

# Do's and Don'ts Investment Pros Don't Usually Explain

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Investing professionals don't explain all that you need to know to invest successfully. Here are some of the issues we discuss here:

- How *not* to undertake your investments
- Widely-publicized economic trends you can safely disregard
- Conflicts of interest of market professionals
- A promising long-term investment approach

## How Not to Conduct Your Investment Life

-- If you're paying even moderate interest on credit cards, hold nothing in savings accounts, bonds, or stocks. Why earn money at low rates in one hand only to pay it out at high rates from the other? Funnel all the money you can to paying off the debt.

-- Large, known expenses to be paid in the next 5 years, such as tuition payments, a new summer home, or assisted-living costs, should not be included in your long-term investment portfolio. Set these funds aside in a money market fund.

-- But most large, *unknown* expenses (usually called emergencies) should indeed be invested for the long term. Six months of income in reserve seems excessive. Two month should be enough. Stock prices stay the same or go up about two-thirds of the time. Add the extra funds to long-term investments that are outside of qualified retirement programs. When an emergency occurs, pay with a credit card. Then sell some of the investments and repay the card.

-- Minimize exposure to your employer's stock. Tying both your current and your retirement income to the success of a single company is too much risk. The key to successful investing is diversification.

-- Don't let taxes control your financial life. To save taxes, you usually have to give up control. The most effective way to pay no income tax is to have no income. Who wants that?

-- Be wary of municipal bonds. Most of them are callable, meaning that if interest rates go down (and bond prices rise), the municipality can buy back the bond from you, with the price per bond usually 2 percent above the \$1,000 par value. For the municipality, this is a sweet deal. If interest rates go up and the bond price falls, you're stuck with a loss, which, until maturity, is potentially unlimited. But if interest rates go down and the bond price rises, your profit is restricted to only 2%. Heads, the municipality wins. Tails, you lose.

-- Take advantage of employer matching in 401(k) plans, but otherwise use Roth IRAs and regular investments. The costs of 401(k) plans generally run at least 2 percent a year. Also, withdrawals from 401(k) plans and traditional IRAs are highly taxed as ordinary income. The investment program suggested below generates mostly long-term capital gains, which are taxed at low rates. Also, the inheritance of traditional IRAs is extremely complicated and prone to costly errors.

-- Avoid buying small numbers of individual stocks. The stock market itself is sufficient risk. If you just stay in, you're well rewarded. But if you hold only a few stocks, the market may rise, while your particular stocks fall.

You have extra risk, but no extra reward. Diversify to at least three dozen stocks from various nations and industries. Better yet, participate in entire markets with index funds or exchange-traded funds.

-- Avoid actively-managed mutual funds. During the 1990s, only 28% of all actively-managed U.S. stocks funds beat the market, mostly because of high costs. Would you make a bet with a 72% chance of poor results? Most actively-managed mutual funds also trade too much, leading to high-taxed, short-term capital gains. The total costs can easily amount to 5% or more a year, and if you buy a fund through a salesman, you pay sales costs as well.

-- Do not buy Class B or Class C shares of a mutual fund. True, no commissions are charged up front, and the salesman can say, "No commissions." But sales charges are indeed paid. They're not called commissions; they're called "expenses," and they're charged against your account, generally amounting to more than if you paid the front-end costs of Class A shares and held for the long term. Do not buy Class C shares in expectation of holding the fund for only a short time. If you intend to hold a fund for a short time, don't buy it at all. Best of all, acquire mutual funds that incur no sales charges, like those of Vanguard. Except for annual rebalancing (see below), hold for life.

-- Avoid rapid trading. 95% of traders lose. Say your account holds \$10,000 and you buy and sell once a week. Assume the commissions are only \$20. That's 0.4% a week. Assume the difference between the bid and asked prices average 0.2% a week. Your total costs come to 0.6% a week. With 50 round turns a year, the costs total 30% a year. The stocks you buy and sell must gain that much every year just to break even! Can you accomplish this? I doubt it – not year after year. As Warren Buffett put it, you can't produce a baby in one month by getting nine women pregnant.

-- Forget about stock charts. Historic price and volume trends have no predictive value. They look like they ought to work, but they don't. The technical analysts who rely on charts say that we should use them only in combination with fundamental analysis. Baloney! If an investment method doesn't work on its own, it won't work in combination with another.

-- Some people say to themselves, "I'm special. An investment return of only 10% a year isn't enough for me. I expect 20% or more." If this applies to you, you're heading for trouble. In purchasing clothing, cars, or houses, be as special as you please. But if you expect to be special as an investor and you take big risks or trade often, you're likely to lose. Take what the long-term market gives you. This is far better than most people achieve.

-- Don't sell your stocks when you retire. But don't retire too soon.

-- If you try to outguess the market, you'll be wrong more often than right. If you're wrong even once, you'll never catch up. The market is always a surprise. When I first became a broker as a young man, I told a partner of the firm that I thought the Dow would fall about 30% during the next 12 months. The partner, a stuffy fellow, looked down his nose at me and declared, "Mr. Richards, you are not a *reasonable* man!" I felt the size of a pea. But as it turned out, the Dow did fall about 30% during the next 12 months. I had made three correct predictions: when the Dow would start going down, how much it would fall, and when it would stop falling. I said to myself, "If I can do that when I don't know anything, imagine what I can do when I know something."

After a while, I began to know a little something. I tried over and over to duplicate my early success, but I never succeeded. Finally, I realized that I'd just been lucky. Heaven help you if you guess the market correctly when you first get into it. You'll think it was due to skill. You'll try to repeat your success and be left way behind.

-- Disregard currency fluctuations. In 1978, the dollar's *weakness* was headline news, and the stock market rose big. In 1985, the dollar's *strength* was headline news, and the stock market rose big. In 1995, the dollar's *weakness* was headline news, and the stock market rose big. Currency fluctuations don't affect long-term stock market trends. Forget about them.

### Conflicts of Interest of Investment Experts

If you're building a bridge, hire the best architect and engineer you can find and rely on them. With tangibles, obvious causes and effects can be depended on. But with intangibles, like stocks and bonds, cause and effect is far from obvious, especially in the short term.

*The Business Media:* Commentators and investment experts in the media are informed - but only about the past. About the future they know no more than the rest of us. For business-show TV producers, the first priority is not to make money for us. Their first priority is to make money for themselves; indeed, this is the first priority of most of us. The TV producers don't have to be right about the market, but they do have to be interesting. To increase the number of viewers, they provide the latest information. But this is no advantage to us, because it stimulates frequent trading.

Television commentators *sound* authoritative, but don't be fooled. After a day of higher prices, I heard one of them say, "Given the decidedly negative action during the last week, the market was due for some type of bounce." Why didn't he tell us the day before? He didn't, because he didn't know.

Here's another statement I heard. "With all the volatility, the market is giving no signal about where it's headed." Nonsense! The market *never* signals where it's headed. When a surprise occurs, the prices jump immediately. If the news is good and you're out of the market, you're too late to get in. If the news is bad and you're in the market, you're too late to get out.

Money managers that have recently performed well are interviewed on television as gurus. But after Lady Luck subsequently casts her favors on others, last year's guru slinks back into the pack.

You may have heard a market expert being interviewed on television say, "It's a stock-picker's market." This means he expects the market to remain relatively flat, but you can increase the value of your portfolio anyway by choosing the right stocks. The expert may be touting his services as a stock picker himself. He makes it seem as if outdoing the market is a piece of cake. It isn't. Will Rogers said, "Making money in the stock market is easy. You buy a stock, and it goes up. If it doesn't go up, don't buy it." Most people who pick stocks fail to equal the market by a long shot. Stock pickers who do beat the market generally hold their stocks for decades.

Television reporters feel they must give reasons why the market made a certain move during the day. But they didn't interview every one of the millions of people who participated in the market that day. They're just guessing. Sometimes they're right, sometimes not. When a commentator says that prices moved a certain way "for technical reasons," he has absolutely no idea why.

Early one morning, I heard a radio interview of a prominent TV business commentator. During the week prior to the interview, the Dow had fallen from 9700 to 9250. The commentator was asked, "What's going on in the market?"

"We're in the middle of a correction," he replied. The unmistakable meaning was, the market would fall another 450 points or so and then resume rising.

But on that very day, the market *rose* more than 100 points. In a couple of more days, the Dow returned to 9700. We weren't in the middle of a correction after all; the correction had already ended. If you had followed the

commentator's advice and waited for the Dow to fall another 450 points, you'd have been out in the cold. It wasn't the commentator's fault; he seems like a well-meaning fellow to me. But he's paid to give the appearance of knowing things that none of us *can* know.

Before the opening on another morning, I heard a different TV business commentator give a rundown of the current business news. She said, "There was a net outflow of money from mutual funds last month. That's a negative."

Note the present tense. It implies that the net outflow of money from mutual funds *last* month will cause prices to fall *this* month.

The implication is wrong. Last month's business news has no bearing on this month's prices. As explained in the previous position paper, this month's prices anticipate the business news that no one will know about for another 4-to-6 months. Most investors don't care about the past. They're continually guessing about the future.

Besides, the commentator's announcement implies a ridiculous outcome: If the net outflow of money from mutual funds last month causes prices to fall this month, then the net outflow of money *this* month would cause prices to fall *next* month. On we go, right down to zero. No, the market doesn't work this way.

To be more accurate, the commentator might have said, "There was a net outflow of money from mutual funds last month. That was a negative." But using the past tense doesn't attract viewers. We don't care about last month. We want to know about *this* month. And while you're at it, Ms. Commentator, would you please give us some idea about *next* month?

Sorry, she can't do that. Smart as she is, no one knows what the market will do next month – even the next minute. But to attract viewers, she has to *imply* that she knows. Using the present tense gives this impression.

Pay no attention to business commentary you hear on television. If you follow expert advice about the market, you're going to lose. If you keep doing it, you'll lose big. The best time to buy stocks is when you get the money. The best time to sell is never.

*Market letter writers* may or may not be investors, but they are publishers. Like television producers, they don't have to be right. They just have to be interesting. Often, their predictions are wrong, because they get caught up in the widespread sentiment about the market. They're generally pessimistic at bottoms and optimistic at tops.

*Stock analysts* seldom advise investors to sell a stock. If they did, managements of companies would stop talking to them. When analysts are bullish about a stock, they say "buy." When they're bearish, they say "hold." It's a secret code.

*Stockbrokers* benefit when their customers trade a lot. Customers don't. If you call a broker and say "I've been looking at ABC stock. What do you think about it?" While talking with you, the broker senses whether you're bullish or bearish. If you're inclined to buy, he'll encourage you to do so. If you're inclined to sell, he'll try to excite you about what you might own instead. Brokers make money by persuading people to act. It's easier to get the client to act if the broker reinforces what the person already believes.

Don't ask a stockbroker to predict the future about anything. Flip a coin instead. At least you'll be half right.

## A Promising Long-Term Investment Approach

The rate at which your investment portfolio grows is less important than the rate at which you add money to it on a regular basis. Set aside 10% of your earnings and arrange for the money to be invested automatically. Except for annual rebalancing, just hang on.

Buy a preponderance of stocks. After adjusting for inflation, there has never been a ten-year period in American history when a broad portfolio of stocks didn't return more than bonds. Even in losing ten-year periods, stocks lost less than bonds. During every *twenty*-year period in U.S. history, stocks haven't lost even once, but bonds have.

Use index funds or exchange-traded funds (ETFs). Both of them track indexes, which are hypothetical portfolios designed to measure a particular market sector. The most famous is the Standard & Poor's 500 Index, which tracks the performance of the 500 largest U.S. stocks. Standard & Poor's chooses which stocks to include in the index. As the prices collectively move by a certain percentage, the index changes by the same percentage.

Some indexes, like the Russell 3000, track broad markets. Others track specific sectors, such as large stocks, small stocks, growth stocks, value stocks, stocks of specific industries, stocks of foreign countries, REITs, commodities, and bonds. All of these indexes are themselves tracked by index funds and by exchange-traded funds.

Index funds and ETFs have low costs, because no stock research is needed. The fund buys the very same stocks that are included in the index being tracked, saving *research* costs. Since the individual securities included in indexes are changed infrequently, index funds and ETFs trade infrequently, saving *transaction* costs. They also hold for the long term, saving *tax* costs. Index funds and ETFs don't try to beat the index they're tracking; they just try to equal it. (For more on ETFs, buy "Understanding Exchange-Traded Funds," written by yours truly and released by McGraw-Hill in March 2007.)

Most indexes hold hundreds of stocks and are therefore well diversified. But you should be doubly-diversified by purchasing various indexes from different sectors of the market. It's called asset allocation. As one sector falls in price, others might rise, thereby reducing the volatility of the whole. When bad markets occur, you're less likely to sell your stocks. But the performance of the whole will probably be almost as good as that of the best-performing sector.

Index funds and exchange-traded funds are both good, but I prefer the latter. Use Foliofn as the brokerage firm ([www.foliofn.com](http://www.foliofn.com)). You can invest dollar amounts, rather than the number of shares, and receive fractional shares.

For a fine investment strategy, I refer you to my website, [www.archierichards.com/suggested\\_portfolio.html](http://www.archierichards.com/suggested_portfolio.html).