19. Investing 2: Understanding and Creating Your Investment Plan (IPS)

Introduction

Once you have put your finances in order and know what to do before you invest, you are prepared to invest. Like a good road map, a good Investment Plan (or Investment Policy Statement) helps you know where you are and where you are headed. A good financial road map helps you know your goals, your budget, and your risk tolerance; it also helps you avoid hazardous detours, such as get-rich-quick schemes, which may delay or stop your progress. A good financial road map helps you decide where you want to go in terms of your personal and family goals and helps you get there by making wise choices regarding investment and savings programs. A good Investment Plan is key to achieving your financial goals. The purpose of this chapter is to help you write your personal Investment Plan.

Objectives

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

A. Understand the importance of financial goals and how to set them
B. Know the importance of your Investment Plan and how to prepare it
C. Identify and be aware of get-rich-quick schemes and how to avoid them.

Understand the Importance of Financial Goals and Know How to Set Them

Not every personal goal is a financial goal, but many personal goals require some money to be accomplished. Certain personal goals cannot be accomplished without meeting specific financial targets, such as saving for the down payment on a house or saving for a child’s education. If you do not calculate and plan for the costs of many of your personal goals, it is likely that you will not be able to accomplish them.

The processes for setting personal goals and setting financial goals are the same:

1. Catch your vision, identify your goals and write them down.
2. Prioritize your goals, and list them in order from most important to least important.
3. Calculate the financial costs of each goal that requires financing.
4. Set a completion date for each goal and record the total amount needed to complete the goal.
5. Determine how much you must save each month (and which accounts you will use to save that money) to meet your goals.

6. Begin saving now.
7. Periodically evaluate your progress toward achieving your goals.

There are several important questions you should ask yourself about each of your financial goals to see if you are really committed to attaining them.

First, how important is the goal to you? How much you are willing to sacrifice to pursue the goal? Most goals require sacrifice to achieve. If you are not willing to make the sacrifices necessary to achieve a particular goal, it is likely not important to you and will be difficult for you to achieve.

Some of the goals on your list may really just be wishes—things you dream of having or achieving but are not really committed to working toward. So ask yourself, is this truly a goal, or is it just a wish? Wishes do not count—eliminate them from your list.

Second, how much money do you need to accomplish the goal? Once you have calculated the financial cost of each goal, determine whether the amount you need is before taxes or after taxes, and whether it is before inflation or after inflation. This is important to determine because the differences between these amounts may be substantial. Do not let inflation or taxes keep you from achieving your goals.

Finally, when do you need the money? Is the goal feasible with your current financial plan? Good financial plans require you to sacrifice—to stretch—but they are also reasonable for your individual financial situation.

Understand the Importance of your Investment Plan and How to Prepare It

The most important financial-planning document you will prepare, besides your list of personal and family vision and goals, is your Investment Plan. In finance terms, your Investment Plan is also known as your investment policy statement (IPS). An Investment Plan is important because it creates a framework for every investment activity in which you will participate. It states what you will invest in, how you will invest, why you will invest, what percentage of your money you will invest, and so on. In short, your Investment Plan significantly affects your investment returns. Write this plan well and then follow it carefully. An example of a good Investment Plan is found in the Learning Tools directory of the website under Investment Plan Example Template (LT05A). Your Investment Plan is a detailed description of all the major components of your investment strategy. It will help you to do the following:

1. Represent yourself: It explains your personal investment characteristics, such as your risk tolerance and your personal constraints, and how those relate to your asset allocation and targets.

2. Articulate what you will and will not do: This plan clearly states what you will and will not invest in and how you will invest. It also includes investment guidelines that

will help you invest your money wisely and achieve your goals.

3. Provide an investment framework and guidelines for making wise investment choices. If you clearly think through and plan how you will invest now that you have few assets (and are not influenced by fear and greed), you will have an investment framework and guidelines to help you reason through decisions that could have a major impact on future financial goals and retirement. If followed carefully, your plan will help you avoid poor investment decisions that could have major repercussions for your financial life. But you must write your Investment Plan carefully and then follow it.

Your Investment Plan is divided into four separate categories:

1. Risk and return objectives
2. Investment guidelines and constraints
3. Investment policies, plans and strategies
4. Portfolio monitoring, reevaluation, and rebalancing

1. Risk and Return Objectives

This category describes your expectations for returns on your investments. These expectations will, to a large extent, determine your asset-allocation decisions. In other words, these expectations will determine how you will distribute your investments among different asset classes. This category also addresses your expectations for risk and outlines how much risk you are willing to accept.

Expected returns. You should not invest without specific goals in mind. For your first goal, you should decide what return you expect your total portfolio to make over a specific time period. You cannot know with certainty what the actual returns will be before you invest. However, you can estimate an expected return, or a goal you hope to achieve during a certain period of time (such as a week, a month, or a year). Be aware that your expected return will have a major impact on what your portfolio looks like.

- An expected annual return of 1 to 2 percent will likely be the result of a diversified, very low-risk portfolio.

- An expected annual return of 3 to 4 percent will likely be the result of a well-diversified, low-risk portfolio.

- An expected annual return of 5 to 6 percent will likely be the result of a well-diversified, moderate-risk portfolio.

- An expected annual return of 7 to 8 percent will likely be the result of a less-diversified, high-risk portfolio.

- An expected annual return greater than 9 percent will likely be the result of an undiversified, very high-risk portfolio that is heavily dependent on high-risk assets.

Note that you will determine your expected returns for two periods of time: before retirement and during retirement.

There are several ways to estimate your expected returns. To give you an idea of how to estimate your expected returns over a period of time longer than one year, it may be helpful to look at the long-term history of the asset classes you have selected. Look at Historical Return Simulation for Asset Classes (LT23).

Expected risk. Since a higher expected return requires you to accept more risk, it is important that you know your risk-tolerance level, or your willingness to accept risk. Where you are in your life, as represented by your age, will likely have a big impact on how much risk you are willing to take. In general, when people are younger, they are more willing to accept risk because their investments will have more time to grow and overcome losses. As people grow older, they usually become less willing to accept risk because they will need their investment funds sooner for retirement and other purposes. Investors that have a low tolerance for risk should typically devote the majority of their portfolios to bonds and cash because these investments are the least risky of all asset classes; however, these investments also have the lowest returns. Investors that are willing to accept more risk may allocate more of their portfolio to U.S. and international stocks versus investments in bonds and cash. The challenge of wise investing is to balance your risk and return expectations with your situation in life and your personal goals.

Defining risk in your portfolio is a challenge. Professional investors usually state an annual standard deviation as the acceptable risk level for their portfolios—for example, 12 percent. From a financial standpoint, this means that 66 percent of the time the investor's risk will be within one standard deviation (plus or minus 12 percent) of his or her mean or average return. If an investor's average return is 8 percent, this means there is a 66-percent chance that the investor's returns will be between –4 percent (8 percent – 12 percent) and 20 percent (8 percent + 12 percent). While using a standard deviation to define risk may be helpful for some, this method will not work for everyone. I would like to propose a more simple way of defining risk: using investment benchmarks.

Instead of defining your risk-tolerance level in terms of a standard deviation, you can simply define it by deciding that you are willing to accept the risk of the benchmarks you have chosen for your portfolio. You can determine how risky a particular asset is by looking at your investment benchmark. If you have a small-capitalization stock mutual fund or asset that has had a return of 6.5 percent over the last 10 years and a standard deviation of 19.3 percent, you can compare this asset to an investment benchmark for small-cap stocks. From Table 4 in the previous chapter, note that small-cap stocks have yielded a 7.2 percent return over the past 10 years with a 20.6 percent standard deviation. Your mutual fund or asset has a slightly lower return than the benchmark (6.5 percent versus 7.2 percent), but with slightly lower risk than the benchmark (19.3 percent versus 20.6 percent).

You can also determine a portfolio's risk level by comparing the portfolio to weighted individual benchmarks. For example, if you choose a portfolio that is made up of 50 percent U.S. stocks, 20 percent international stocks, 25 percent bonds, and 5 percent real estate (all percentages should add up to 100), then your risk is equal to the risk defined by the benchmarks of each of these asset classes. In this case, your risk would be equal to the benchmarks of each element in a portfolio that contains 50 percent U.S. stocks (as measured by Standard and Poor's 500 Index, a major benchmark for large-capitalization stocks); 20 percent international stocks (as measured by MSCI Europe Australia, Far East Index (EAFE), a major benchmark for international stocks); 25 percent bonds (as measured by the Barclays Aggregate Index, a major benchmark for bonds); and 5 percent real estate (as measured by Standard and Poor's REIT Index, a major benchmark for real estate investment trusts). A list of the major benchmarks for a portfolio can be found in the Learning Tools directory of the website under Possible Benchmarks for Investment Plans (LT15) and Expected Return Simulation and Benchmarks (LT27). Asset class performance over the past 1, 5, 10, 25, 50, 75, and 85 years can be found in Table 4 in the previous chapter of this manual.

2. Investment Guidelines and Constraints

The second category of your Investment Plan is investment guidelines and constraints.

Investment guidelines. Your investment guidelines are the road map for how you will invest over your lifetime. These guidelines and constraints explain the ways in which you will invest differently at different phases in your life. Generally, most individuals have three stages of their financial life cycle. Most investors who are younger than age 55 are in stage one, or capital accumulation and growth. Investors who are approaching or in retirement are typically in stage two, where the main goal is investment preservation, or maintaining the value of investments. The choice of the number of stages is arbitrary. You can add more stages if you choose.

Your investment guidelines should provide you with a general road map for investing money at different stages of your financial life cycle. These guidelines should integrate all of your financial goals to give you a complete financial perspective.

Investment constraints. Once you have decided on your investment guidelines, you should identify your investment constraints. Your Investment Plan should address a number of important constraints: liquidity, investment horizon, tax considerations, and any special needs.

Liquidity is the speed and ease with which an asset can be converted into cash. As you create your plan, consider how important it is for you to have the option of turning your assets into cash quickly. Ask yourself how much money you will need at different times in your life and how quickly that money needs to be available. Examples of liquidity constraints include paying for graduate school, making a down payment on a house, and sending a child to college. To pay for these expenses, you will need to convert assets into cash.

Investment Horizon is the amount of time you are planning to keep an asset to save for a particular purchase. Consider how soon you will need to use the funds from a particular investment. Examples of short-term investment horizons include saving for a new car or making a down payment on a house. An example of a long-term investment horizon would be saving for retirement or saving for your children's college educations.

Tax considerations take into account your current tax bracket and your current tax rates. Consider your tax position: are tax-free or tax-deferred investments more advantageous than taxable investments? You cannot simply compare the stated returns of particular assets; you must compare assets by taking into account that certain investments eliminate federal or state taxes and those other investments are tax-free. For example, if you are comparing government I and EE savings bonds versus corporate bonds, you must take into account that government I and EE savings bonds are state tax-free (and federal tax-free if principal and interest are used for college tuition costs), while corporate bonds have no tax advantages.

Special-needs are constraints related specifically to your family, your business, and other areas of life that are important to you. Do you have a child with a disability? This may impose specific requirements on your Investment Plan because you will likely need life insurance to provide funds for a disabled child in case of your death. Is a large part of your wealth tied up in your company? This imposes constraints such as the decision of how much you should invest in your company's employee stock-ownership plans. You may have other special constraints that will influence your investment decisions. It is critical that you understand your special needs before you begin investing.

3. Investment Policies, Plans and Strategies

Your Investment Plan also includes your investment policy, which is a written statement of what you will and will not invest in, how you will allocate your investments, and how you will distribute your assets. Your investment policy is divided into six sections:

- Acceptable and unacceptable asset classes
- Investment benchmarks
- Asset allocation
- Investment strategy
- Funding strategy

Acceptable and unacceptable asset classes. It is important that you decide which assets you will invest in before you begin investing so that others will not be able to convince you to invest in asset classes that are not suitable for you at your stage in the financial life cycle. Invest where you have a particular expertise or where the odds are in your favor. You should plan to invest in asset classes that have a history of delivering long-term returns, not just high returns over very short periods of time. For example, I recommend that investors invest in stocks, bonds, mutual funds, and cash and cash equivalents; I do not recommend investing in futures, options, foreign currencies, or precious metals. The investments I have recommended have long-term histories of consistent performance, while the investments I do not recommend lack a history of consistent performance.

Review the historical performance of various asset classes to roughly estimate future performance. After reviewing the historical performance of the various asset classes, it is likely you will decide to invest in stocks and mutual funds, bonds and cash equivalents, and real estate.

Once you have identified which asset classes you will invest in, you must also determine which asset classes you will not invest in. Asset classes on this list may include those in which you do not have expertise or those in which the odds are against you. For example, most investors should probably not invest in asset classes such as foreign currencies. The foreign currency trades are controlled by large international banks, which employ hundreds of very experienced men and women with PhDs in finance. These banks have billions of dollars invested in computers and computing power as well as real-time databases to alert them immediately to economic changes that may affect currencies. The odds are not in your favor: investing in foreign currencies is known as a "zero sum game." This means that for every winner, there must be a corresponding loser. You do not want to be that loser. Other asset classes that typically require a great deal of expertise include commodities (especially commodity futures contracts, which have very high levels of implicit debt), precious metals, and art. Be cautious of investing in these areas unless you have specific expertise to support your investment decisions.

Investment benchmarks. These are hypothetical investment portfolios that show how a specific set of assets performed over a specific period of time. These portfolios can help investors evaluate how their investments are performing versus how the benchmark is performing over the same time period. Unless you have a benchmark by which you can judge your investments' performance, you cannot know how your investments are doing. For example, if you invest in a mutual fund of large-cap stocks and your annual return is 6 percent for 2016, how do you know if this is a good or bad return? You cannot know if you do not have anything to compare this information with. But if you know that your benchmark for large-cap stocks, the Standard and Poor's 500 Index, rose 12 percent during 2016, then you know that your investment underperformed in that year. Your investment was up 6 percent for the period versus a 12 percent return for the benchmark.

Investors select benchmarks based on asset classes, size or capitalization, geography, issuer, and investment style. Investment benchmarks are covered more thoroughly in later sections of this course.

Asset allocation. Asset allocation is the process of determining how much you will invest in each specific asset class in your portfolio. Research has shown that the decision of how to allocate your assets is the most important factor affecting your portfolio's performance.[1] As you write this section of your Investment Plan, you should answer these questions:

- How much will you invest in each asset class?
- What percentage of your total investments will you invest in each asset class?
- What is the minimum allocation of funds you will invest in an asset class at any point in time?

- What is the maximum allocation?
- What is the target allocation?

Your target asset allocation will probably vary throughout your life. Again, the younger you are, the more likely it is that you will be willing to invest in riskier asset classes. Likewise, the older you are, the less likely it is that you will be willing to invest in riskier asset classes.

In general, the first decision you should make when determining your asset allocations is between stocks and bonds. One time-tested way to decide how much you should invest in bonds is to use your age as the percentage for the allocation. The logic behind this starting point is that the older you are, the more you should invest in bonds because bonds are less risky than other investments. The remainder of your portfolio would be allocated to equities.

The second step you should make when you are determining your asset allocations is to understand your risk tolerance. I recommend that you take a number of different risk-tolerance tests to help you decide how to make allocations in your portfolio. One example of a risk-tolerance test is found in A Risk-Tolerance Test (LT16) in the Learning Tools directory of the website. Based on the results from this test, you may either decide to increase your equity allocation above the time-tested approach if the test indicates you are an “aggressive” investor or reduce your equity allocation if the test indicates you are a “conservative” investor. The amount you increase or reduce for different allocations should be based on your individual tolerance for risk.

After you have decided on your portfolio’s allocations, you should add different types of stocks and bonds to deepen your portfolio. You might add some small-cap stocks or some international stocks if you want to take on more risk. Or you might add some federal tax-free municipal bonds or state tax-free Treasury bonds if you want to reduce the risk of your portfolio. You can then broaden your portfolio by adding additional asset classes, such as real estate, emerging markets, and inflation-linked bonds.

Once you know the asset classes you want to invest in, it is important that you decide on a minimum allocation, maximum allocation, and target allocation for each asset class. Having a set minimum allocation preserves diversity in your portfolio. Diversification is an important tool for reducing risk. Since your allocations will change over time, reaching your maximum allocation will be a signal that it is time to rebalance your portfolio back to your target, or ideal allocation, based on your current expectations and the current market conditions.

When you are determining minimum, maximum, and target allocations, you should take into account where you want to be throughout your entire investing life. It is likely you will have to make different allocations for the different stages of your financial life cycle—for example, newly married, kids in college, retirement, and so on.

Investment Strategy. Your investment strategy describes how you will invest your money. It clarifies how you will manage, prioritize, and fund your investment; it also describes how you will evaluate new investments. The following paragraphs explain some of the questions you should answer about your investment strategy.

Will you use active management or passive management? Active management is a strategy in which you try to outperform your benchmarks by actively buying and selling stocks and bonds. This strategy requires considerable time and expense to maintain. Passive management is a strategy in which you invest in index funds, or exchange-traded funds, instead of trying to beat your benchmarks: index funds, or exchange-traded funds, simply mirror the performance of your benchmarks. This strategy is much cheaper in terms of time and costs, and it is often more tax-efficient as well.

You may also choose to use a combination of active and passive management for your portfolio. For example, you may choose to use active management for your tax-deferred accounts (these accounts do not require you to pay taxes until retirement, when you withdraw the money) and passive management for your taxable accounts (these accounts require you to pay taxes each year). Your choices will depend on your goals, your objectives, and your investment style.

Will you invest in mutual funds or individual assets? Mutual funds are professionally managed portfolios that are composed of similar assets. Mutual funds offer the benefits of diversification and economies of scale. Investing in individual assets, such as stocks and bonds, allows you to control what you invest in and when you will realize capital gains. While it is much more exciting to invest in individual assets, these assets also involve much more risk and instability. You may choose to invest in a mix of assets: a combination of mutual funds and individual stocks or bonds.

Will you use leverage in your investing? Using leverage is the process of borrowing either money or securities for your investment activities. Using leverage is not recommended. While leverage increases the potential for return on an investment, it also magnifies the potential for loss. Many investors have lost significant amounts of financial assets by using leverage. There are two types of leverage used by a few individual investors: buying on margin and short selling.

Buying on margin is borrowing to purchase a stock. The amount of borrowing you use is referred to as your “leverage.” For example, you are sure the value of a stock you do not currently own will go up soon. You invest $10,000 of your own money and invest another $10,000 that you borrow from your broker—buying on margin. If the value of the stock goes up, you make a larger profit because you used leverage to invest more. However, if the value of the stock goes down, you incur a larger loss because you invested more, and you must still pay back the $10,000 you borrowed, regardless of the price of the stock. With leverage you can lose considerably more than the amount you put up of your own money.

Short selling is another type of leverage in which you borrow stock and then sell it immediately. For example, you are positive the value of a stock will go down. Before the stock goes down, you borrow a hundred shares of that stock from your broker and sell them. Again, you are borrowing, but this time you are borrowing stock instead of money. If the stock price goes down, you will be able to buy the shares back at a lower price; you make a profit by selling the borrowed shares at a higher price and buying them back at the lower price to replace the stocks you borrowed. However, if the value of the stock goes up, you will have to use your own money to buy back the more expensive shares; you must also repay any dividends paid during the period you borrowed the shares.

Using leverage is risky because you can lose much more than you originally invested. Do not take the chance. Joseph F. Smith stated the following:

> If there is anyone here intending to go into debt for speculation . . . I would advise him to hesitate, pray over it, and carefully consider it before he obligates himself by borrowing money and going into debt. In other words, keep out of debt if you can. Pay your debts as soon as you can.[2]

Finally, how will you handle new investments? You need to decide the maximum percentage you will allocate to any new investment. Most experts advise that this amount should generally not be more than 10 percent of an investor's assets. Too often, people lose a great deal of money by putting all of their investments into one company or product that they think is a sure thing. There are no sure things. To avoid falling into this trap, decide now on the maximum amount you are willing to invest with a single investment: in other words, decide how much you would be willing to lose with a single investment.

You should also decide on the maximum amount of your company's stock that you will include in your 401(k) or other retirement account. For most people, this amount should not be more than 5 to 10 percent of the funds in their retirement account. Remember the principle of diversification. If your company does well, your job is secure and your retirement portfolio is strong. If your company does poorly, you may lose your job, and your retirement portfolio may be reduced substantially as well.

Funding strategy. You cannot invest without having the funds to invest, and you should not invest with borrowed money. Where will you get the funds for your investments? In a previous section, I recommended that you always pay the Lord first—that you pay tithes and other offerings before anything else—and then pay yourself a minimum of 10 percent, hopefully more (20 percent).

Most financial planners recommend that you save a minimum of 15 percent when you are young, and they recommend that this amount should increase as you get older. Once you have set aside the recommended 10–20 percent each month, invest this money wisely according to your personal Investment Plan. In this manual, I recommend that you save 20 percent of every dollar you earn after college.

How will you manage the funds for your various financial goals? One way to save for different financial goals is to set up different investment vehicles for each of your financial goals. You can use a 401(k) plan to save for retirement, a taxable account to save for your children's weddings, and 529 funds and Education IRAs to save for your children's educations. You can also set up investment accounts to save for an emergency fund, a house down payment, or a car fund. If you pay yourself at least 10 percent (hopefully more), you can divide this money among your financial goals; for example, you could allocate 5 percent to your 401(k) plan, 4 percent to your investment fund, and 1 percent to your 529 funds.

4. Portfolio Monitoring, Reevaluation, and Rebalancing

The final part of your Investment Plan is describing how you will monitor, reevaluate, and balance your portfolio. Monitor and compare the performance of each of your assets against benchmarks on a monthly, quarterly, and annual basis. How did your assets perform? Which assets had returns that were greater than their benchmarks, and which assets had returns that were less than their benchmarks?

Setting goals is not a one-time event. You should continually review and reevaluate your goals. Has your situation in life changed? Which goals need to be changed to accommodate your situation?

Finally, has your portfolio shifted away from your target asset allocations because of time or because of the performance of your assets? How will you rebalance your portfolio to regain your target allocations, while at the same time minimizing the tax effects of rebalancing? We will discuss the topic of rebalancing in more detail in later sections.

Final Thoughts on Your Investment Plan

To conclude our discussion on investment plans, I would like to offer a few final suggestions. First, develop a good Investment Plan and stick to it. This plan is your road map to attaining your financial goals. Think it through, write it well, and follow it closely. An example of a good Investment Plan can be found in Investment Plan Example Template (LT05A). Feel free to copy this plan and personalize it based on your views of risk, return, constraints, investment policy, and portfolio monitoring and rebalancing. Instructions on filling this plan out are found in Investment Plan Example Instructions (LT5B).

Second, compare the performance of your assets to your chosen benchmarks on a monthly, quarterly, and annual basis. No one will watch your portfolio like you will.

Third, beware of following the investment crowd. It is unlikely that last year's best-performing asset classes will be this year's best-performing asset classes. In my experience with investing, I have found that winners rotate. Avoid chasing last year's winners.

Finally, remember that there are tax consequences for selling—try to minimize those tax consequences as much as possible. Beware of churning, or buying and selling too often. Rebalance your portfolio annually—perhaps even less often.

Identify and Beware of Get-Rich-Quick Schemes

Get-rich-quick schemes are investment methods in which you can supposedly make a lot of money in a short amount of time without having any knowledge or incurring any risk. If a promise seems too good to be true, it usually is. No one can guarantee a consistently high rate of return. Markets are unpredictable and so are returns. "Guaranteed high returns" are typically neither guaranteed nor high. The way to make money in the stock market is the old-fashioned way: saving and investing in a diversified portfolio for many years.

M. Russell Ballard stated the following about get-rich-quick schemes:

> 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.[3]

There are many types of get-rich-quick schemes. The paragraphs below discuss some of the most common schemes.

In **day trading,** an individual with little or no training in investing spends all of their free time in an attempt to outperform the market's benchmarks (and other investment professionals) after taxes and other fees. Most day traders make very little money and waste a lot of time at the expense of their families and often their regular jobs. Few, if any, day traders beat the market consistently over time and after taxes. While day traders may make money when the market is going up, day trading is not a viable long-term strategy.

For many, day trading is a form of entertainment, not investment. As long as you consider day trading to be entertainment, and as long as you only speculate with a small percentage (less than two percent) of your overall portfolio, it can be entertaining and fun. But it is not investing.

Trading rules are recommendations generated by individuals or computers for buying and selling stocks, mutual funds, and other assets. An example of a trading rule would be you would buy a stock when the 15 moving average crosses up through the 30 day moving average, and sell it when it crosses down through the 30 day. Marketers insist you will be able to beat the market by using these rules. Do not be fooled by these "trading" rules." Think about the marketers' motives. Ask yourself, if this trading rule is so great, why are they telling me? If the rules were useful, the sellers would just use them to get rich; they would not sell them to others. Be aware that all trading rules have major flaws. The biggest flaw is that they do not work consistently.

Stock market secrets are shortcuts, or secrets, that supposedly only the professionals know; marketers are willing to share these secrets with you—for a price. Again, look at the marketers' motives. Ask yourself, if this secret is so good, why don't the marketers invest their own money, make millions of dollars, and retire to an island in the Pacific? If the shortcut were useful, the marketers would use them to get rich. They would not share them. In investing, it is critical to use time-tested information about markets, instruments, and trading; taking supposed shortcuts is usually hazardous to your wealth.

Outright lies are the promise of high and consistent above-market returns without risk. Don't get sucked in. If it seems too good to be true, it usually is. No one can guarantee a consistently high specific rate of return. Markets and returns are volatile. Guaranteed high returns are never guaranteed or high. The way to make money in the market is the old-fashioned way—to invest in a diversified manner for many years.

Insights on Get-Rich-Quick Schemes

There are no get-rich-quick schemes that work consistently. Following are four general tips to help you identify and avoid get-rich-quick schemes:

1. *Beware of the amount of time, energy, and money the suggested strategy requires*. I recommend you spend time with your family and work, and keep your money for yourself and invest it.

2. *Beware of the agency problem*. Ask yourself what a person wants to be given in exchange for his or her rules and secrets. If the answer is money, keep the money for yourself and invest it wisely.

3. *Beware of the "you can do it too" pitch*. Ask yourself if they really did it. Most sellers of get-rich-quick scheme are very selective as to the information they will supply. They only reveal selective bits of information about their success (and in some cases the information is wrong). They comment on "selective performance" when the method actually made money; "selective funds," the funds that actually made money; and "selective time periods," the time periods when the method worked. Most sellers have not even tried the strategies they suggest.

4. *Beware of the hidden costs of trading*. When sellers tell you about potential returns, they usually have not accounted for transaction costs, taxes, and other trading costs; these costs will substantially reduce your annual returns.

Summary

Certain personal goals cannot be accomplished without meeting specific financial targets, such as saving for the down payment on a house, or saving for a child's education. If you do not calculate and plan for the costs of your personal goals, it is likely you will not be able to accomplish them.

The most important financial planning document you will prepare, besides your list of personal and family goals, is your Investment Plan. An Investment Plan is important because it creates a framework for every investment activity in which you will participate. It states what you will invest in, how you will invest, why you will invest, what percentage of your money you will invest, and so on. Write this plan well and then follow it carefully.

We have discussed the importance of creating a personal Investment Plan that can help you achieve your financial goals. Remember that your personal Investment Plan is your road map to successful investing: it will help you achieve your goals and avoid dangerous get-rich-quick schemes. The following are some final thoughts to consider before you invest:

1. Learn and follow the principles of investing. Avoid taking shortcuts.
2. Make investing an automatic part of your lifestyle. Strive to reach a point where you do not have to think about investing, you just do it.
3. Let others help you save. Take advantage of employee benefits and federal and state tax advantages. Use tax-deferred and tax-eliminated investment vehicles as much as possible.
4. Institute barriers that limit your access to your savings. The harder it is to liquidate your investments, the less often you will use your investment assets for everyday purchases.
5. Invest bonuses and other money you receive unexpectedly to help you achieve your financial goals more quickly.

Finally, get-rich-quick schemes are investment methods in which you can supposedly make a lot of money in a short amount of time without having any knowledge or incurring any risk. If a promise seems too good to be true, it usually is. No one can guarantee a consistently high rate of return. The way to make money in the stock market is the old-fashioned way: following the principles of successful investing and doing it consistently for many years.

Assignments

Financial Plan Assignments

Open your copy of your Investment Plan Investment Plan Example Template (LT05A). Make sure you understand the terminology related to investment plans. I will discuss many aspects of this plan in upcoming sections.

First, you will not have only one portfolio for your investments; you will likely have many portfolios, all of which are important parts of your Investment Plan. Review your vision and goals. What are you trying to accomplish individually and as a family through investing? Think through your general investment guidelines in Section IIA for both Stage 1 and Stage 2, and fill in those sections.

Using Expected Return Simulation and Benchmarks (LT27) , input your stock and bond allocations from your work you have done in the previous section.

There are four different asset classes for equities or stocks that I have data for. *Large-cap stocks* are the largest and biggest companies, generally with market capitalization (or shares outstanding multiplied by share price) of over $10 billion dollars. *Small-cap stocks* have market capitalization generally between $250 million and $2 billion dollars. *International stocks* are those registered on exchanges outside the United States. And *emerging market stocks* are stocks of companies listed outside the U.S. and outside the major developed markets.

In bonds and cash, there are two different asset classes. Treasury bonds are long-term government securities, which are government debt with maturities generally one year or more. Treasury bills are government debt with maturities less than one year.

Real Estate Investment Trusts (REITs) are neither stocks nor bonds but have components of both.

Using the dropdown boxes in Expected Return Simulation and Benchmarks (LT27), try to come up with a preliminary target asset allocation. This is not your final target but just a preliminary pass.

Second, determine your investment constraints. When will you need money from your investments and why? Now is a good time to think about these needs. Fill out the constraints on Section II.B.1-4. on liquidity, time horizon, taxes, and unique needs. Your average and marginal tax rates should also be added and will come from your section on Tax Planning.

Finally, determine your policies. I recommend you make a first pass at your policies and then refine them as you learn more about investments. Major policies include:

> **III.A.1. Acceptable asset classes:** Decide now what you will invest in and what you will not invest in. I recommend against asset classes where you have no discernible advantage.
>
> **III.A.2. Total assets:** What is the maximum amount you will invest in any single asset? Remember the principle of diversification.
>
> **III.A.3. Short selling or buying on margin:** Decide if you will use debt to invest. I recommend against it. Do not invest with borrowed money.
>
> **III.A.4 Un-acceptable asset classes:** What asset classes will you not invest in? Make the decision now. I recommend against foreign currencies, options, futures, derivatives, and collectibles and other
>
> **III.B.1-2. Investment benchmarks:** Determine your investment benchmarks for each of your asset classes. I strongly recommend a minimum of four asset classes, so you will have at least four investment benchmarks. Suggestions for benchmarks for the various asset classes can be found in Expected Return Simulation and Benchmarks (LT27).
>
> **III.C.1-2. Asset allocation strategy**: Determine your target and minimum and maximum

allocations for your two different stages.

III.D.1. Investment strategy: Determine how you will invest. Will it be mutual funds or individual stocks? I strongly recommend mutual funds, at least initially, when your assets are few.

III.E. Funding strategy: Determine your funding strategy. How will you save money for investing and saving? What is your goal to save each week or each month? How will you keep your priorities in order?

III.F.1. New investments strategy: What is the maximum amount you will invest in new investments? I recommend not investing more than 5 to 10 percent in any new investment (except for broad-based mutual funds with more than 50+ assets).

III.F.2. Investments in company stock: Think about the maximum you will have in your retirement fund in investments of your company's stock. I recommend no more than about 10 percent due to diversification concerns.

III.F.3. Unlisted investments: Finally, what is the maximum amount you will include in unlisted investments, i.e., investments that are not listed on a recognized stock exchange? While I recommend you not invest in assets that are not listed, it is your choice.

Learning Tools

The following Learning Tools may also be helpful as you prepare your personal Investment Plan:

Investment Plan Example Template (LT05A)
: You are encouraged to copy this Investment Plan template and change the investment goals, objectives, allocations, and other areas to make them consistent with your personal goals, objectives, return and risk requirements, asset allocation targets, and other investing parameters.

Investment Plan Example Instructions (LT5B)
: These are instructions for preparing your Investment Plan.

Expected Return Simulation and Benchmarks (LT27)
: This spreadsheet helps you see the impact of various investment strategies as well as the volatility of different asset classes. It also shows you the historical impact of different asset-allocation decisions.

Possible Benchmarks for Investment Plans (LT15)
: This document give ideas for possible benchmarks for your different asset classes.

Review Materials

Terminology Review

Active management. Active management is the process of trying to beat market returns by the active buying and selling of mutual funds and stocks.

Buying on margin. Buying on margin is borrowing money to invest. You borrow money from your broker and use it to purchase financial assets. If the stock goes up and you sell the stock, you make a profit due to leverage. Be careful as you can lose much more than your original investment.

Day trading. It is the process of an individual giving up all his spare time in an area in which he has little or limited competence, in an attempt to consistently beat the market and other professionals after taxes, costs and fees.

Financial Goals. Financial goals are personal goals with a cost attached.

Investment Benchmarks. An investment benchmark is the standard by which to judge your asset performance. You never choose an asset without choosing an investment benchmark. Use your investment benchmark to determine how well you are doing.

Investment Constraints. These are specific needs you have which will constrain how you will invest your portfolio.

Investment Guidelines. Your investment guidelines are the general road map on how you will be investing your assets over your life cycle. It integrates your personal goals and your financial goals into a complete financial perspective.

Investment Horizon. This is when will you sell the investment.

Investment Plan (also called and Investment Policy Statement). Your Investment Plan is the most important document you will prepare in regards to your investing activities. It sets the plan and framework on every investing activity. It states what you will do: what you will and will not invest in, how you will invest, why you will invest, what percentages you will invest, etc. In short, it is the key document that will impact your investment returns most for the rest of your future.

Investment vehicles. These are tax-law defined vehicles which allow you to save tax-advantaged for specific goals, i.e., Retirement: 401k, 403b, Roth 401k, IRA, Roth IRA; Education: 529 Funds, Education IRA etc.

Leverage. The decision of using debt to invest. It is not recommended.

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

Mutual Funds. These are professionally managed portfolios of similar instruments which offer the benefits of economies of scale and diversification.

Passive management. Passive management is the process of accepting average returns through purchasing index funds rather than trying to beat the market. It is much cheaper and more tax efficient.

Short-sell. Short-selling is borrowing shares from your broker, selling those shares, and hoping the price of the shares will decline to you can rebuy them at a lower price. Be careful as you can lose much more than your original investment. Don’t risk it!!

Stock Market Secrets. These are supposed short-cuts or secrets that only the professionals know, but they will share them with you for a price. Don’t get taken.

Tax Considerations. These are how taxes will impact your investment decisions, including your tax position, specifically your marginal and average tax rate; and how tax-free investments may fit into your plan, i.e. municipal versus corporate bonds.

Unique Needs. Unique needs are special needs that may impact your investing decisions.

Review Questions

1. How are your financial goals related to your personal goals?
2. What is the difference between a goal and a wish?
3. What is an Investment Plan? Why is it important?
4. What are the four categories of an Investment Plan?
5. What is an investment benchmark? How do they help an investor? What is the consequence of not having a benchmark to follow?

Case Studies

Case Study 1

Data

Last year Anne sold short (this is another term for short selling) 400 shares of stock at $90 per share. Six months later the stock fell to $45 per share and she covered her short, i.e., she bought back shares to replace the shares she sold short. Over the six-month period, the company paid out two dividends of $1.50 per share. Her total commission cost for buying and selling the shares came to $125.

Calculations

A. Determine Anne's profit or loss from this transaction.

B. What would her profit or loss have been if the stock had rallied to $250 per share and she had to cover her shares sold short?

Case Study 1 Answers

A. Profits are made on short selling as the market price of a stock goes down. In this example, the stock fell to $45 per share. To determine Anne's profit or loss, use the following calculation:

Total value of the shares sold short at $90 * 400 $36,000 credit
Repurchase cost of the shares ($45 * 400) –$18,000 purchase
This is the purchase cost to cover the shares she borrowed and sold.
Gross Profit $18,000
Dividends (2 *$1.50 x 400) –$1,200

Since Anne sold these shares, she must pay back the dividends the owners would have received if they didn't lend her the stock.

This is your commission cost –$125 commissions
Net profit $16,675

This is Anne's profit if the stock price declined from $90 to $45 after she sold the shares short and covered the shares at $45.

B. Profits are made on short selling as the market price goes down. In this example, the stock's price went up to $250 per share. To determine Anne's loss, use the following equation:

This is the sale of the shares at $90 (* 400) $36,000 credit
Purchase cost to cover borrowing ($250) –$100,000 purchase
Net profit –$64,000 loss

Dividends (2 * $1.50 x 400) –$1,200 dividends

Since Anne sold these shares, she must pay back the dividend.

Commissions –$125 commissions

Net profit –$65,325 net profit

This is Anne's loss if the stock price increased from $90 to $250 and she was forced to cover the shares at $250.

Case Study 2

Data

Bill is one of the 8,400 Utah victims of the 12DailyPro Internet fraud, where investors were supposed to receive a 12 percent return per day without any products or services.

Application

A. What advice would you give to Bill regarding purchasing products of this type in the future?

B. Which principles of investing did this fraud violate?

Case Study 2 Answers

A. 12DailyPro was a Ponzi scheme, where new investors' money was the "return" to investors who got into the scheme before later investors. Investors had no idea how the firm made money but were only concerned that they made money. It seemed too good to be true, and it truly was.

B. 12DailyPro violated two main principles: (1) Principle 6: Know what you invest in and who you invest with and (2) Principle 9: Invest only with high-quality individuals and institutions.

Case Study 3

Data

Kim just purchased 1,000 shares of NS corporation at $15 per share, and 50 percent was purchased on margin (i.e., she borrowed 50 percent to buy the shares). She held the shares for six months and sold them. Interest on her margin loan was 12 percent annually.

Calculations

A. Assuming the price increased to $30 per share and Kim sold the shares, what is the total profit of her investment after paying back the loan with interest? Profit = total revenues – total expenses. Assume the money she invested is part of her expenses.

B. Assuming the price decreased to $5 per share and she sold the shares, what is the total value of her investment after paying back the loan with interest?

C. Generally, should an individual buy on margin?

Case Study 3 Answers

A. Kim's purchase at $30 $30,000 ($30 * 1,000 shares)

Interest –450 ((6 months /12 months) * 12% * $7,500)

Loan amount –7,500 (She borrowed 7,500.)

Her personal money –7,500 (She put up 7,500 of her money.)

Her profit is $14,550

B. Kim's purchase at $5 $5,000 ($30 * 1,000 shares)

Interest –450 ((6 months /12 months) * 12% * $7,500)

Loan amount –7,500 (She borrowed 7,500.)

Her personal money –7,500 (She put up 7,500 of her money.)

Her profit –$10,450

C. No. Buying on margin is a bad idea and should be avoided at all costs.

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[1] Robert G. Ibbotson and Paul D. Kaplan, "Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?", *Financial Analyst Journal*, Jan./Feb. 2000, 2633.

[2] Conference Report, Oct. 1911, 128–29.

[3] "Keeping Life's Demands in Balance," *Ensign,* May 1987, 13.