Investing Tips

When you're working to achieve your financial goals, make sure that you don't lose money along the way. From 1995 to 2005, consumer prices rose an average of nearly 3.5 percent every year. If you kept $1,000 in cash during those years, by 2005, assuming no interest, the buying power of that money would have declined to about $700.

Regardless of what the market did, simply by not investing the money, you would have lost some of it. But if you put the $1,000 into investments, such as a mutual fund or stocks and bonds, there was at least a chance that the buying power of your money would be the same or higher—either because the investment went up in value, or because you received dividends or interest on it, or both.

So, in unpredictable times like these, how should you invest the money you're saving for your future? There are lots of choices: mutual funds, index funds, stocks and bonds are some of the options. In each category there are thousands of possibilities, but investing doesn't have to be complicated if you follow these basic principles.

Start Early

How long your money is invested can make a big difference in how much you have when you retire. Check out the examples in the chart at the bottom of the page.

The 22-year-old invested less money than the 40-year-old. But she ended up with more because she started early. It's based on the power of compounding. Your money goes up in value, and you continue to earn more on the higher amount, as the value increases. For example: if you invest $500 in a stock whose price goes up 6 percent in a year, it will be worth $530 after one year (6 percent times $500).

If the price rises 6 percent again the next year, you'll have $561.80 ($530 times 6 percent). If you choose your investments well and keep track of how they're doing, this pattern can continue as long as you do not sell them.

The other way to make money investing in stock is by receiving dividends. A dividend is a cash payment issued by the company—it may be issued monthly, quarterly or annually—as a way of sharing its profits with stockholders. Even if the price of the stock does not go up, you still make money on it.

Starting Age	Amount Invested	Ending Age	Years of Contributing	Total Invested	Value by Age 65
22	$500 a year	30	8	$4,000	$38,037
40	$500 a year	65	25	$12,500	$27,432

Match Your Investments to Your Goals

You may be saving for your child's college in five years, or for your retirement in 25 years. The appropriate investments for these goals are different. The time your money will have to grow has a lot to do with the type of investment that's right for you.

The longer you have until you'll actually need to spend the money, the more risk you can take with your investment. Over many years, investing in stocks grows your money more than investing in bonds or leaving it in cash, such as a money market or savings account. But stock prices can go down as well as up. Let's say you decide to retire in two months. You need to start selling some stocks to get retirement income. If the price of your stocks has gone down at that moment, this can be a big problem. So as you get closer to retirement or to needing the money for something else, you'll probably be better off choosing lower-risk investments.

Diversify to Reduce Risk

One of the best ways to balance your risk and rewards on your investments is to diversify. This simply means putting money into more than one type of investment, as well as cash. To understand why you should diversify, think about what happened at Enron. Some employees put large amounts or even all of their 401(k) money into company stock. When the company collapsed, they suffered large investment losses, on top of losing their jobs.

When you diversify your investments, you spread your money among what are called asset classes, such as stocks, bonds and cash equivalents such as a money market fund. The process of deciding how much to put in each category is called asset allocation. This way, your success doesn't depend on a single company, industry or type of investment. For example, if your stocks are going down in value, the value of your bonds may be holding steady or increasing.

Let's say you decide to invest 60 percent of your assets in stock and 40 percent in bonds. Once you have chosen this asset allocation, you need to own more than one investment in each category. For example, you should own several different stocks in different areas of the economy, such as drugs, technology and energy. Two relatively simple ways to diversify could be:

- ❖ Invest in mutual funds—for example, a stock fund that invests in many different companies or in several different market areas; or
- ❖ Invest in index funds—for example, one made up of large companies and one made up of small companies.

Here's how three basic investment categories—stocks, bonds, and cash—measure up on the risk scale:

Investment Type	What it is	Historical Returns
Stocks	Ownership of a piece (share) of a company	10.2%
Bonds	A loan to a company or a government	5.4%
Cash	Cash or the equivalent (savings deposits, money market funds, etc.)	3.8%

Keep Fees Low

It costs money to invest. The fees and expenses you pay for investing will reduce your returns, so pay close attention to them. For example, you may be charged a sales commission when you buy or sell a company stock or a mutual fund. The size of the commission is not related to how well the investment will do. In the case of mutual funds, you can invest without paying a sales commission but there are other fees.

You also pay fees when you buy or sell individual stocks. Using a discount broker and buying and selling investments online can keep your costs down. When buying any investment or other financial product, shop around for the best deal.

Use Index Funds

These are mutual funds that hold all (or a representative sample) of the stocks or bonds that are included in a particular index. This type of mutual fund reflects performance of a particular group of investments, such as stocks. You may have heard of the S & P 500. It's a list made up of large U.S. companies. There are index funds made up of the same stocks that are in the S & P 500. If you own one of these funds, when the index goes up, your investment makes money. When it goes down, your fund loses money.

There are many types of index funds. Some just track stocks of small companies or large companies; others may track stocks in a particular industry, such as manufacturing. There are also bond index funds. Index funds offer many benefits because they:

- ❖ Are simple. You don't need specific investment know-how to invest in one. For example, to invest in the stocks of large companies, you can just buy shares of an index fund that invests in those stocks.
- ❖ Cost less. Index funds are cheaper than other funds because they don't pay for experts to choose stocks or for frequent trading in the market.
- ❖ Offer diversity. While some investments in the fund may go down, others may go up.
- ❖ Outperform other funds. Index funds match the performance of the market before deducting expenses, and after expenses they outperform most other funds because of their very low costs.
- ❖ Offer tax advantages. You pay capital gains tax on the sale of stocks when you make a profit. Since there's less buying and selling in an index fund, your capital gains tax is often lower than it would be if you bought and sold individual stocks.

Keep It Simple

Investing doesn't have to be complicated. Owning a few simple, well-chosen investments is a sound approach. In addition to index funds, there are other types of mutual funds that do the diversification for you. These include target retirement date or life cycle funds, which contain a mixture of stocks, bonds and other types of investments. The mixture is adjusted according to how long you have until you retire; it becomes more conservative the closer you get.

Make Investing a Habit

Arrange for direct deposit from your paycheck or bank account into funds or other investment accounts. If you own a stock that pays a dividend, arrange to automatically use the dividend money to buy more shares of the same stock. Or use "dollar-cost averaging." This means investing a specific amount, let's say $50 per month, in the same stock, month after month and year after year. It's a good way to grow your money while spreading the risk over a long period of time.

Rebalance to Stay on Track

Rebalancing is a way to stick to the investment strategy you've chosen for yourself. Let's say your investment strategy is to invest 60 percent of your money in stocks and 40 percent in bonds. Six months later, stock prices are way up. Now you have 70 percent in stocks, and bonds are only 30 percent. This doesn't match your original strategy. One way to rebalance is, as you add money to the account, invest it in bonds. Another is to immediately sell off some stocks and/or buy more bonds to bring your holdings back into balance. Some mutual funds are regularly rebalanced to help them stay diversified and control risk.

When should you rebalance? Many experts suggest you check every six months, or at least once a year, to see if your portfolio is out of balance. You should also rebalance when you have important life changes, such as having a child, getting divorced, starting a new job or retiring.

Invest for the Long Haul

Financial markets can go up and down. Investing is a long-term proposition. Over the long term, stocks have returned 10.2 percent per year on average, far ahead of bonds and cash. People are living longer in retirement, and while exposure to stocks should usually moderate with age, even retirees often need some stock investments for growth. Stocks have historically come back after major financial downturns. The past is no guarantee of the future, but being an informed investor helps smooth out concerns over sudden market moves.

With uncertainty in the markets, it's natural to be anxious and confused. But using your emotions as a basis for financial decisions is a losing game. Hasty decision-making often leads to selling low, when the market has tumbled, and buying high, when the markets are bouncing back. Pulling out of your investment plan may have unwanted consequences. For example, cashing out your annuity early can trigger surrender charges. Carefully weigh options and consequences before making any investment decisions. Set up a solid financial plan that fits your stage in life and comfort level and stick to it.

Your To-Do List:

- ❑ Use the interactive calculator at **www.bankrate.com** for help determining the right asset allocation for your personal circumstances. Search for "asset allocation calculator."
- ❑ Before you buy a mutual fund, add up the fees using AARP's free 401(k) Fee Calculator at **www.aarp.org/401kfees**. Consider "no-load" mutual funds, which don't charge a commission.
- ❑ Read more about index funds at **www.aarp.org/money** and click on "Investing."
- ❑ Take a free online investing course. "Investing for Success" is sponsored by the National Urban League and the Investment Company Institute Education Foundation. Go to **www.investingforsuccess.org**.

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