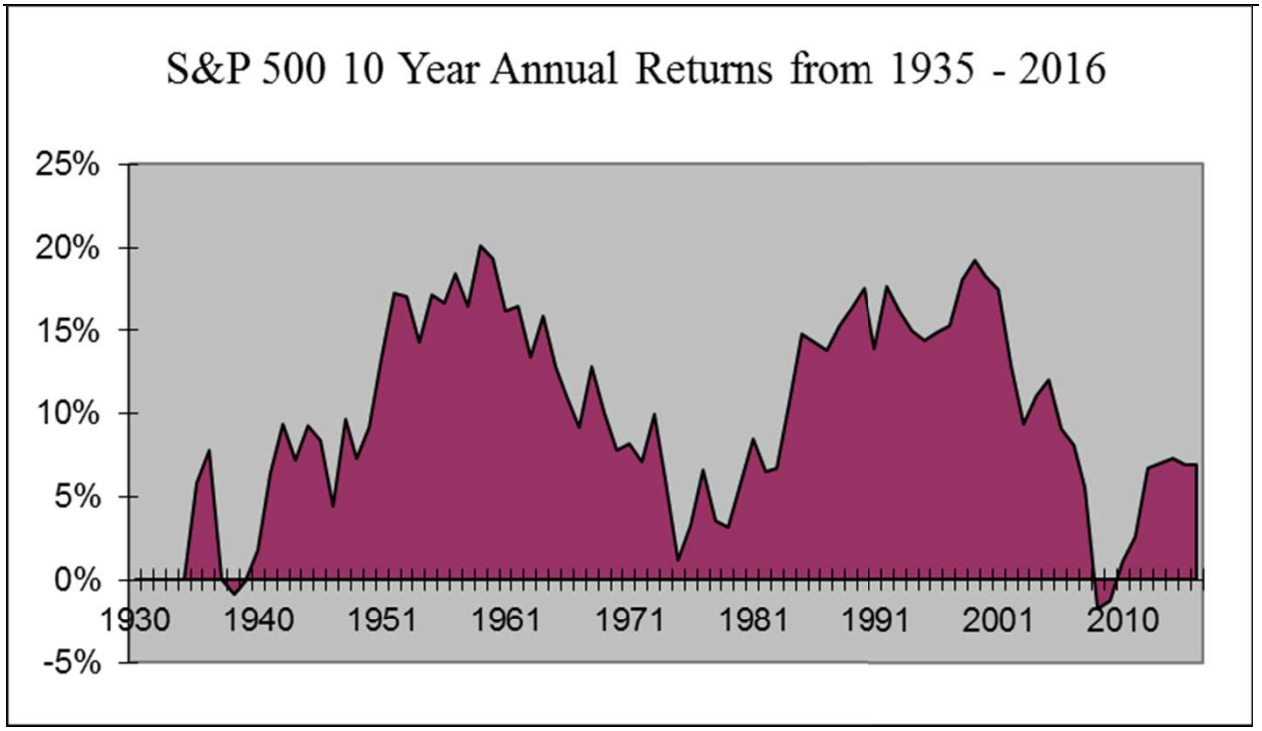


Chart 7. 10-Year Annual Returns



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.

Table 4. Geometric Return and Risk over Specific Time Periods

Total Returns For the Periods Ending December 31, 2016

	1 Year	5 Years	10 Years	25 Years	50 Years	75 Years	90 Years
S&P500							
Compound Return	12.0%	14.6%	6.9%	9.1%	10.2%	11.6%	10.0%
Standard Deviation	10.1%	10.3%	15.2%	14.4%	15.1%	14.3%	18.8%
SmallCap							
Compound Return	21.6%	15.5%	7.2%	12.1%	13.1%	15.1%	12.2%
Standard Deviation	18.5%	14.7%	20.6%	20.0%	21.5%	20.5%	28.5%
T-bond							
Compound Return	1.2%	2.9%	6.7%	7.6%	7.6%	5.7%	5.5%
Standard Deviation	13.6%	11.4%	12.6%	10.6%	10.8%	9.1%	8.6%
T bill							
Compound Return	0.2%	0.1%	0.7%	2.5%	4.9%	3.8%	3.4%
Standard Deviation	0.0%	0.0%	0.4%	0.6%	0.9%	0.9%	0.9%
EAFE (International)							
Compound Return	11.4%	4.7%	1.1%	5.6%			
Standard Deviation	13.0%	14.0%	18.6%	16.3%			
Emerging Markets							
Compound Return	19.5%	-1.7%	2.3%	6.4%			
Standard Deviation	17.3%	15.9%	23.4%	22.7%			
REITs							
Compound Return	5.5%	11.2%	4.7%				
Standard Deviation	16.4%	16.1%	35.6%				
CPI							
Compound Return	2.0%	1.3%	1.8%	2.3%	4.1%	3.7%	2.9%
Standard Deviation	0.6%	1.1%	1.4%	1.2%	1.3%	1.5%	1.8%

Source: Ibbotson Associates 1925-2015 for large cap, small cap, T bond, T bill and Inflation, and Morgan Stanley Capital International for the remainder.

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.
3. Stay diversified.
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.

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.

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:

22. Charles E. Davis, "A Banker's Dozen: Guidelines for Wise Investing," *Ensign,* Sept. 1991, 64.

25. Joe J. Christensen, "Greed, Selfishness, and Overindulgence," *Ensign,* May 1999, 9.

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?

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[1] Kimball, Spencer W. Ensign, June 1976, p. 4.
[2] Fred R. Shapiro, "Who Wrote the Serenity Prayer," *Yale Alumni Magazine,* Jul./Aug. 2008.
[3] Oaks, Dallin H. "Brother's Keeper." *Ensign,* Nov. 1986, 20, emphasis added.

[4] Anonymous.
[5] Rich Fortin and Stuart Michelson, "Indexing Versus Active Mutual Fund Management," *Journal of Financial Planning*, vol. 15, no. 9, 2002, 82.
[6] Aye Soe, "S&P Indices Versus Active Funds (SPIVA) Scorecard Year-end 2016", *S&P Research*, McGraw Hill, 2017.
[7] Carla Fried, "The Problem with Your Investment Approach," *Business 2.0*, Nov. 2003, 146.
[8] James R. Moss, "Sheep, Shepherds, and Sheepherders," *New Era,* June 1977, 20.
[9] "Reach with a Rescuing Hand," *New Era,* Jul. 1997, 4.