Personal Finance Self-Education Packet

Table of Contents:

Importance of Personal Finance, Saving, and Investing
Why You Want to Invest – Compounding Interest
How to Think about Saving and Investing
Short Term and Long Term Accounts
IRAs and 401Ks – The Details
Important Retirement Questions

Investing and Markets Basics
Asset Classes and Funds
The Importance of Asset Allocation
Investing Emotions
Stocks, Index Funds, and Mutual funds
Different Types of Investing Styles

Other Important Things
Opening a Brokerage Account
Credit – Getting Your Financial House in Order
Taxes – Another Important Thing
Paying it Forward – Smart Woman Securities allows you to do this!

Recommended websites:
LearnVest - www.learnvest.com – Information on personal finance
Motley Fool – www.fool.com – Introductory information to the markets and investing
Mint – www.mint.com – Aggregate all of your finances on one website
Credit Karma – www.creditkarma.com – Resource to check your credit score

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Importance of Personal Finance, Saving, and Investing

Why You Want to Invest – Compounding Interest

The Power Compounding Interest
If there were an eighth wonder of the world, we’d nominate the equation for compound interest: Your money \( x (1 + i)^n \). (If you're not a math geek, don’t worry; we're going to decipher that for you.) Albert Einstein (or maybe it was Yogi Berra) called this deceptively simple formula the "greatest mathematical discovery of all time." We call it your ticket to financial independence. That's right, just three straightforward inputs can change your life: the amount of money you invest; the rate of return you get; and how much time you have to let your money grow. Since words cannot adequately describe the magical nature of compound interest, let's try a few visuals. Here's how a single $1,200 investment grows over time in four savings scenarios.

How a single $1,200 investment grows

<table>
<thead>
<tr>
<th>Savings Account (0.5%)</th>
<th>Money Market Fund (2%)</th>
<th>Certificate of Deposit (5%)</th>
<th>Stock Market (9%*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial investment $1,200</td>
<td>$1,200</td>
<td>$1,200</td>
<td>$1,200</td>
</tr>
<tr>
<td>5 years</td>
<td>$1,230</td>
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<td>10 years</td>
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<td>25 years</td>
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<tr>
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<td>$1,394</td>
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</tr>
<tr>
<td>35 years</td>
<td>$1,429</td>
<td>$2,400</td>
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</tr>
<tr>
<td>40 years</td>
<td>$1,465</td>
<td>$2,650</td>
<td>$8,448</td>
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</tbody>
</table>

*Based on the stock market's historical rate of return.

As you can see, simply socking away one lump sum and leaving it put could turn $1,200 into nearly $40,000 over 40 years. Not only have you earned interest, but you’ve earned interest on your interest. And all you had to do was invest your first paycheck. That said, let’s be honest: $37,691 ain't what it used to be. So let’s make one small revision and invest $1,200 every year. Behold compound interest in a mildly caffeinated state.

A more compelling table than the previous one:

<table>
<thead>
<tr>
<th>Savings Account (0.5%)</th>
<th>Money Market Fund (2%)</th>
<th>Certificate of Deposit (5%)</th>
<th>Stock Market (9%)</th>
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<tr>
<td>Initial investment $1,200</td>
<td>$1,200</td>
<td>$1,200</td>
<td>$1,200</td>
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<tr>
<td>5 years</td>
<td>$7,321</td>
<td>$7,695</td>
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<tr>
<td>10 years</td>
<td>$13,596</td>
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<tr>
<td>30 years</td>
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<td>35 years</td>
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<tr>
<td>40 years</td>
<td>$54,721</td>
<td>$76,582</td>
<td>$160,656</td>
</tr>
</tbody>
</table>

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

If we could, we would cue a soaring chorus of angels opening the doors to usher you into the Valhalla of investing … but we misplaced that file somewhere on our hard drive. And the best part about compound interest is that it works the same for
everyone, whether you have $20 to invest or $200,000. Go ahead, tinker with this compounding calculator to see what we mean. If you don't believe you can become a millionaire with just the resources you have right now, keep reading.

The amazing tale of the Mississippi washer woman
Oseola McCarty was born in Mississippi in 1908. For nearly 75 years, she lived in the same simple house, washing other people's clothes for a living and putting whatever money she could into savings accounts at local banks. In the summer of 1995, Oseola made local and then national headlines when she donated $150,000 to the University of Southern Mississippi to establish a scholarship fund. "I just figured the money would do [scholarship recipients] a lot more good than it would me," she said. It soon came out that this washer woman had managed to amass nearly one quarter of a million dollars over her lifetime. Time -- a key part of the compounding equation -- helped turn her meager early investments into hundreds of thousands of dollars. As remarkable as the Oseola McCarty story is, the ending could have been a blockbuster. After she died in 1999, one of her bankers wrote to us saying: "Time was able to turn even the modest returns of her early investments into hundreds of thousands of dollars. If we had been able to introduce her to equities earlier, she would have left millions instead of thousands." Remember, the amount you save and your time horizon -- how long you have until you need the money you've invested -- are only two-thirds of the compounding equation. Oseola excelled in both. But she did pay a price for ignoring the rate of return on her investments. Typically, the more risk you are willing to take on (by, say, investing in stocks rather than bonds), the higher your potential return. But risk is a four-letter word to a lot of folks: They're happy to settle for lesser returns to avoid it.

Bad idea. Stuffing all your savings into the Serta -- or sticking only with safer investments like Treasury bills or bonds -- is even more disastrous. It's not simply that they return less. It's that they barely keep up with the rate of inflation, and that means your retirement dollar is not going to go as far as you think. We believe the best place for your long-term savings is the stock market. There you have it: Financial independence is just three variables away. So start saving now (as much as you can), and invest it well. Because the sooner you get the wonder of compounding working for you, the sooner you'll reach your financial dreams. And that's exactly what this series will help you do.

How to Think about Saving and Investing
Don't pay yourself just yet
Most of us have heard the old adage, "Pay yourself first." It has been trotted out so often that it's part of the financial canon -- the de facto Rule No. 1 for managing your money. It's certainly sound advice, but frankly, it leaves us hanging: How much? How often? Where to put it? What's next? As far as financial rules of thumb go, we think we've come up with a better one. Just in case you overlooked the big, bold headline, we prefer this mantra: Treat every dollar as an investment. That's the very foundation of successful investing. We like it because it offers a clear guideline for every financial decision you encounter.

Make one great investment every day
To us, an investment is more than something you make in your brokerage account. An investment is anything that affects the quality of your life. Once the basics are covered -- food, shelter, workplace-appropriate attire -- every dollar equals opportunity. And every day presents new opportunities to make your money work harder for you, whether for long-term gain (retirement savings), short-term safety (emergency fund), or immediate pleasure (mocha latte -- hey, we're not here to judge). After a while "treat every dollar as an investment" becomes second nature. It seeps into your subconscious like a catchy song you just can't shake. Soon you'll be looking for "investment" opportunities in every nook and cranny. But before you set up your brokerage account and dive in, make sure you're not overlooking a few essential first investments.

Investment No. 1: Pay off The Man. In almost every scenario, there is no better use for your first freed-up dollars than paying off high-priced debt, which, for most, means revolving credit card debt. We'll prove it. Consider the difference between setting aside $200 a month and coming up $200 short and covering it with a credit card. After five years of that -- assuming you simply stuff your $10s and $20s into a coffee can, your credit card charges 18% interest, and you pay a minimum $15 a month toward the balance -- here's where you'd be:
Years $200 in Monthly Savings Amounts to … Putting $200 per Month on a Credit Card Amounts to …

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<tbody>
<tr>
<td>1</td>
<td>$2,400</td>
<td>($2,652)</td>
</tr>
<tr>
<td>2</td>
<td>$4,800</td>
<td>($5,583)</td>
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<tr>
<td>3</td>
<td>$7,200</td>
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<td>4</td>
<td>$9,600</td>
<td>($13,278)</td>
</tr>
<tr>
<td>5</td>
<td>$12,000</td>
<td>($18,288)</td>
</tr>
</tbody>
</table>

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

Believe it or not, there is BOTH good and BAD debt. You generally don't want debt, but not all debt is equal. Good debt is the money you borrow to pay for something you expect to increase in value over time. If you buy a house at one price and sell it later for a higher price, then the profit you make should justify (and be more than) the interest you paid on the loan. School loans are also good debt because higher degrees are an investment in your future earning potential. As a result, good debt includes mortgages and school loans. Bad debt is, well, everything else. Anything that doesn't increase in value after you buy it: We don't care how much you wanted that last minute vacation with your best friend: Credit card debt is bad. Even car loans are bad debt, too, because the car loses value the second it leaves the lot. At all times, you want to limit bad debt as MUCH as possible. We want it to be ZERO. This includes credit card loans, car loans, etc.

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

**Investment No. 2: Amass a cash cushion.** Stuff happens -- stuff that requires money to fix, such as a job loss, car transmission issues, and a really bad haircut before your high-school reunion. If you don't have the money on hand, you'll have to make a crash financial landing, which could mean patching over the problem with a credit card. Your emergency fund needs to be readily accessible in a simple savings account. Don't expect to make a killing on this investment. The interest you can get on most savings accounts won't even keep up with inflation.

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

**If you …**

- Have no dependents relying on your income
- Are the sole breadwinner or work in an unstable industry
- Are retired and living on a fixed income

**Then your emergency fund should cover living expenses for …**

- 3 to 6 months
- 6 to 12 months
- 5 years

**Sweat the big stuff and the 80/20 rule**

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

We'd much rather you spend your energy on the big stuff that really pays off -- the 20% of line items on your budget that counts for 80% or more of your spending -- things like your mortgage, cars, travel, insurance, and any four-figure line items in your budget. Free online budgeting tools like Mint.com, QuickenOnline.com give you an instant snapshot of your spending and saving. Pinpoint your 20%, and earmark a few hours to cut those costs. Then take that savings and put it to work in bona-fide investments -- in the traditional sense, that is. Not coincidentally, making those first stock market investments is the topic of the next step. And for many of you, we're about to unearth an investment that is guaranteed to double a portion of your money. Really!

**Action: Spend less -- instantly.** Someone somewhere has probably given you the advice to track your spending for a month to see where your money goes. We prefer instant gratification. Instead of recording your every purchase for 31 days, just do it for three days. In fact, you don't even need to track it -- just consciously ask yourself every time you whip out your wallet, "Is this the best investment I can make with this dollar bill?" For a helpful reminder, sheath your credit and debit cards in our "Spend Less Patch." We guarantee you'll start making smarter money choices.
Short Term and Long Term Accounts

Pardon us for interrupting your illustrious investing career for this very important public service announcement: Any money you need in the next month, five months, or five years *does not belong in the stock market.* Go ahead and read that sentence again. It is the key to avoiding heartache, headache, and a lifetime of Pepto addiction. Got it? If so, please continue reading. For those into footnotes, we've provided this one:

*The last place for your short-term savings is anyplace where it is at risk of being worth less when you need it most. That rules out the stock market, which is prone to roller-coaster-like ups and downs, as is evident on any chart that tracks its month-to-month performance. Now, we don't want to scare you away from stocks. Over five- and 10-year periods, that squiggly line on the chart that resembles a ride on the Great American Scream Machine morphs into a gently rising upward slope. The key is time -- giving your money time to ride through the stock market's bumps and tumbles and reap the rewards of long-term investing.*

With that important bit of business out of the way, we're ready to find proper accommodations for all of your savings needs and devise a strategy for funding your long-term financial goals.

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

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

Keep in mind that one type of account may not best serve *all* of your short-term savings needs. For example, cash earmarked for a home down payment that you plan to make in a few years is ideal for a CD. Junior's summer camp tuition is better off in a high-yield savings account. (More detail on finding the best place for your short- and medium-term savings.)

Short Term Savings

There are three main types of saving accounts, including basic savings, CDs, and Money Market Accounts. In general, ignore the different names, they all help your money grow. Whichever you choose, you must look for:

• No monthly fees for having the account
• A low minimum balance (or none at all)
• FDIC insurance coverage
• The highest possible interest rate

Obviously, a high interest rate sounds like a good thing. To really grasp how your savings account grows your money, though, you have to understand APY and compounding interest. APY (Annual Percentage Yield) is the yield (AKA, amount) your deposit will earn over the course of a year. The APY takes compounding into account. Compounding is interest you’re earning on the interest your investment has already earned. When the gains you make on your investment start to earn money and those returns start to earn money, and so on, your money grows exponentially. Once you've deployed your funds for near-term needs, it's time to find the right spot for the money you'll need to cover Saturday date nights … in the year 2041.

Let's start by assuming that you know about savings accounts and you want to do better. One step up from savings accounts are money market accounts and CDs (certificates of deposit). Both pay higher interest rates than traditional savings accounts and are offered by banks, brokerages, and mutual fund companies. Both are pretty safe. You won't get rich investing in either, but you won't get poor, either.

CDs

With a certificate of deposit (CD), you fork over your money for a specified period of time (three months, six months, one year, two years, etc.). In exchange, you get a certificate specifying the interest to be paid, the length of the contract, and the amount deposited. At regular intervals, you'll receive interest on your CD. When you redeem the CD, you receive your original principal, plus accrued interest. Most bank CDs are insured by the FDIC. So far, so good. If you park your funds in CDs, remember that you're committed for the term of the CD. Withdrawing early will get you a ticket on your windshield in the form of the dreaded "substantial penalty for early withdrawal." Don't let the language scare you off -- if you run into an
emergency and need your cash, or if you decide to move it into the fast lane and go for a higher return, you can retrieve your money. Find out exactly how substantial the penalty is in your specific case. It may be only a few months' worth of (fairly paltry) interest.

**Money Market**

A money market account is a mutual fund that invests in securities such as U.S. Treasury bills, short-term corporate debt, and CDs. Because money market accounts stick to short-term, low-risk securities, they are relatively safe and easily accessible. Yields are not fixed like they are with CDs. Instead, they vary according to short-term interest rates. At the time of this writing, they were hovering in the 4-5% range. Until you've decided which long-term investing methodology is for you, money market accounts are safe, efficient havens for your cash. You get a reasonable rate, often comparable to a CD, without the potential penalties. Brokerage accounts often "sweep" any cash in your account into a money market account every night so that it earns interest. Even if you aren't ready to make your first investing decision, you can open a brokerage account and earn interest in a money market account until you're ready to invest. Nothing beats earning while you're learning. In addition, many money market accounts offer check-writing capabilities, making them ideal holding places for money earmarked for short-term goals and emergency funds.

**Beyond Banks**

Once you know what type of account you want to open, the next question is... where? Your choices are banks, mutual fund companies, and brokerages, but all three are expanding their services, and the lines between them are blurring as each organization tries to be all things to all people. Any of the three types of institutions may offer money market accounts, CDs, credit cards, and checking accounts. Some banks and brokers will also offer financial planning services and mutual funds. Some mutual fund companies offer brokerage accounts. As far as we know, banks still have a monopoly on drive-through tellers.

**Long-term parking**

Your long-term cash stash (specifically, money designated for your retirement years) belongs in accounts set up solely for that purpose -- we're talking IRAs and employer-sponsored retirement accounts (such as 401(k)s). Now, sit back while we guide you through this savings maze.

**Long-Term Parking, Lot A: Your 401(k) (or other workplace plan)**

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

Well, if you work full-time, chances are you have that opportunity through your employer-sponsored retirement account -- your 401(k), 403(b), or 457. If your company offers one of these plans -- with a company match -- for goodness sake (and your sake), don't pass up the free money! We typically recommend that you put your first long-term investment dollars into this type of account if it’s available. Ask your friendly HR department how to get started. These plans allow you to contribute pre-taxed money directly from your paycheck (within limits; see the IRS's website at [IRS.gov](https://www.irs.gov) for this year’s allowable contribution amounts). That way your money grows tax-free, and (added bonus alert!) your contributions lower your taxable income for the year (which means a lower tax tab come April). You pay the piper (in this case, Uncle Sam), only after you retire and begin to withdraw the money. Some employers don't offer a match, and some plans provide horrid investment choices and charge high fees. Plus, it's not always easy to figure out if your plan is one of the lemons. Don't worry, we've got your back. "Save Your 401(k)" shows you how to assess your plan, and what to do if it's a stinker. We can even help you identify the best investment alternatives in your 401(k) plan.

**Long-Term Parking, Lot B: An IRA**

Once you’ve maxed out your workplace retirement account or even if you don’t have a job, divert your next retirement dollars into an IRA. IRAs have one big advantage over workplace retirement accounts: They typically offer more investment options. However, Uncle Sam won't let you contribute as much money to these accounts each year (again, check with the [IRS](https://www.irs.gov) for this year's limits). And, depending on your income, you may not be eligible to contribute to one fully -- or at all. IRAs come in two garden varieties -- Roth and traditional -- and they offer different tax advantages:
Traditional IRA: Tax-wise, this account works just like a 401(k) -- the money you put into it is not taxed until you make withdrawals during retirement. Also, like a 401(k), you can deduct the money you contribute from your income, lowering your tax bill in the year you make the contribution.

Roth IRA: This account gives Future You a tax break. The money you sock away here is never deductible. However, come retirement you get off scot-free -- you pay no taxes on the gains or the principal when you withdraw the money. A Roth IRA also allows you to withdraw your contributions tax-free at any time for certain things, such as a first-time home purchase or education expenses, whereas with a traditional IRA (and 401(k)), you'd not only pay taxes, but you'd also get hit with penalties.

Which one is right for you? We like the flexibility of the Roth -- and the fact that the earnings grow tax-free. That said, the Roth is not necessarily the best choice for everyone. Read "Roth vs. Traditional IRA" for a rundown of the choices, When you're ready to open an account, our three-step article will show you how to get one set up.

Long-Term Parking, Lot C: Taxable accounts
If, after maxing out the tax-advantaged retirement accounts above, you still have money to sock away, we have just two things to say: (1) Huzzah!, and (2) watch out for Uncle Sam! The only real difference between retirement accounts (IRAs and 401(k)s) and regular (taxable) accounts is, you guessed it, how the investments are taxed. Follow these two basic guidelines to (legally) dodge the taxman (as much as possible):

Fill your tax-favored retirement accounts with the most tax-inefficient investments. Those are the investments that generate the biggest tax bills -- bonds, real estate investment trusts (REITs), high-turnover stock mutual funds (if you must, though we're not fans). The payouts from these investments are taxed at ordinary income tax rates, so shelter them within your plan for as long as possible.

Use non-retirement accounts for investments that are already tax-efficient. That includes long-term, buy-and-hold vehicles like stocks that pay little or no dividends, or tax-managed stock funds. Since you won't pay taxes on these investments until you sell, they have a built-in tax-deferred benefit -- as long as you hold for many years. When ultimately cashed in, the gains will be taxed at the long-term capital gains rate, which is lower than ordinary income tax rates. Setting up a taxable account is as easy to do as opening an IRA. Compare fees and special deals in our Discount Broker Center, and you'll be off and investing in no time. Once you set up your accounts, just three things are left on your "to do" list: Lather. Rinse. Repeat.

Put your savings on auto-pilot
OK, now you know that saving and investing your money is good for you -- just like eating right and exercise. Fortunately, discount brokers and fund companies make it a whole lot easier than counting calories and doing your cardio -- through dollar-cost averaging. That's just another name for automatic investing. It works just like your 401(k): Money is taken out of your account before you can even think about spending it. What are you waiting for? The sooner you get your short- and long-term savings accounts set up, the sooner you can get to the fun stuff -- investing.

IRAs and 401Ks – The Details
The topic of retirement is daunting, we know. So deep breath, we'll make it easy! Retirement is expensive. We're not just talking about fancy vacations; we're talking about critical expenses like proper healthcare and visits to your children. Experts suggest that the amount you're estimated to need for paying bills during retirement equals about 70% of whatever you made in the years before that. Saving early makes a real difference.

If you contributed to a Roth IRA every year starting at age 20, you could retire as a millionaire! Here's why time is your biggest asset: Chelsea and Katie both put in $24,000 over the years, but Chelsea began putting in money ($50 per month) at age 25 while Katie began saving ($100 per month) at age 45. Even though they both put in the same total amount, by the time they are 65, you can see that Chelsea has almost twice as much money to retire with as Katie. Thanks to compounding interest, Chelsea’s savings have earned more interest on interest over time than Katie's.
We’ll say it again, starting early really matters. Time and compounding interest are everything to you. Retirement IS a discussion you should be having today.

Once you’ve committed to saving money for retirement, the next question is what’s the best type of account to save it in? Today, we’ll walk you through the three main retirement vehicles, and tomorrow we’ll figure out which one is best for you.

1. 401(k)
An employer-sponsored retirement account that’s funded by contributions from your paycheck. (link) Many employers even match your contributions, in which case we recommend taking full advantage of the match, because it amounts to free money! With a 401(k), your contributions are tax-deductible and tax-deferred, which means that you won’t be charged taxes until you’re ready to take the money out at retirement.
[Click here](#) to learn more.

2. Traditional IRA
Anyone who has income can open a Traditional IRA. Similar to a 401(k), your contribution is tax-deductible and grows tax-deferred until retirement. (link) You are penalized for removing money before you’re 59.5 years old, but there are exceptions if you’re using the money to buy your first home, pay for higher education, or for extraordinary medical costs or disability. (Tomorrow we will show you a chart that demonstrates what the heck tax-deferred and tax-deductible mean.)
[Click here](#) to learn more.

3. Roth IRA
A Roth IRA is considered “tax exempt” meaning you put money in that you have already paid taxes on—so your Roth investment grows tax-free. (link) You can open a Roth IRA if you make less than $105,000 per year as a single person or $167,000 as a married couple filing together. Roth IRAs have many perks, so they are often the favorite investment vehicle of experts.
[Click here](#) to learn more.

In a year, you can contribute to both a 401k and an IRA (Roth or Traditional). We will talk about this more tomorrow and whether it makes sense for you. For now, the three accounts are summarized below:
So, you have a sense for the differences between the retirement vehicles, but which one is right for you? Roll up your sleeves – it is time to get serious about your financial future!

Let’s talk about your options:
1. If your employer offers a 401(k) matching plan, enroll! Contribute as much as you can (up to the $16,500 limit) to get your full matching benefits. If your company does not match and you can save more than the $5000 IRA contribution limit, you should definitely still contribute to your 401(k)!

2. If your company doesn’t sponsor a 401(k) and you make less than $105,000 a year, we want you to open a Roth IRA. Even if you can only spare $50 to contribute, doing this is a game-changer for your financial future! If you make more than $105,000, open a Traditional IRA and know that the government will allow you to roll this over into a Roth IRA. Don’t worry about this today.

The chart below should help you understand why a Roth IRA makes more sense for you than a Traditional IRA if you qualify: Let’s say you are 25 years old and aiming to retire at 65. If you contribute to your IRA every year from the age of 25 to 65. The below is how Traditional and Roth IRAs will differ when you retire.

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<th>Traditional IRA</th>
<th>Roth IRA</th>
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<td>Your income today</td>
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<td>Your annual contribution each year</td>
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<tr>
<td>You pay taxes today on your contribution</td>
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<td>Yes</td>
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<tr>
<td>Your total contributions after 40 years:</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>At 65, assuming a 8% return, your IRA total before taxes would be:</td>
<td>$1,398,905</td>
<td>$1,398,905</td>
</tr>
<tr>
<td>Value after TAXES</td>
<td>$1,212,271</td>
<td>$1,398,905</td>
</tr>
</tbody>
</table>

**The Take Away:**
- Simply put, if you did not pay taxes on the money you put in, you now have to pay taxes on the money you take out. This is considered "tax-deferred" savings.
- With a Roth, you owe nothing in taxes when you’re 65 since you already paid the taxes when you contributed the money. This is considered "tax-exempt" savings since you don’t have to pay taxes on all that interest earned!
3. If you contribute the max of $5,000 to your IRA and still have money to save for retirement (i.e. your Emergency Savings fund is in tact), then—even if you don’t receive employer matching—you can focus on maxing out your 401(k) at $16,500!

4. If you don’t receive employer 401(k) matching, we are going to have you open an IRA right now! Aside from making sure you pay your bills on time, this is the single most important thing you can do for your financial future!

**Your Orders:**

1. Understand whether you qualify for a Roth IRA by evaluating all of your income. If you make less than $105,000/year – you qualify!

2. If an IRA is best for you, choose a brokerage account for your IRA – Roth or Traditional. If you need to build your savings over time and are not in a position to open your account with a lump sum, check out TDAmeritrade. At the bare minimum, make sure the brokerage account you choose meets the following:

   **Important Points:**
   - No fees for opening the account
   - No annual service fees
   - Low minimum balance requirement
   - Trades for less than $10 per trade
   - Investing research tools
   - Accessible customer service, in case you have any questions

3. Sign up online. Make sure to set up online statements.

4. Link your bank account, if possible. Many online brokerage accounts allow you to associate a savings or checking account for easy transfers. We want you to do this so that you can make a contribution to your IRA with as little drama as possible. The brokerage will probably make small deposits into your bank account within a few days, and you will have to identify the deposits to verify that the account is really yours.

5. Once your account is cleared, make your first deposit!! Even if you can only afford to contribute $50 today, put in something to get yourself started.

Don’t stop now! You can do it! If you don’t yet have a retirement account, you need one to secure your financial future! If you want to be walked through the process in greater detail, check out “I Want To Open An IRA“.

**Important Retirement Questions**

And now, ladies and gentlemen, the inflation-adjusted million-dollar question: Can you afford the retirement of your dreams? While you ponder that, it's likely that a few other questions will come to mind:

- How much money will I need when I retire?
- What kind of lifestyle will I be able to afford?
- What will my current savings be worth by then?
- How much can I afford to take out every year?
- Will I need to adjust my plan?

Does anyone have a brown paper bag? I'm feeling lightheaded.

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

1. **Contribute to the right accounts.**
   Just to review: If your boss matches your contributions to your retirement plan at work (your 401(k), 403(b), 457, or other employer-sponsored plan), save at least enough to take full advantage of that benefit. Remember, contributions reduce your taxable income, and the investments grow tax-deferred.
The next stop in the retirement account hierarchy is to fund an IRA (either a Roth or traditional variety). If you're not eligible for the Roth, contribute to the traditional IRA only if contributions are tax-deductible. If not, stick with your 401(k) (unless it really, really stinks), because you'll get the tax deduction.

2. Choose the right investments.
A lot of people get tripped up on this one. But don't let it stop you from putting a plan into motion. We showed you how to construct a well-balanced retirement portfolio with a whole day's supply of vitamin D. The "right" investments for you will change over time as you near the point where you stop investing new money and start spending what you've saved.

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

3. Save enough.
With life expectancy increasing by leaps and bounds, if you give notice at the traditional age of 65, you may want to think in terms of a 30-year retirement. That's a lot of electricity bills and all-you-can-eat buffet brunches. So, how much do you need to save? As much as you can. A more specific answer can be found in the following table, which assumes you have not yet started to save for retirement:

<table>
<thead>
<tr>
<th>Age</th>
<th>Percentage of Income to Save</th>
</tr>
</thead>
<tbody>
<tr>
<td>20s</td>
<td>10%-15%</td>
</tr>
<tr>
<td>30s</td>
<td>15%-20%</td>
</tr>
<tr>
<td>40s</td>
<td>20%-30%</td>
</tr>
<tr>
<td>50s</td>
<td>30%-40%</td>
</tr>
<tr>
<td>60s</td>
<td>40%-50%</td>
</tr>
<tr>
<td>70s</td>
<td>50%-60%</td>
</tr>
<tr>
<td>80s</td>
<td>Vegas, baby!</td>
</tr>
</tbody>
</table>

3. Run your numbers to see if you're on track (and then run them again).
Are you saving enough to retire when you want? Are you withdrawing too much in retirement? There's one way to find out: Run your plan through a good retirement-savings tool. Check out some of the free financial calculators on the Internet. Since each will give you a different answer, try at least three. First, try "Am I saving enough? What can I change?" and "How much will my savings be worth?" You also might find some good tools on your broker's website or as part of your personal-finance software. If you start pricing it out now, you won't experience sticker shock when your ticker isn't quite as strong. Our post-retirement expense calculator will help you figure out how much that round-the-world trip, fishing cabin, or class in paperclip art will cost. The good news is that many expenses decline or disappear completely in retirement. Once you've retired, you no longer have to pay Social Security or Medicare taxes; you no longer divert money to 401(k)s or IRAs; and retirement income is often taxed at lower rates.

4. Stop paying for other people's retirements.
Unless the person managing the money in your mutual funds is bound to you by matrimony or blood relation, you probably don't intend to contribute to their bank accounts. Too many investors overpay for underperforming investments, ponying up 1.4% in management fees (a typical expense ratio) for funds that barely keep up with their benchmarks. Your generosity is not properly appreciated. By choosing lower-cost but better-performing funds, you can add 1% to 2% a year to your portfolio returns. Compounded over many years, we're talking tens of thousands of dollars. So keep a sharp eye on fees. Below is a pocket guide to what we think is reasonable to pay:
### What to Pay for Financial Products:

<table>
<thead>
<tr>
<th>Financial Service or Product</th>
<th>Reasonable Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index funds</td>
<td>0.3% or less for domestic index funds; less than 0.05% for others (REITs, international, etc.)</td>
</tr>
<tr>
<td>Actively managed mutual funds</td>
<td>1% or less for domestic funds; 1.5% or less for global funds</td>
</tr>
<tr>
<td>401(k) administrative fees</td>
<td>0.25% or less (unless your employer picks up the tab)</td>
</tr>
<tr>
<td>IRA administrative fees</td>
<td>Free, if possible. Many brokers charge no administrative fee for retirement accounts, though they may require a minimum investment.</td>
</tr>
<tr>
<td>Non IRA/401(K) administrative fees</td>
<td>Free, if possible. Many brokers waive administrative fees if you maintain a minimum account balance or sign up for an automatic investment plan.</td>
</tr>
<tr>
<td>Stock trades</td>
<td>$20 or less</td>
</tr>
<tr>
<td>Financial advice from a certified financial planner</td>
<td>1% or less of assets under management, or (even better) choose a fee-only financial planner</td>
</tr>
</tbody>
</table>

### 5. Know how to crack your nest egg.

Finally, the big day. You kissed the boss good-bye, and you're ready for a lifetime of ... well, whatever the heck you want. It's time to begin tapping your portfolio. Should you start with your traditional IRA, your 401(k), or your regular brokerage account? This is no small matter. One study found that choosing the right order could extend a portfolio's life expectancy by more than two years. The general rule: Start withdrawing from non-retirement accounts. After that, move on to tax-deferred money, and save your Roth for last. However, there are many exceptions to these rules, so take the time to learn more before you retire.

### Live it up today, too!

We'd be remiss if we did not give proper due to a very important period in your life: The here and now. In the words of John Lennon: Life is what happens when you're busy making other plans. We firmly believe that saving for tomorrow is not about sacrificing today -- it simply requires striking the right life-money balance. So we'll end this lesson with your moment of Zen: Living rich and getting rich are not mutually exclusive.

### Action: Find out if you're saving enough for retirement.

Well, are you? That's what calculators are for! (Check out the "Am I saving enough? What can I change?" calculator in particular.) You will also be able to play "what if" games and see the results quickly, should you decide to vary things like inflation, rates of return, date of retirement, and desired income.
Investing and Markets Basics

Asset Classes and Funds
There are all types of investments or asset classes (these words are not scary, we promise.) and each has a different level of risk. The asset classes, or individual “securities”, that are commonly referred to in the media are Stocks and Bonds.

Index Funds - Simply put, these group together a certain asset class (most commonly stocks or bonds) in an attempt to diversify your risk within that asset class. For example, the S&P 500 groups together 500 of the largest U.S. based companies. Its return is thought to be representative of the stock market as a whole. As such, when you buy the S&P 500 you buy a little piece of all of the 500 companies – and voila! – you have a diversified stock portfolio without paying a lot to a Portfolio manager to try and “beat the market”, when in reality, they rarely do.

Mutual Funds - Investing in a mutual fund allows you to invest in an array of stocks and bonds, so you can lower your overall risk through diversification (while one may drop in value, for example, another may do extraordinarily well). These funds are actively “managed” – meaning you pay a fee to invest in the fund and the Portfolio Manager (the person in charge of the fund) tries to beat the market for you (and by beat the market we mean earn you a higher return than you would have gotten in an index fund).

ETFs (Exchange Traded Funds) - In contrast to mutual funds, ETFs are not managed by a portfolio manager (so they usually have NO Fee). Rather, ETFs electronically simulate the performance of a well-known index fund.

Your Asset Allocation
A general rule of thumb is that the higher the potential return of an investment, the greater the risk of losing money. Generally for retirement accounts, the younger you are, the more risk you can tolerate, or in other words—stocks should take up a greater percentage of your portfolio. But remember—this is specific to your retirement portfolio as it is considered to have a long-term investment horizon.

The concept of what percentage of your portfolio should be made of stocks, bonds and other investments is called asset allocation. Your individual asset allocation should be driven by answers to questions like:

- How old are you?
- When do you expect to need your investment money? (If you’re 25, you won’t need it for 40 years!)
- Do you have enough other savings that you won’t need to dip into your retirement portfolio?
- What is your risk tolerance? (i.e., while “on average” you will make money in the long run, how tolerant are you of volatile performance—some years your investments will do well, some years they won’t.)

Take-away: Your mix of investments (your asset allocation) is just as important as your actual investments. You want a mix of assets that are both risky (high rewards) and conservative (so you don’t lose all your money).

As a general rule of thumb, you can subtract your age from 120 and the resulting number is how much of your Retirement Portfolio should be invested in stocks. Example:
When you log onto your account you will have the opportunity to purchase many different types of securities. We know that it can be incredibly daunting, but fear not, focus only on the most important decisions. There are TWO basic ways we recommend investing.

**Option 1:**
If you don’t want to worry about buying several different investments your brokerage firm will have something called “lifecycle funds.” A lifecycle fund is a single product that allocates your money across a wide range of investments—both stocks and bonds, with securities from different countries, industries and market capitalization. The allocation between stocks and bonds is determined by how far away you are from retirement. From what you learned yesterday, the younger you are the more stocks you should be invested in. With lifecycle funds, as you age, the fund automatically adjusts to own more of the less risky investments. So, basically you can just set it and forget it—these lifecycle funds do the allocation for you!

To find a lifecycle fund that might be suitable for you go to the security search field and type in “lifecycle.” Find the fund that has the closest year to your projected retirement—in its name and that is the right one for you! For example, FUND 2050 is the right choice for someone who is currently 25 and plans to retire at 65. There will likely be several different companies to choose from—we recommend going with a name you know or find the one that charges the lowest expenses. The problem with lifecycle funds is that they can be a little more expensive because you are paying a manager to make all the investment decisions for you! So what’s the alternative?

**Option 2:**
You can pick your own individual investments. Don’t be scared—it’s not as hard as it may sound. We recommend that you buy only index funds. To refresh your memory, an index fund is…. A security that group together a certain asset class (most commonly stocks or bonds) in an attempt to diversify your risk within that asset class. For example, the S&P 500 groups together 500 of the largest U.S. based companies. Its return is thought to be representative of the stock market as a whole. As such, when you buy the S&P 500 you buy a little piece of all of the 500 companies—and voila!—you have a diversified stock portfolio. Since a manager isn’t making individual security selections index funds are the cheapest thing you can buy. So, you might ask how do I choose? Well, first, you need to determine based on your age what percentage of your money should go to stocks vs. bonds. If you don’t remember what percentage is right for you read our “Rule of Thumb” equation.

Now that you know what percentage of your money you should be investing in stocks we recommend that you find a U.S. stock index fund. The most common type of index fund is for the S&P 500. You’ve probably heard the term before, that’s because it is a great representation across industries of publicly traded U.S. companies. Type “S&P500 Index” into that search box we mentioned before and you will have no shortage of choices. This is a good linchpin for your portfolio. We also suggest that you invest a portion of your stock allocation outside the U.S. Experts typically say somewhere between 10% and 35% of your stock allocation is a good guidepost.

If you opt for either the lifecycle or index strategies for your retirement, good for you—you will be properly invested for retirement! But we want to be clear: These are great “minimum-effort” strategies. Realize that there are many different types of funds in which to invest! Each fund has a different investment goal, and if/when your goals change, you want to make sure your strategy does, too. We can’t tell you exactly what securities to buy, but we assure you if you chose one of the brokerage firms we recommended they will have great tools online and awesome support to help you.

**Your Orders:**
1. Play around with the tools on your online brokerage account to understand what is the best fund for you and how much you need to start (and to continue!) saving for retirement. Among the companies we recommend, each has tools to help you determine…
   1. How much you will need for retirement
   2. Your asset allocation (doesn’t hurt to confirm what the “Rule of Thumb” equation suggested)

You may need to log on to access these tools and don’t hesitate to call customer service if you can’t find them. For example, ING Direct’s Retire My Way (which also meets our IRA fund criteria) helps you plan how much you will need for retirement
and whether you are on track to have that much based on your current contributions.

2. Either pick the lifecycle fund that is right for you or research index funds that meet your needs.

3. Choose a fund and buy in. Alternatively, you can earmark it if you need to save first. (You’ve gotten this far – don’t stop now!) You will receive a “fund prospectus” every time you buy a fund. These are awfully intimidating but are mandated by law to confirm that you understand the fees and risks associated with the account. Again, if you have questions call customer service. That’s what they are there for!

4. Make a note on your calendar to rebalance/check in with your portfolio a year from now and/or to make sure a target retirement fund is in fact what you need.

The Importance of Asset Allocation

As fun as finding winning stocks is (and trust us, it really is fun), your allocation to stocks (equities) is only one slice in your total investing pie. Asset allocation basically comes down to how much you should have in cash, how much in bonds, and how much in stocks. The four rules for asset allocation will help you slice up your portfolio into these important pieces.

Rule 1: If you need the money in the next year, it should be in cash.
You don't want the down payment for your vacation home to evaporate in a stock market -- or bond market -- crash. Keep it in a money market or savings account. And, of course, make sure it's FDIC-insured.

Rule 2: If you need the money in the next one to five years, choose safe, income-producing investments such as Treasuries, certificates of deposit (CDs), or bonds.
Whether it's your kid's college money or the retirement income you'll need in the not-so-distant future, stay away from stocks.

As with all investments, risk and reward go hand-in-hand when it comes to "safe" assets. So, in order of "safest" to "still safe but technically riskier," we have Treasury notes and bills, CDs, and corporate bonds. That's also the order of lowest to highest yield. CDs are still very safe (as long as they're FDIC-insured!), and they can usually be bought commission-free. Shop around for the best rates; your local bank may not offer the best deal. As for corporate bonds, the general rule is to choose bond mutual funds over individual bonds if you have less than $25,000 to invest. However, keep in mind that bond funds can actually lose money, which can be awfully inconvenient if it happens right before you need it. Stick with funds that focus on short- to intermediate-term bonds. And be vigilant about costs -- you can find plenty of good funds with expense ratios below 0.50%.

Rule 3: Any money you don't need within the next five is a candidate for the stock market.
We are fans of the stock market, and we know our history (with a little help from Ibbotson). Here's how stocks, bonds, and Treasuries have fared historically:

Geometric Mean Returns (1926 through 2008)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Average Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-Cap Stocks</td>
<td>9.6%</td>
</tr>
<tr>
<td>Long-Term Government Bonds</td>
<td>5.7%</td>
</tr>
<tr>
<td>U.S. Treasury Bills</td>
<td>3.7%</td>
</tr>
</tbody>
</table>

Of course, that's one long time frame, and in the short run, no one knows what stocks will do. But make no mistake: Even if you're in or near retirement, a portion of your money should be invested for the long term. That's because, according to the Centers for Disease Control, a 55-year-old can expect to live another 26 years. A 65-year-old has another 18 years ahead of her. The average 75-year-old lives into her late 80s. A 110-year-old, however, should sell everything and get to Vegas while he still can. (Kidding … mostly.) So unless you're a 95-year-old skydiver who smokes, expect your retirement to last two to three decades.

To make sure your portfolio lasts that long, you should ...
Rule 4: Always own stocks.
Over the long term, equities are the best way to ensure that your portfolio withstands inflation and your retirement spending. According to Jeremy Siegel's * Stocks for the Long Run*, since 1802 stocks outperformed bonds in 69% of rolling five-year investing periods (1802-1807, 1803-1808, etc.). The percentage of the time that stocks whoop bonds only improves as you look over a longer horizon.

**Holding Period Stocks Outperform Bonds**

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Year</td>
<td>67%</td>
</tr>
<tr>
<td>5 Year</td>
<td>69%</td>
</tr>
<tr>
<td>10 Year</td>
<td>80%</td>
</tr>
<tr>
<td>30 Year</td>
<td>99%</td>
</tr>
</tbody>
</table>

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

For holding periods of 17 years or more, stocks have always beaten inflation, a claim bonds can't make. The bottom line is that *when* you need your money will partially dictate *where* you put it. What else determines your asset allocation? That favorite term among financial gurus: your tolerance for risk.

**Risk drives return**
Most people base their investment strategies on the returns they want, but they have it backward. Instead, *focus on managing risk and accept the returns that go along with your tolerance for it*. It'd be great if we could get plump returns with no risk at all. But to achieve returns beyond a minimal level, we have to invest in things that involve some possibility that we'll lose money. So ask yourself: What would you do if your portfolio dropped 10%, 20%, or 40% from its current level? Would it change your lifestyle? If you're retired, can you rely on other resources such as Social Security or pensions, or would you have to go back to work (and how would you feel about that)? Your answers to those questions will lead you to your risk tolerance. The lower your tolerance for portfolio ups and downs, the more bonds you should hold in your portfolio. As an extra aid in determining your mix of stocks and bonds, consider the following table, from William Bernstein's *The Intelligent Asset Allocator*:

<table>
<thead>
<tr>
<th>I can tolerate losing ___% of my portfolio in the course of earning higher returns</th>
<th>Recommended % of portfolio invested in stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>35%</td>
<td>80%</td>
</tr>
<tr>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>25%</td>
<td>60%</td>
</tr>
<tr>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>15%</td>
<td>40%</td>
</tr>
<tr>
<td>10%</td>
<td>30%</td>
</tr>
<tr>
<td>5%</td>
<td>20%</td>
</tr>
<tr>
<td>0%</td>
<td>10%</td>
</tr>
</tbody>
</table>

So, according to Bernstein, if you can't stand seeing your portfolio drop 20% in value, then no more than 50% of your money should be in stocks. Sounds like a very good guideline to us. OK, you now know how much you should have in stocks. But what kind of stocks -- large caps, small caps, value, growth, international? And how much?

**Action: Determine how much you should invest in stocks.** Just use Bernstein's table above. And remember that our appetite for risk changes depending on current market and personal circumstances. So err on the conservative side if you're taking this quiz during a bull market (and vice versa).

**Investing Emotions**
We're about to share with you the secret to avoiding a $10 billion investing mistake. It's not more money, a higher IQ, or superb market timing. It's mind control. The way we're wired -- our natural inclinations to seek more information, look for
patterns, compare options, and even flee to safety -- is great at keeping us out of harm's way. But these same emotional
tendencies are also our biggest liability when we're in investing mode. In other words, your brain is to blame for all those
boneheaded money mistakes.

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

2 traits you must have to be great
And now, the information you've been waiting for: the secret ingredients to investing success, regardless of education,
investing styles, or golf handicaps: Timeline and temperament.

Timeline: As we mentioned, investing in stocks requires a minimum five-year time horizon. Think of it like sending some of
your money on vacation while your other money takes care of the more immediate chores, like paying for car repairs, a house,
or a kid's college tuition. But, at the risk of sounding like a country and western song, it can be hard to be a long-term investor
in a short-term world -- which brings us to the second secret ingredient for investing greatness.

Temperament: Successful investors have the ability to remain calm and levelheaded when everyone around them is freaking
out. That mindset makes the difference between investors who consistently outperform the market and investors who get
lucky for a while. Wal-Mart foible aside, Warren Buffett says this is the key to his success. When a group of business-school
students asked Buffett why so few have been able to replicate his investing success, his reply was simple: "The reason gets
down to temperament."

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

Hop off the emotional roller coaster
To cultivate a good temperament -- one that focuses on the long term, not the short term, and ignores the crowd in favor of a
well-thought-out strategy -- channel Steve McQueen (or whomever is the cool dude/dame du jour). Build resistance to the
emotional triggers that lead to bad investment decisions. Here are a few exercises we regularly do to keep our cool:

Memorize this affirmation: "I am an investor; I am not a speculator." All together now: "I am an investor; I am not a
speculator." As investors, we:

Buy stock in solid businesses. We expect to be rewarded over time through share price appreciation, dividends, or share
repurchases.
Don't time the market. And we certainly don't speculate when we buy stocks. Speculation is what Wall Street traders do.
Focus on the value of the businesses we invest in. We try not to fixate on the day-to-day movements in stock prices.
Buy to hold. We buy stocks with the intention of holding them for long haul.
We recognize that believing your affirmation is sometimes easier than living it. To avoid behaving like a speculator …

Tune out the noise: Put down the newspaper, turn off CNBC, and stop clicking that. And that. And, yes, that too. None of it
is doing you any good. Fixating on the market's minute-to-minute news won't help you make your next brilliant financial
move. At best, all the hours, days, and weeks spent soaking in sensational stories will yield a few timely bon mots to toss off at
the next office happy hour. Mostly, though, it's all noise, and it's costing you a serious amount of sound sleep -- and maybe
even some actual money.
**Stay strong, think long!** Investing success is not measured in minutes, months, or even a year or two: We pick our investments for their long-term potential. So resist the urge to act all the time. Make decisions with a cool head after letting new information sink in. Sometimes the best action to take is no action at all.

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

If you don't already have one, start a watch list so you can keep up with the companies that pique your interest. Add your list to a portfolio tracker so that all the company news will be in one place. When preparation meets opportunity, that's when great investments are made. To be a successful long-term investor, you need to be a long-term investor. For an index investor, the secret of success is: Do nothing. The market tanks? Do nothing. The market zooms up beyond all rational expectation? Do nothing. Doing nothing is very hard. The inability to do nothing has probably been responsible for just as many wrong moves as all the boiler-room shysters on Wall Street put together. But doing nothing is the secret to successful index investing. Your friends and co-workers might call you an idiot and you may even feel like an idiot at times, but doing nothing works every time. Doing something rarely does.

Note that this isn't necessarily true when it comes to investing in individual stocks, although many times doing nothing is the best thing you can do. For individual companies, you need to know when to hold 'em and when to fold 'em, but if your goal is to match the market -- and beat more than 75% of managed funds -- you don't need to worry about that. One of the hardest things for some new investors to learn is patience. But patience is the critical skill. Next is learning to ignore those friends and co-workers -- especially that guy who sold and went to cash the last time the market was higher than it is now. He will rub it in.

Here's why you need to ignore him. First, he's probably... umm, how to put this nicely... he's probably not being completely forthcoming about all aspects of his "brilliant" move. But more important, when's he getting back in the market? Folks who sold everything and went to cash just before the Asian monetary crisis in the summer of 1998 probably felt pretty smug. But if they didn't correctly call the market bottom (and when the market's down, everyone's predicting it will just drop farther) and get back in before the end of the year, they lost money because the market has never been that low again. If this paragraph doesn't make perfect sense to you, read "The Perils of Market Timing."

**Dealing With Paper Losses**

Panicking and selling when your account is down is the one sure way to turn a "paper loss" into a real loss. (A paper loss is when your holdings have fallen in value, but you haven't actually lost any money because you haven't sold anything. Until you sell, you don't have a real loss.) The first time you go through a market retreat is the worst. After you experience the recovery, the next time isn't so bad. So here are some tips to get yourself through your first big market drop.

Focus on the long term. Ask yourself: What is the "real" consequence of my S&P 500 index fund being worth $20,000 this year instead of the $30,000 it was worth last year?

While we don't mean to trivialize the real pain that can come with a paper loss, a successful investor has to keep investing in perspective. If your loss is in a specific Internet penny stock that just went bankrupt, well, yes, you do have a real loss on your hands. With an index fund that mirrors the return of the S&P 500 or the total market, you won't have the same potential for upside return as you would with some of the high flyers, but you also won't have the same downside risk. And that's the whole point of starting out your investing career with an index fund. Your index fund holding may be worth $20,000 now after being worth $30,000 last year, but remember, what really matters is what it's worth when you sell it, which should be many years down the road. At that point, it might be worth $40,000 or $50,000 or even a lot more. Investments rarely go up in a straight line. Expect some slumps. Remember, since 1926, the U.S. stock market has posted an average annual return of 11%. During that time we've had major and minor depressions, inflation and deflation, wars both hot and cold, political turmoil, natural and man-made disasters, and Pee-wee Herman. The market managed to survive and thrive through all of that, even if it wasn't thriving every moment or every year.
So, while your account is in the paper loss territory, remember that life and economic growth goes on, your very real life is unaffected in any way by paper losses (you weren't counting on this money for the mortgage payment, right?), and you have every reason to realistically expect the paper losses to turn into paper gains. So, stop checking the ticker on a daily basis and get on with the business of living life.

Risky Business: Volatility

Unfortunately, we know of no way to get high returns from the stock market without taking on some risk. Scary word, eh? Fear of risk is probably the main reason many people never achieve financial independence. But let's look at just what we mean when we say risk. For all practical purposes, when we talk about risk in the context of index investing, we don't mean the risk of losing all your money. We aren't even talking about the risk of losing some of your money, if you have patience. The risk that an investor takes on when he invests in a market index is the risk that the value of his investments will fluctuate. Another name for that kind of risk is volatility. Volatility means that at any point in time, the value of your investment may be below or above its starting value or some intermediate value. It's never a smooth uphill climb. (Notice that we aren't talking about individual companies here, but the market as a whole as represented by index funds or index shares.)

Say you had invested $1,000 in a broad market indicator like the S&P 500 on the last day of 1997. By the middle of July 1998 (seven measly months later), your investment would have been up 22.6% and worth $1,226. Wow, what a run-up! But just seven measly weeks later, your $1,000 investment would have been worth $1,011 -- up just 1% for the year and a 17% drop from the July high. If you stuck it out, though, your investment would have bounced around some in September, and then in October it would have started a steady climb to end the year at $1,273. Total gain for the year: 27.3% (28.6% if you include dividends, which the index doesn't show), one of the better years on record. Now, that's volatility. Wild as that ride was, it was actually less painful than some other market drops because the recovery was fast. When you draw that story out over a year or more, living through the long down stretches can be excruciating.

This first chart shows how 1998 looked to an investor, but let's look at the second chart:

![Chart 1](image1.png)

The second one reflects how the S&P 500 has grown since 1926. Notice two things -- first, the long-term trend is up; second, all of that up and down business in 1998 barely shows as a blip. Even the Great Depression makes little impact when viewed from a long-term perspective.

"Alternate Choice" Risk

Another kind of risk is that the market will underperform some alternative investment choice such as a fixed-return investment like a CD or bond. This happens occasionally. Even though the long-term performance of the S&P 500 has averaged 11% per year over the past 75 years, there have been stretches where the return over a 10-year period has been negative. There are no guarantees in the stock market. That's why we emphasize investing only with long-term money.

Onward and Upward

Why is the long-term trend always up? Because markets reflect the efforts of individual people to better themselves. Boiled down to basics, that's what the long-term chart tracks -- human and business productivity. In the short term, the markets can
fluctuate wildly, but over the long term they consistently reflect our increasing standard of living. And that's what we suggest that beginners invest in -- not specific companies, but growing economies.

The Last Word on Risk
Volatility can be painful, but it's not the same as catastrophic risk. Want to talk about catastrophic risk? Let's look at tech stocks last year -- no, let's don't. The S&P 500's 17% loss over seven weeks in 1998 is quite volatile enough for our purposes. We aren't going to be getting into tech stocks or analyzing specific companies in this seminar. There's no reason for a beginner to take on the risk of individual stocks -- at least not with too much money. It can be instructive for a beginner to plunk just a little into a stock or two, just to get her feet wet. But it's not required at all. You can beat more than three-quarters of professional mutual fund managers simply by investing in the market as a whole, and that kind of return, applied to some serious savings, is enough to ensure your future financial independence.

Investments to Avoid
Speaking of catastrophic risk, tech stocks aren't the worst of it. Want to see your money evaporate? Try these:

- Penny stocks (stocks trading for less than $5 per share)
- Options
- Day trading
- Futures and commodities
- Technical analysis
- Margin investing
- Shorting

Haven't heard of shorting? Not up-to-date on the latest in technical analysis? Good. Stay that way -- at least until you have managed to become a competent investor who can beat the market with your own stock picks. Then, if you want to, you can look into these highly risky ways to lose all your money if you don't know exactly what you are doing (and sometimes even when you do). Shorting and margin investing are legitimate tools for serious investors. But they are power tools and can be very dangerous in the hands of a novice. If we've piqued your curiosity simply by mentioning these more exotic investments, you can find out more about them by simply clicking on the links above. But beware!

Stocks, Index Funds, and Mutual Funds
You've paid off your credit cards. You've saved up an emergency fund. You've opened a brokerage account. You've done your research, and found the stock of your dreams. Let the guns blaze!

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

First, this is just one of many investments you'll end up owning. That's to say, you want to invest in sips, not gulps. Your first purchase should be as petite in size as it is bold in spirit. Second, don't forget that your first investment is also a learning experience. As any craftsman will tell you, there's no better way to learn than by doing. A journey of a thousand miles begins with a single step. And that's what we recommend to you: Buy a single share of your favorite stock. Just one. This one share will teach you more about life as an investor than we could ever hope to teach you here. Follow it. Get to know it. Read the quarterly earnings releases, listen to the conference calls, and see how the stock's daily fluctuations affect you. For future stock purchases, you should keep trading costs and commissions to less than 2% of your total purchase amount, but we'll let that slide on your first buy. But there's something else we want you to pick up while you're making a stop at your friendly broker: A stake in an index fund.

The passive investor's best friend
How many times have you heard someone ask, "How'd the market do today?" But what is "The Market?" And how do we know how it did? Usually, the answer reflects the performance of an index -- such as the Dow Jones Industrial Average or the
Standard & Poor's 500 -- rather than the market as a whole. What all indexes have in common is that the value of the index changes proportionally to the value of the stocks in the index. So when the index goes up, the aggregate value of the stocks in the index has grown by a proportional amount, and vice versa. And you can invest in those indexes -- through index funds. These funds don't look to beat the market -- they look to match it as closely as possible. That might not sound enticing at first blush, but consider that index funds offer:

**Instant diversification:** When you invest in an index fund, in one fell swoop you've spread your dollars across industries, markets, currencies, and countries, substantially lowering your risk in the process.

**Low costs:** Index funds have much lower expenses than actively managed mutual funds. The average actively managed U.S. fund charges its investors 1.4% for the privilege of owning shares. The Vanguard 500 Index (VFINX) fund, meanwhile, carries an expense ratio of only 0.16%.

**Superior returns:** According to the Motley Fool research, only 42% of actively managed funds beat the S&P 500 through the 15 years ending January 2009. And we're not alone; numerous studies show that you're likely to underperform by investing in a typical Wall Street fund. And as we just pointed out, you'll pay a lot more for that privilege. Little wonder that we think index funds should be the foundation of your portfolio. But for now, we simply recommend that for every dollar you put into individual stocks, you roll the same amount into an index fund (the Vanguard fund we mentioned above is good choice).

So far you've seen the value and importance of defining your goals and designing a financial plan to reach them. In this lesson, we look at what should certainly be the first stop for all investors -- an investment that, for most investors, could also be the last. We're going to give you the one-stop shop for a lifetime of successful investing, the closest thing yet devised for getting the full value of the stock market into every man, woman, or child's investment account. We present to you... index investing.

In 1975, a man named John Bogle presented a then-radical idea to the board of directors of the newly formed Vanguard Group (a mutual fund company). He suggested creating an extremely low-cost mutual fund that would not even attempt to beat the returns of the entire stock market (as measured by Standard & Poor's 500 index). Instead of hiring expensive well-dressed managers to actively buy and sell stocks -- trying to guess where the market was going or which companies were better buys at one moment, and which were overpriced at another -- this mutual fund would simply buy all the stocks in the S&P 500. That way, investors could participate in the successes and failures of the 500 biggest companies in America. Since the S&P 500 index is widely regarded as "the market," an investor in this index fund would automatically match the market's return.

In case you're curious, the S&P 500 includes companies such as AOL Time Warner, Boeing, Cisco, Coors, Disney, Exxon Mobil, Ford, Gateway, Gillette, Hershey, Intel, Johnson & Johnson, Lockheed Martin, Marriott, McDonald's, Motorola, Oracle, PepsiCo, Pfizer, Safeway, Sara Lee, Schwab, Sears, Texas Instruments, Toys R Us, Wal-Mart, Walgreen, Waste Management, Wells Fargo, Wrigley, Xerox, and Yahoo! And that's just a small part of its holdings. Most major American companies that you can think of are part of this massive index.

Let's back up a second now in case we're getting ahead of anyone. Whenever you read or hear the words "index fund," what's being discussed is a mutual fund that buys just the stocks that are listed by an established stock market index. What's an index? It's a list of companies that represent some aspect of the market. An index could attempt to measure the whole market, some part of the market, a specific industry, or a foreign market, but it's always a group of companies with something in common.

The index's value is generally the average value of these companies. When the average value of the companies in the index goes up, the index goes up by the same amount. When the average value of the companies goes down, the index goes down by the same amount. (It can get more complicated than that, but essentially the value of the index rises and falls with the value of the companies that comprise the index.) So when you hear that the Dow gained 120 points, or 1.2%, that means that the average of the prices of the 30 companies that make up the Dow Jones Industrial Average went up 1.2%.

To back up further still, let's make sure everyone understands that mutual funds are companies set up to receive investors' money, and then having received it, to make investments with that money. When you buy shares in a mutual fund, you are a
shareholder -- an owner -- of that fund, but you are also an indirect owner of the companies that the fund has invested in. If you buy an index fund, you own a piece of every company that makes up your fund's index. So if you buy even one share of the Vanguard 500 Index Fund, for example, you own a tiny piece of the 500 of the largest companies in the U.S. Now, onward!

The Vanguard S&P 500 index fund chugged along for years, spawning an occasional competitor and getting modest attention, but eventually it dawned on the industry that John Bogle was really on to something -- especially since most actively managed funds continued to lose to the overall market year after year. Then, in 1993, the American Stock Exchange introduced a new kind of index investment. Now known as exchange traded funds (ETFs), or index shares, this approach to index investing works much like a mutual fund, except that the shares are traded on an exchange just like stocks or closed-end mutual funds. An index share represents partial ownership of a huge block of stock that duplicates the composition of a particular market index. Instead of owning a share of a company or a mutual fund, you own a share of that block of stock (known as a "depositary receipt").

Like the first index fund, the first index share was based on the S&P 500 index. Dubbed SPDRs (for S&P Depositary Receipts), they quickly became known as Spiders and trade on the American Stock Exchange under the ticker symbol SPY. Today there are dozens of index shares available, and more are planned. Index shares can be purchased from any broker just like stock. They have ticker symbols so that you can easily get quotes on their value and see their performance history. (Index funds have tickers, too, but they can be harder to find.) Once purchased, index shares function just like shares in an index fund -- you own both the index share, and, indirectly, a small piece of every company in that index. Their price rises and falls with their index. We will refer to both index funds and index shares as "index investments."

The crucial thing that distinguishes an index investment from a managed mutual fund is that the index investment simply owns all the stocks that make up the index rather than attempting to pick the best stocks. Its goal is to match the performance of the index, not beat it. Index investments, with their firm ambition to match, not beat, the market, are, ironically, better performers than most actively managed mutual funds, and thus better choices for most investors. But, gee, aren't you supposed to aim high? How can an investment that aims for mediocrity be such a good idea?

Why It's Not Easy Being a Mutual Fund Manager

You might think that just throwing darts at the newspaper stock listings would produce market-matching or market-beating results for at least half of those who try just by sheer luck. Actually, on many occasions, monkeys randomly selecting stocks have fared better than professional money managers. (We're not making this stuff up -- check this out.) Odd as it seems, less than 10% of U.S. stock mutual funds that have been in business for at least 10 years have actually beaten the S&P 500 over the last three-year, five-year, and 10-year periods, according to Morningstar.com.

The problem is, trying to outguess the market, either by trying to determine which way the entire stock market is heading or by picking the companies expected to go up the most, costs serious money. You've got to hire somebody (usually a team of people) to do all that guessing and stock picking for you. And then, on top of that, you've got to hire another bunch of people to advertise the myth that the particular guessers you've hired have particularly good crystal balls so that people will give your guessers lots of money to invest. With all these people, the costs can add up pretty quickly. But those costs severely handicap the poor money managers, making beating the market -- or even matching it -- a very difficult task. So what does this mean for you? By far, the majority of investors who have attempted to beat the market using mutual funds with money managers at the helm have failed to attain the average returns of the market. The amount of money this has cost them is staggering. Don't get on that boat.

From 1984 to 1999, the stock market as measured by the S&P 500 index provided an annualized return of 17.7%, compared with just 15.0% for the average diversified mutual fund. That's a 2.7% underperformance for the average mutual fund. That might not sound like much, but year after year, it adds up. Had you invested $10,000 in 1984 in an average mutual fund, by the end of 1999 your account would have stood at a respectable $93,000. But had you matched the market with an index fund, your balance would have been a shade over $135,000. That's a difference of $42,000! And that gap continues to widen. After 25
years, the market-matching account would be more than twice the size of the average mutual fund-matching account.

Why Do Managed Mutual Funds Do So Poorly? Let Us Count the Ways

Expenses
First, there is the expense ratio of the average fund. That's the average amount that a fund charges its shareholders every year to cover salaries, glossy brochures, and TV ads. During the study period we mentioned above, the average expense ratio for a managed mutual fund was about 1.2%. (Over the last couple of years, expense ratios have been rising, and the average currently stands at 1.5%.) By comparison, the Vanguard S&P 500 Index Fund expense ratio is 0.18%, and the expense ratio for Spiders is 0.12%. This means that for a $10,000 investment, you'd fork over $150 per year to the average mutual fund (one that doesn't perform as well as an index fund), versus just $18 for the year to the index fund or $12 for Spiders. High expense charges are the biggest handicap for fund managers. Just to cover that expense fee, they have to beat the market by 1.5%. But that's not the only problem these poor fund managers have to face.

Turnover
Many funds buy and sell their holdings at a rapid pace. No matter who you are, buying and selling stocks is not free. There are always trading costs involved. Currently this turnover of stocks occurs at an average rate of 85% per year. That's right, the average fund buys and sells almost as many stocks as it owns (typically, many billions of dollars worth of trading). The transaction costs involved in buying and selling so many shares every year result in an additional 0.7% of your money disappearing into some broker's pocket every year. Index funds have much less turnover each year than most managed mutual funds.

Cash Reserves
Fund managers typically hold about 8% of their portfolios in cash reserves. They feel that they need some cash on hand to cover a potential imbalance between cash flowing into the fund and cash demands when investors sell, and they think they need these reserves to buy into the market when it is underpriced. This practice, known as "market timing," is expensive. Remember how the market outperforms CDs, Treasury bills, and bonds? Those safe, low-return investments are where the funds park their cash waiting for the "right" time to buy, but few of them manage to get the cash into the market at the optimum time. This holding of cash reserves by mutual funds results in another 0.6% of annual underperformance. Add it all up and you see that after the 1.5% loss to expenses, 0.7% loss to turnover, and 0.6% lost to cash inefficiency kick in, even fund managers who are skilled (or lucky) enough to have picked stocks that matched the market's performance are 2.8% behind.

Taxes
And then there are taxes. All that buying and selling generates "taxable events." Any stock sold at a profit results in capital gains, which are taxed. This doesn't come out of the fund's stated returns like the factors discussed above, but it does come out of your pocket (unless you are investing in a tax-advantaged account like an IRA or 401(k) plan.) Mutual funds range from pretty good to abysmal when it comes to tax efficiency, but index funds are very tax efficient. They might do a bit of balancing on a daily basis, selling or buying to keep their holdings in the right proportion to each other, but major selling only takes place when the index is changed. For example, when Company XYZ is added to the S&P 500, all S&P 500 index funds will buy proportionate shares of Company XYZ and sell the stock it replaced. This doesn't happen too often, though.

Did you get all that? We sure hope so. But if not, remember this much -- index funds can capture most of the gains the stock market generates because that's what they are designed to do. They have virtually no cash reserves, very low turnover, and low expenses, plus they don't have hotshot managers guessing what the next hot stocks will be. Matching the returns of the stock market, rather than the returns of average mutual funds, means a lot over time. Consider this example, from a recent speech by outgoing SEC Commissioner and friend of the individual investor, Arthur Levitt:

"A $1,000 mutual fund investment made in 1950 with returns mirroring the S&P 500 would be worth over half a million dollars today. But, before you start shopping for the yacht, there's still a bit of math to do. After you figure in the compounding costs of mutual funds, conservatively a little under 2%, that figure is reduced to just $230,000. If the fund is not
meant to be tax efficient, that number drops to -- if you can believe it -- just $65,000. Without paying attention to costs, an investor stands a better chance of earning a million dollars as a contestant on *Survivor.*"

**The Pros and Cons of Index Funds**

**Pros:**
- They outperform the vast majority of managed mutual funds.
- They typically have no loads or sales commissions. So you can add small amounts to your holdings regularly without paying sales fees.
- They have low annual expenses.
- You can authorize a regular automatic withdrawal from your bank account and the money will go straight into your fund. You don't even have to lick a stamp.

**Cons:**
- Not all index funds are available from every broker or fund company. (You may need to buy into an index fund directly from its company, such as Vanguard.)
- Some index funds charge high maintenance fees and/or commissions (loads). Just avoid those funds. There are plenty of pretty much identical funds with very low fees.

**But about that stock**

Yes, we love index funds, but we also believe everyone should own at least one stock (and ultimately, at least 15 to reduce your risk and increase your odds for success). Why? Well, it's fun (really!). By owning a stock, you have your own little piece of history, and you get to witness firsthand the power of capitalism and entrepreneurship at work.

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

**Different Types of Investing Styles**

Growth, value, international. Which style is right for you?

**Growth investing, starring Peter Lynch**

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

So what makes Lynch so great? A wildly successful investor, Lynch truly stole our hearts with his books *One Up on Wall Street* and *Beating the Street,* both of which were resounding calls for the empowerment of small investors. By sharing his commonsense and replicable philosophy in a plain-spoken fashion, Lynch convinced a generation of investors that they didn't need an MBA or a white-shoe stock broker to invest in the stock market. The core drivers of Lynch's growth-centric strategy are pretty straightforward: Invest in growing, unheralded, easy-to-understand companies. Here's how it rolls:

**Buy what you know:** Lynch believes that the average investor knows more than they think. Not only do you consume an array of products and services on a daily basis, but you've developed unique career insights that can give you a leg up on the Street. Put them to use! Invest in what you know, understand, and are comfortable with, and leave the rest for the "pros."

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

Value investing, starring Warren Buffett
No offense to the father of value investing, Benjamin Graham, but his pupil and understudy Warren Buffett is The Man when it comes to the practice and theory of value investing. Value investing is the art of buying stocks for less than their fair, or "intrinsic" value. For Buffett and his legion of value-investing disciples, the craft involves three steps:

Buy great businesses: Buffett looks for businesses that boast strong brands, management teams, cash flow, and staying power. Serious staying power. The kinds of businesses that you think will outlive you -- names like Coca-Cola (NYSE: KO), Procter & Gamble (NYSE: PG), and Johnson & Johnson (NYSE: JNJ). Once he finds these great businesses, he looks to buy them when they're out-of-favor, and then patiently holds on for years upon years as these beauties compound wealth.

Be contrarian: It takes some nerve to buy stocks that everyone else is down on, but Buffett has made a living by going against the grain. As he's been wont to say, "Be fearful when others are greedy, and greedy when others are fearful."

Invest for the long haul: As Buffett once said, "Our favorite holding period is forever." And if you can't tell from our section on investor temperament, we feel the same way!

International investing, starring Sir John Templeton
As with Lynch and Buffett, we celebrate Sir John Templeton's philanthropy, intellectual curiosity, and Foolishness. Templeton's success was not the result of a proprietary trading scheme, inside information, massive amounts of leverage, or complicated derivatives. Rather, like Lynch and Buffett, Templeton succeeded because of sound, fundamental research and the patience and discipline to hold stocks for years. His philosophies have become widely adopted today because they work and because people realize that in a global economy, it no longer makes sense to be provincial about investing. But many individual investors continue to try to time the markets and trade with a short time horizon. His success also reflected a willingness to look where other investors would not. Appreciate Templeton for all we've said, but also for:

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

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

John meets Warren meets Peter
business-focused, diverse portfolio of growth and value stocks, both foreign and domestic. But your exact mix is a matter of personal style and risk tolerance.
Opening a Brokerage Account
You've learned about the importance of saving and investing, the best investing choices for beginners, and what kinds of accounts you need to get started. Now all that's left is to put your money where your mouse is and set up an account. You can start the process right here online. Since opening a brokerage or mutual fund account may be a first-time experience for you, we'll go through the process very carefully, starting with: How do you go about actually opening an account? And with whom? Simply put, a broker is a middleman. Since you probably aren't inclined or able to run down to the New York Stock Exchange each time you want to make a trade, your broker does it for you -- for a fee. How much of a fee? Well...

Full-Service Brokers
In the bad old days, the men were men, the fees were hefty, and the information flow was choked off before the individual investor ever got near it. In exchange for making trades for you -- and for throwing in some "expert advice" -- brokers would charge hundreds of dollars even for relatively small trades. These brokers still exist, and are known as "full-service" brokers. Some of them do a bang-up job for you, and earn the hefty fees they charge. Many, though, don't serve you as well as an index fund would. In general, we don't think much of most full-service brokers, simply because we feel that you are the best captain of your investing ship. And, as the historical returns of "managed funds" have shown, the returns that you get from using "expert advice" don't come anywhere near justifying the expenses you run up for it.

Discount Brokers
With the advent of the Internet, more and more people have turned to discount brokers. (Discount brokerages actually originated offline several decades ago, pioneered by Schwab.) How much of a discount do you get? Well, that varies according to the firm, but you can buy or sell stock for $10 or less per trade these days. You don't get much (if anything) in the way of advice. (Which is good -- the only thing worse than no advice is bad advice!) What you get instead is the ability to make trades easily and cheaply -- and various online tools for stock research if you want them.

Here is a discount brokerage comparison table that allows you to see some sponsoring brokers' services and fees side by side. Another good resource for comparing brokers is Gomez.com. Keep in mind as you compare brokerages that while all the apparent differences and details can seem overwhelming, there really isn't that much of a difference between most brokerages. Just about any broker will place and execute your orders and send you monthly statements. It's hard to go wrong in choosing one. Still, don't pick entirely blindly. Do a little research until you find an appealing brokerage that offers all you need.

Comparing Brokerages
There are, broadly speaking, two factors to consider when choosing a discount broker: fees and services

Fees - Before deciding on a broker, you need to know: How much do they charge per trade for a market order? (Don't worry about "limit orders" until you are farther along your investing road.) The answer might range from $7 or less up to $30 or more. If you only plan to trade once or twice a year, the difference shouldn't matter too much. But if you trade twice a month, the difference between $10 and $25 trades amounts to $360 per year. Is there an account minimum? Is it lower for IRAs? Is it lower if you agree to an automatic deposit plan? If you're flush with funds, this factor might not be a deal-breaker for you. But if you've got just $1,000 to invest, you can cross off any brokerages with minimums higher than that. Are there any account maintenance fees (especially IRA fees)? What about account closing or transfer fees? Compare the fees that you're likely to be charged at any brokerages you're considering.

Services - All online brokers offer Web-based trading, but do they also allow you to make trades over the phone -- either by using a touch-tone keypad or by speaking to a human being (and how much more do they charge for these services)? Do they have local offices near you (if that's important to you)? Do they have a reasonably good reputation for customer service (i.e., if you need to speak to someone do you have to be put on hold for seven hours)? You can assess this for yourself just by calling
or emailing each contender and asking any questions you have. Are their account statements easy to read? You may be able to view sample statements on their website. If not, perhaps some contenders will fax or mail you samples.

**Mutual Fund Companies**

As we learned, a mutual fund company is a good choice if your plan is to invest only in index funds, especially if you are inclined to add small amounts to your account on a regular basis (an excellent idea!). While most mutual fund companies offer brokerage services, their commissions are usually significantly higher than online discount brokerages. Since you can find discount brokerages that will let you invest in mutual funds for free, it makes little sense to go with a mutual fund company if you have plans to invest in individual stocks as well. (At the very least, perhaps you could invest in your desired index/mutual funds through the company, but also open a separate brokerage account for stock investing.) If you feel that an index fund is for you, and you have no plans to branch out into stocks in the near future, a fund company will be your simplest choice. The Vanguard 500 Index Fund has traditionally kept expenses extremely low and has returns at the top of the pack.

Questions to ask mutual fund companies:
- Does the fund you're interested in have loads (i.e., commissions) or any other fees associated with it besides modest annual maintenance fees?
- What is the account minimum -- is it lower for IRAs or if you set up an automatic deposit plan?
- Are there IRA account maintenance fees?
- What are the account closing or transfer fees?

Some fees are a necessary part of doing business. But you should know what they are beforehand and compare what different companies charge.

**Making a Choice**

This is the tough part. Narrowing down your list of brokerage contenders and picking The One. We can't make that decision for you, but we know that this is often the place where people get stuck. While services and fees can be very important, overall, we think it's wa-a-a-ay more important to get your account open and put your money to work than it is to torture yourself over choosing the perfect broker. (Hint -- there is no perfect broker!) Check out a bunch of brokerages, make sure you understand the fee structures, look over the various services and features of interest, and then pick one. If you're getting butterflies in your stomach, pick one with no transfer or account-closing fees, and remind yourself that you can always switch if a better deal comes along.

**Opening the Account**

Opening an account is not, as they say, rocket science. It's not even backyard astronomy. Although IRAs require some additional paperwork, opening a brokerage or mutual fund account is just like opening a bank account. Fill out a form and send them your money. Remember, you don't have to invest right away. You can put your money in a money market fund and let it rest a while before it's put to work in an index fund or stocks, and you'll probably be earning more in the money market account than you got in your savings account.

To set up an account with a mutual fund company, simply call the company (many phone numbers are listed on this [No-Load Index Funds Chart](#)) to ask for an account application or go to its website where, in most cases, you'll be able to download an application. Remember to ask for an IRA application if that's the type of account you want to open. Either way, once you get to the site, you can print out the application forms, sign them, enclose them in an envelope with a check to initially fund your account, and you'll receive confirmation of your ability to start trading in pretty short order.

A brokerage account application will want you to choose among different types of accounts. So let's review the options here.

**Cash Account**

This type of account asks you to deposit cash (doing so with a check is fine), and then you can use that cash to buy stocks, bonds, mutual funds, etc. It's not much more complicated than that. Cash accounts are ideal for beginning investors.

**Margin Account**

In a margin account, the cash and securities in your account act as collateral for a line of credit available to you from the brokerage. In other words, with a margin account, you can borrow from your broker in order to invest in additional stock (or
even just for your personal use). The interest rates that brokers charge, while below typical credit card rates, make the return that you need to earn on your investments much higher than if you're investing with your own cash. For example, if you're being charged 9% margin interest, then you'd better earn a good bit more than 9% on your investments in order to make the borrowing worthwhile. If your holdings head south for a while, you may find yourself making hefty interest payments while waiting for your investments to recover. (Alternatively, you might sell some of your holdings at deflated prices in order to cover your loan, or you might have to scrape together additional cash to deposit into the account.) We generally counsel strongly against using margin -- at least for beginners. Even if you're a seasoned investor, we think that borrowing more than, say, 20% of the value of your holdings is pretty risky. Although we don't recommend using margin, a margin account may be required by your broker in certain cases. That's fine. You can open a margin account -- just don't avail yourself of the margin loan provision. You can spend decades investing in a margin account without actually going "on margin."

Option Account
This type of account allows you to trade options, which is a much riskier business than trading stocks. In general, we're not fans of trading options because they have relatively high fees associated with them, a short timeline, and can result in you losing all the money you put into them. (Very few stocks ever get to zero value like options can -- and often do.) Even options on good stocks can be bad investments. Most brokers won't let new investors open option accounts, so you don't need to worry about this one for a while.

IRA Account
We don't counsel against this one! In fact, we think it's a great idea. The popular Roth IRA is the best option for anyone who qualifies. The process is simple, and is laid out for you in our IRA Center. Most of the tax-related work is done for you by the brokerage. (Note: Check to see if the broker charges an IRA account fee. Some do, and the service they provide is worth paying for, but some don't, and why pay if you don't have to?) Be sure to specify whether you want to open a Roth IRA or a traditional IRA. The application form for each will be a bit different. Mainly you will have to specify beneficiaries who will get the account in the case of your death. Remember, both mutual fund and brokerage accounts can be IRAs.

Which Account Is Right for You?
By all means, if you qualify for a Roth IRA, that should probably be your first choice. The tax advantages are so great that there just isn't any reason not to. After you've maxed out your Roth account and any company retirement plans, a plain cash account (or margin account if your broker requires it) is your next choice.

Once the Account Is Open
You generally go to the broker's website and log on with your account number and password. You can then check quotes, view your portfolio and account balance, and, if you like, make a trade. You can also view a history of prior trades over a given time period. If you've never placed a trade over the Internet before, you might want to choose a brokerage that offers phone trading -- just in case. A phone trade will cost more, but you also get to pick the brain of the broker. After that, the next time you trade, the online form probably won't seem so intimidating.

Once You're Up and Running: Kinds of Orders
If you're new to investing, an overview of the kinds of stock orders you can place is in order. Don't let all these details intimidate you, though. After all, you're just beginning. You might not actually buy or sell any stock for a while as you learn more. Still, you'll likely run across some of the following terms, so a few explanations might prove handy. **Market Order:** This is for immediate execution at the best price available when the order reaches the marketplace. This is the most common type of order and is nearly always filled, since no price is specified and it's a good one for beginners, too.

**Limit Order:** This is an order to buy or sell only at a specified price (the "limit") or better. Limit orders are used by investors who have a maximum or minimum price at which they're willing to trade.

**Fill-or-Kill:** This order is sent to the floor for immediate execution. If it cannot be filled immediately, it's automatically canceled.
**Day Order**: This order terminates automatically at the end of the business day if it hasn't been filled.

**Good 'til Cancelled (GTC)**: This order remains in effect until cancelled by the customer or executed by the broker. It doesn't typically remain in effect forever, though; many brokerages cancel GTC orders after a month or two.

**All or None (AON)**: This is a limit order for which the broker is directed to attempt to fill the entire amount of the order or none of it. An all-or-none order differs from a fill-or-kill order in that, with an all-or-none order, immediate execution is not required, but the broker can't break up an order for, say, 1,000 shares by buying 750 when that's all that's available, then waiting until another 250 comes on the market, possibly at a higher price.

**Stop Order**: This becomes a market order when a specified price is reached or passed. Buy stops are entered above the current market price; sell stops are entered below it. For example, you might place a stop order to have your shares of XYZ automatically sold if the price falls below $40 per share.

**Stop Limit Order**: This is similar to a stop order, but it becomes a limit order instead of a market order when the price is reached or passed. If you place a "sell 100 XYZ $55 stop limit" order, then if XYZ drops to $55 per share or below, the order becomes a limit order to sell 100 shares at no less than $55.

These are the major types of orders. Note that some of them can be combined. Also, understand that as a beginning investor, you can do just fine simply placing market orders.

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**Credit – Getting Your Financial House in Order**

No matter what else you do financially, a huge part of your financial future is dependent on your credit. Your credit history means everything when it comes to doing things like taking out a student loan or buying a home. So how do YOU build up a solid credit history? It all starts with making sure you have a credit card with your name on it that is not linked to anyone else. You might already have one credit card, or ten. No matter what your credit card situation is currently, you’ve got to make sure you’re on top of it and know the credit card rules.

First of all, while one swipe of your credit card may get you whatever you want in a given moment, it’s not cash. A credit card transaction just means you’re borrowing money and promising to pay it back later. It can be tempting to spend money that you simply don’t have with a credit card, but we’re telling you: You must not do that. Instead, you should have one credit card, with your name on it (so you build up your credit history), and pay it off in full, every month. The basic thing you need to know is that credit cards can be dangerous for some people—if they spend more than they have. But, YOU can make your credit card your key to a brilliant credit card future. You can, and you will.

Know these four major credit card rules.

- Never miss a payment.
- Don’t cancel more than one credit card a year. (Canceling credit cards can be tricky business, so know what you’re doing first.)
- Never open department store cards. (Retail cards have insane Annual Percentage Rates, so don’t go there, EVER. And, NO, we don’t care that you could get a 15% discount today…)
- Never take a cash advance. (Credit cards aren’t cash, and using a credit card to get cash will result in crazy immediate interest rates.)

Credit score? Credit report? What the heck are those and how are they different? Well, they’re only some of the most important financial paperwork that exists on you and your financial history. In other words, you’ve got to figure out the answers to these questions. Don’t worry—we’ll break it down for you.

Whether or not you regularly check your credit report and score, they are constantly being updated to reflect your financial track record. You need to know what both look like for you.

A credit report is a file on you, full of a lot of important info. Your credit history that includes:

1. Your personal information (social security number, past addresses, current address, employment history)
2. A summary of your financial accounts (and how responsible you’ve been with them)
3. Whether or not you’ve filed for bankruptcy
4. Any inquiries that have been made on your credit report (from lenders, for example)
A credit score is the numerical reflection of your credit report. Your credit report is put through a mathematical formula in order to get your credit score—which will range between the 300s up to 850. When we talk about credit scores, we're usually referring to your FICO score (FICO is the name of a credit score corporation). We want you to be at least in the 700s range, so let’s work to get there! Above 760 is considered excellent.

Why should you care? The higher your score, the better off you’ll be. We’re talking lower interest rates on your credit cards, better loans, and more. If you get in-the-know about your credit report and credit score, it’ll pay off. Your credit score is the number associated with your credit report. There are five main things that go into that three-digit:

1. Whether you pay your bills on time. (Do you? The answer should definitely be YES. Remember those reminders you put in your calendar?)
2. How much you owe, relative to your credit limit. (Your credit limit is what you can spend on all of your credit cards combined. Ex. $3,000 per card and you have 2 cards, your credit limit is $6,000). You want there to be a big difference between the limit the bank has put on your credit card and what you actually spend. In other words, don’t “max out” your credit cards.
3. How long have you had credit? (A credit card in your own name is a must-have!)
4. Have you applied for a lot of new credit recently? (Trying to get twenty new cards at once is never a good idea.)
5. What does your credit mix look like? (Is it made up of credit card debt or student loans?)

The bottom three factors account for about 35% of your credit score: These things are all within your control, and we especially want you to get the first two correct because they account for the majority of your score! We want your score to climb above 760. So, if you’re not happy with your credit score, you have the power to make it better. And remember, you can personally check your credit score as often as you want. You can check your credit score at www.creditkarma.com. It’s that easy. Credit Karma is a site that gives you your credit score FOR FREE.

Taxes – Another Important Thing

First and foremost, taxes are not something to fear! They are something to tackle and tackle CORRECTLY. Your number one priority should be to make sure you have the time and resources to get your taxes done error-free.

The IRS website has great resources, and there are plenty of FREE tax software options to use if you have had a relatively simple financial life this year. What do we mean by “simple”? If you receive the bulk of your income from one source and you are not changing your filing status this year (single, married filing jointly, married filing separately, Head of Household, etc.), you qualify as having a “simple” financial life. The more complex your financial situation, the longer your taxes may take you to complete. If any of the below situations apply to you, a paid version of a tax software, such as TurboTax (about $30), or hiring an Accountant, may save you significant time! While doing your taxes is not quantum physics (sorry, Einstein), it can be time consuming. The IRS estimates that it takes each American an average of 26 hours to file their taxes!

If you decide to hire a tax professional. This still takes a little time as you will want to find someone you TRUST—so do your research and find someone qualified. Most people report paying around $200 or more to have someone do their dirty (tax) work.

No matter how you choose to do your taxes (IRS, tax software or accountant), you will still need to gather the same important paperwork. This is what you will need:

Social Security Numbers
For you, your spouse (if you’re filing jointly) and any dependents.

W-2 Forms
This form records the wages you earned for the year from your employer. (Make sure this number is in your LV budget!) Your employer needs to give you this form, either at the office or by mail. If you haven’t received it by the end of January, make sure to contact Human Resources!

Receipts
If you plan on deducting any expenses or charitable contributions, unreimbursed job related expenses, accounting fees, etc from your taxable income, you will need to have those receipts on hand. Don’t forget to check your credit card statements and e-mail for all donations given.
Bank Account Numbers
If you are filing electronically (which we strongly recommend!) and are expecting a refund, you can opt for direct deposit into your checking account by providing your bank’s routing number and your bank account number. These can be found in a bank statement or on a personal check.

1099 Forms
1099s are forms you receive for ‘income earned’ through interest, dividends, capital gains, scholarships and other forms of income. For example, if you are self-employed, you will receive 1099s from the companies you worked for as an independent contractor.

1098 Forms
Forms for expenses that you can claim tax deductions or credits for –i.e. student loans, coursework, interest you paid on a mortgage, etc.

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<thead>
<tr>
<th>The Form</th>
<th>Purpose</th>
<th>You Collect</th>
<th>Your Employer Provides</th>
<th>Your Bank/Account Number Provided</th>
<th>Other</th>
</tr>
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<tbody>
<tr>
<td>Social Security Number</td>
<td>To verify who you are</td>
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<tr>
<td>W-2 Receipts</td>
<td>To record your wages from the year</td>
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<tr>
<td>Bank Account Numbers</td>
<td>To keep your honest information</td>
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<tr>
<td>1099 Forms</td>
<td>All the other money you earn throughout the year other than from your main employer.*</td>
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<tr>
<td>1068's</td>
<td>Forms for expenses that you can claim tax deductions or credits for.**</td>
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*Including dividends from stocks and even interest earned on your savings account.
**For example, student loans, coursework, interest you paid on a mortgage, etc.

We like these suggestions from TurboTax:
5 Tips To Help You Maximize Your Tax Dollars

Whether doing taxes on your own or not, we recommend you understand these basic concepts:
• Progressive Tax System
• Withholdings
• Credits/Refunds

Progressive Tax
The US has a progressive tax system. This has nothing to do with social and political views of people who work at the IRS. It simple means that you pay a progressively higher tax rate as you make more money. It is relatively easy to pin down your tax bracket: Currently, federal tax brackets range from 10% to 35% of taxable income. But your taxable income is not what’s in your weekly paycheck. It’s what’s left after exemptions, deductions, and credits are taken out.
2010 Tax Brackets

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<th>If your taxable income is between...</th>
<th>Your tax bracket is</th>
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<tbody>
<tr>
<td>0 and 8,375</td>
<td>10%</td>
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<tr>
<td>8,375 and 34,000</td>
<td>15%</td>
</tr>
<tr>
<td>34,000 and 82,400</td>
<td>25%</td>
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<tr>
<td>82,400 and 171,850</td>
<td>28%</td>
</tr>
<tr>
<td>171,850 and 373,650</td>
<td>33%</td>
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<tr>
<td>373,650 and Above</td>
<td>35%</td>
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</table>

The minor complication is that your tax bracket is different from your tax rate. Your tax bracket is the rate you pay on the “last dollar” you earn whereas your tax rate is the percent of your income you pay to taxes. Luckily, your tax rate is usually substantially lower than your tax bracket.

Withholdings

Though April 15 is officially Tax Day, the truth is that taxes affect you all year long. You know how your gross paycheck is significantly lower than your salary? That’s because of a little thing called withholdings. Withholding is the amount held back from each paycheck to pay your income and Social Security taxes for the year. Withholdings keep you from having to pay your taxes all at once when you file your return. The W-4 form you filled out when you started your job determines how much money is withheld from your paychecks.

Credits/Refunds

You get a “refund” from the government if the tax you paid through your withholdings is more than what you actually owe and/or you are able to claim more refundable tax credits than what you owe in taxes. In 2009, the IRS reports that the average refund was $2,683. While it may seem exciting to get a refund check from the government, you’ve essentially just given the government a long-term interest-free loan! It’s better to owe money at tax time than to get a hefty refund, because it means that you’re the one who’s gotten the loan. Better yet, you want to come out just about even at tax time, maybe owing a small amount. If you didn’t get it right this year, don’t worry. Just reevaluate your W-4 and amend it for the future. See “I Want to Fill Out a W-4 Checklist” for help.

If you’re doing your taxes yourself… Go through the “Understand My Tax Deductions.” It will hold your hand through standard and itemized deductions, plus it will help you calculate your AGI (Adjusted Gross Income). Go to the IRS website. Everyone’s doing it. In 2009, almost 200 million people visited IRS.gov. The IRS is actually the single best place to turn when you have a tax-related question. In addition to their comprehensive website, they offer both a recorded information service (1.800.829.4477) and a live assistance line (1.800.829.1040).

If you need a little help… These are great tax programs that guide you through the process step-by-step:

- Turbo Tax
- H&R Block
- FreeTaxUSA.com Check out the table below for more info.

If you need even more help… An accountant may make sense for you. It’s important that you trust your Accountant so that there is no shady business! (You don’t want your 2010 tax year to make front page headlines if you decide to run for political office one day!) “I Need to Find an Accountant” 8 Tips to Help You Choose a Tax Preparer

Some FAQs…

If you encounter questions along your tax way, we like these resources:

- What do I need to know about paying taxes if I’m in college?
- What if I bought a new car in 2009?
- What if I work freelance?

Click here to see common life events that can affect your taxes.
Paying it Forward - Smart Woman Securities allows you to do this!

Clearly, you crave knowledge since you're actively seeking information to increase your financial smarts and portfolio returns. Having gotten this far in, it's likely you've acquired the skills needed to handle most money-related matters in a take-charge, in-front-of-the-8-ball way. You have no problem picking out a decent bottle of red wine, are vigilant about using your turn signal, and are above-average looking. OK, those last three are just hunches. Still, we think the world of you. And we think the world will be a better place now that you've gotten a bit more knowledgeable. Have we sufficiently buttered you up? We hope so, because before we come to the grand finale of this motley Magna Carta, we have one favor to ask: How about paying it forward?

Put your checkbook away
The kind of "pay" we're talking about is much more valuable than writing more zeroes on a check or donating your lightly used kitchen doodads to charity. We're talking about giving away a bit of your most precious asset -- knowledge. If we've done our jobs right (fingers crossed!), you are now on the path to financial freedom. Now you can help others do the same by passing on the important money lessons you've learned. It's as easy as clicking the "Email" link at the bottom of this page (or any of the other 12 pages in this primer), and sending the information to a few friends or loved ones. If each of us pays our knowledge forward -- the money lessons we've learned here and in the school of hard knocks -- we will improve the financial footing of someone we love and care about. But the giving doesn't stop with one person.

More ways to pay it forward
If you've got more to give, consider helping a friend plot a retirement savings plan, teaching a youngster in your life some basic money math skills, or helping your parents get their important papers in order. You don't have to come up with a way to pay it forward on your own. Ask worthy recipients for suggestions for how you might help lessen their financial worries: Maybe a co-worker is worried about having too much of his 401(k) in the stock market. Talk about the risk-reward tradeoff, and show him the chart that illustrates how much money he should have in cash versus stocks based on his age. When your neighbor asks for a hot stock tip, instead show her how simple it is to discover great businesses. If debt's weighing heavy on a friend's shoulders, print out a copy of "How to Reduce Your Debt" and lend a sympathetic ear whenever the urge to splurge strikes. Of course, this naturally leads to a very important question …

What's in it for you?
Besides the warm-fuzzies and a few giant scoops of good karma, plenty. Paying it forward pays you back. Specifically, there are three ways generosity is good for your mind, your wallet, and the world.

It'll make you smarter. First, we guarantee that you will get smarter by sharing what you have learned with someone else. Studies about the way we process information have found that 10% of what we learn is through listening, 20% takes hold when we get involved (or "own" the information by taking notes and actively participating in the learning process), and a whopping 70% of what sticks in our brain for the long haul gets ingrained by the act of teaching what we know to others.

It'll make you happier. According to Knox College psychology professor Timothy Kasser, people who focus on generosity are happier (and healthier) than those mired in materialism. That's right, we actually experience a psychological lift from helping others. A University of Oregon study found that giving stimulates the brain centers that tell us that our basic needs are being met (the foundation for success, according to Abraham Maslow -- the man behind Maslow's hierarchy of needs), letting us know that it's safe to dial down our hunt-gather-hoard-guard setting. You don't even have to write a check to get good giving vibes: Offering time or lending skills to a good cause takes us out of our navel-gazing routine and connects us to something grander.

It'll make you richer. Another nice side effect of generosity is that giving has been shown to tangibly boost the benefactor's bottom line -- and not just in a tax write-off way. Research shows that people who are observed behaving charitably are often recommended for leadership positions in their professional lives.

Imagine the kind of movement that we could start if everyone reading these words right now did just one thing today to improve their finances. You are one click, one phone call, one conversation away from making financial freedom and stability a way of life. Thanks for paying it forward!