

Accumulating Wealth: An Investing Primer

By Phyllis Bernstein, CPA

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About the Author

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Are you worried whether this is a good time to buy stocks or bonds, or which are the ones to buy? Actually, much of that information is trivia. The great irony is that research has shown asset allocation, which is the decision to buy stocks, bonds, and other investments, determines success. This article provides a concise overview of facts and information to help you become an informed investor. The topics covered include the risks and advantages of starting a long-range investment program. This article also maps out a balanced approach to investing that will enable you to take advantage of the wealth-building power of the stock market.

Nevertheless, a number of the areas covered are highly technical. You are urged to seek additional information and assistance from qualified advisers.

Introduction

You have dreams and plans for the future - buying a home, sending your children to college, taking a special vacation, funding for special events such as weddings, confirmations, etc., and enjoying a comfortable retirement. If you're like most of us, you need to save money to make your dreams come true. Once you identify your goals and objectives, you have to set priorities so you can take charge of your financial future. By having a plan, you have a better chance of reaching your goals.

If you've finally saved some money, it's time to put it to work. Whether you've saved \$1,000 or \$10,000, there are investment opportunities available to you. But before you jump into the world of investing, here are some guidelines typically offered by certified public accountants (CPAs) who provide financial planning services to help you start out on the right foot.

Set Up and Maintain Your Emergency Funds

Everyone's first goal should be to establish an emergency fund. After you have established an emergency fund to see you through the tough times, you should invest money to build for the future. The purpose of investing is to earn the highest returns you can get, given the degree of risk you wish to assume.

Most financial planners suggest that you maintain a reserve, equal to three to six months' salary, for financial emergencies such as job loss or unexpected medical bills. If you have a disability insurance policy, your reserve should cover the waiting period in the disability policy. Invest this money in vehicles that are both highly liquid - easy to turn into cash - and low in risk.

Generally, it is best to carefully distinguish your emergency funds; do not mix the money earmarked for emergencies with other money. In addition, create a distinct set of rules about when to use the emergency fund.

Most financial planners advise against keeping more money than you need in a checking account. Instead, consider one of the several cash equivalents that offer security and easy access to your cash for emergencies and short-term goals, such as a passbook savings account, bank money market deposit funds, money market mutual funds, or short-term bond funds.

Savings Accounts

Even though higher interest rates are available elsewhere, many people like to keep some money readily accessible in savings accounts. Although most banks offer similar interest rates on standard savings accounts, it's worthwhile to shop around. Look at the effective annual yield that a bank offers. That yield is the total amount the account will earn when the interest is added to your savings. Consider, too, the impact of compounding. For example, with \$100 in an account earning five percent interest, compounded monthly, you would earn \$5.11 in year one. However, in the second year, you would earn five percent on \$105.11, or \$5.37, giving you a real return that is actually higher than five percent.

Also ask about the bank's method and frequency of calculating interest. The higher flexibility and return of day of deposit/day of withdrawal is usually the best method available to the depositor; the more frequently the interest is compounded, the better.

Another possibility with savings accounts is that by keeping a minimum amount in your account, you can save more on fees than you lose because of the low interest rate. Certificates of deposit (CDs) and money market funds pay more interest than savings accounts.

Money Market Funds

Money market funds, available through mutual fund companies, have three objectives: preservation of capital, liquidity, and current income. Money market funds hold a wide variety of short-term money market instruments, including bank CDs, bankers' acceptances, commercial paper, U.S. Treasury bills, and government securities. In years during which the market is flat or down, money market funds can provide consistent returns with little or no risk. However, money market funds are subject to income fluctuations, unlike long-term bond funds (which have principal risk).

You can use money market funds as a checking account, an investment vehicle, or as a place to park money between investments. Money market funds provide convenience and accessibility. You can usually write checks on the account (although most have a minimum requirement of \$100 or \$250 per check).

Interest rates, listed in most newspapers, are variable - they fluctuate with market conditions. Rates are not guaranteed, but you can withdraw your funds easily if the rate drops too low for you.

Yield is only one consideration when you are choosing a money market fund. Some funds have higher than average yields because they have temporarily waived their management fees and absorbed other expenses. Still, since rates vary, you should shop around to get the best deal.

Other considerations include having a reasonable minimum amount for check redemption, getting expedited redemptions for withdrawals (usually the same day or the next day), avoiding high expense ratios, having a good telephone system if telephone switching is available, avoiding 12b-1 fees, (12b-1 fees, named for a Securities and Exchange Commission rule, use a percentage of the investor's assets to recoup distribution, marketing and advertising costs in an attempt to find more investors) and paying attention to the size and average maturity of the fund.

Tax-Exempt Money Markets

If you are in a high-tax bracket, you are better off using tax-exempt money markets. To decide whether you are better off with a taxable money fund - as opposed to a tax-free fund - there is a simple formula to determine what the lower tax-free interest rate is worth in taxable dollars.

Subtract your tax bracket from 100 (example: 35 percent from 100 equals 65). Now divide the tax-free interest rate by 65 to determine the taxable rate you need to earn in order to match the tax-free amount.

Certificates of Deposit

CDs are fixed-rate investments that require you to leave your money in the bank for a certain period of time. In general, the longer that period, the higher the interest rate. The best time to buy a CD is when interest rates are at a peak. However, since no one really knows for sure how interest rates will fluctuate, the wisest course may be to stagger the maturity dates of your CDs so that all your money is not locked into the same rate.

Interest rates on CDs vary considerably. Since all local banks offer CDs, look around for the best rate. But remember, if you consider this money part of your emergency fund or cash equivalent, keep the term short. If you need to withdraw the money before the maturity date, you will have to pay a penalty. As with most bank deposits, CDs are usually insured for up to \$100,000.

Developing an Investment Program

Once you have established and built up an emergency cash fund, you will want to consider dividing your additional resources among other investments, such as stocks, bonds, real estate, and mutual funds. The first step is to decide which allocation among these vehicles best suits your situation. In order to make this determination, you must ask yourself a number of questions, including the following:

- What are your goals?
- What is your risk tolerance?
- What time line is available for each of your goals?

A CPA financial planner can help you with this process. The following paragraphs present a brief discussion of risk and diversification, and investments that you may want to consider.

Risk and Diversification

Risk is the likelihood that your investment will either earn money or lose money. You can usually tolerate risk or setbacks without panic selling if you invest for the long term. In general, the higher the return you expect on your investments, the more risk you must be willing to take.

Each one of us has a different risk tolerance. In order to assess your risk tolerance, you must take into consideration your age, financial stability, lifestyle, and goals. But risk tolerance is also subject to other considerations, such as your personal comfort level, that make it more difficult to determine than goals and objectives or time frame. If you cannot bear the uncertainty of having your money in risky investments, you may be better off settling for a lower return and steadier nerves. This may be best for you even though, objectively, the more time you have before you will need to take your money out of investment for use for a particular purpose, the more risk you can take.

You can decrease your overall risk by efficiently diversifying your resources among different investment vehicles. The way you allocate your assets is a very important aspect of a successful investment strategy. For example, real estate values increase or decrease in the same direction as inflation. A bond, on the other hand, responds in the opposite way. Inflation lowers the value of the bond, but deflation raises it. If you own real estate and bonds, you may be protected from losing too much, because one decreases in value while the other increases. Remember, however, that you may never achieve high returns with this strategy, even though proper diversification does not necessarily mean mediocrity.

Although the main reason for diversification is to avoid putting all your eggs in one basket, how you diversify depends mainly on the inflation rate at the time of investment and your own goals and objectives and risk tolerance. Another important consideration is the size of your portfolio. For example, if your portfolio is small, you may find it difficult to adequately diversify by investing in both stocks and bonds. In this case, it may be best for you to keep your money in mutual funds - which are diversified - until you build up enough capital to safely pursue other opportunities. For more information see [Choosing Your Asset Allocation](#).

Stocks

Over the long term, stocks generally perform better than other financial investments. Diversification of your stocks is an important ingredient for doing well in the market. By staying diversified, your losses in one stock can be offset by your gains in another. A number of CPA financial planners recommend mutual funds as the most direct way to achieve diversification in stock investments.

A share of stock is worth whatever someone is willing to pay for it on the open market. Prices are influenced by investor expectations concerning a company's earnings, its industry's future, as well as the nation's economic outlook and interest rates. Most stocks are traded on a regional or national exchange.

When you buy shares of a corporation's stock, you become an owner of the company and earn the right to share in its profits. The following are the two basic kinds of stock that are available:

Common Stock

Holders of common stock have the right to vote on important issues and receive dividends based on the company's profits.

Preferred Stock

Holders of preferred stock receive dividends at a specified rate before dividends are paid to common stockholders. These dividends may be cumulative and the stock may be convertible into common and callable at a specific price and time.

If a company goes out of business and its assets are liquidated, preferred stockholders are paid before common stockholders. Preferred stockholders often have to pay for this advantage by giving up the right to vote and the right to share in the company's profits beyond the stated dividend rate. Furthermore, in most cases, since dividends are payable at a specific rate, the price of most preferred stocks may act more like a bond and therefore limit substantial price appreciation.

Investors who own shares of stock or intend to buy them should be prepared to monitor the underlying stock fundamentals of the companies. But be prepared to hold stock as an asset class for the long term. Then, if your stocks do as well as the Standard & Poor's 500 Stock Index, your patience will be repaid with total returns - dividends and capital gains - that are considerably higher than you would have obtained from bonds.

The New York Stock Exchange is the biggest United States exchange, followed by the American Stock Exchange and several regional exchanges. On their trading floors, brokers buy and sell on behalf of clients. In another arena, the over-the-counter (OTC) market, buyers and sellers are matched mechanically by the computerized National Association of Securities Dealers Automated Quotations System (NASDAQ).

If you decide to enter the market, start reading about stocks and the way the market operates. Learn how the experts select stocks. Read the stock tables in the newspaper and make sure you understand what the key ratios tell you about a stock. You might even subscribe to one of the hundreds of newsletters available on the subject. Then, when you are ready, look for a broker or a money manager. Broker fees and commissions vary widely. Money managers charge between .5 and 3 percent of assets depending on services provided. Your CPA may be able to help you find a broker or money manager that meets your needs.

Most Americans today invest in the stock market - even though they may never have intended to. About 50 million people have stock in their own names. Another 150 million own stocks indirectly, through vehicles such as pension plans, employee stock ownership plans, and mutual funds.

If you hold stocks throughout a market cycle and view them as a long-term investment, positive results are more likely. Over the past 65 years, the total compounded return on stocks, with all dividends reinvested, averaged about 10 percent a year. By comparison, the Consumer Price Index rose at a rate of 3 percent. The following are a few key definitions that are helpful for investors who want to put their money in the market:

Standard Deviation, often referred to as the spread, is a measure of the volatility

around its expected return, the greater the uncertainty of achieving that return. Standard deviation is measured by comparing a stock's average price with its degree of ups and downs.

Return on Equity, a measure of how well a company is performing, is expressed as a percentage; a company's net worth is divided into its net income. Returns of 10 percent are generally considered healthy; over 15 percent is outstanding.

Earnings Per Share (EPS) is the profit allocated to each outstanding share of stock. After-tax earnings are divided by the number of shares outstanding. If the EPS goes up each year, the company is growing.

Price/Earnings Ratio (P/E) allows you to calculate how much you are paying for the current earnings of a company. It is determined by dividing the stock price by the earnings per share. High P/E ratios: those with a multiple greater than 20: suggest a company that is on the fast track: investors are willing to pay more for this stock's potential future earnings. Low P/E ratios are usually more solid but less likely to provide high earnings growth, such as blue chip companies, mature industries, and stock groups that are currently out of favor. For example, a P/E of 25 shows that buyers are willing to pay twenty-five times the current earnings to buy a share of stock.

Book Value per Share measures value. Divide a company's net assets by the number of shares outstanding.

Debt-to-Equity Ratio measures the debt of a company against its net worth. Divide total liabilities by total shareholders' equity. If a company has too much debt, its profitability may be hurt.

Common Stocks usually fall into two categories: growth and income. Income stocks are less volatile than growth stocks and are usually issues of companies in mature industries; they produce regular dividends. Income stocks are usually the mainstay of the conservative investor's portfolio. Blue chip stocks are common stocks of companies with a proven track record of stable growth, steady profits, and regular dividend payments.

Growth Stocks are stocks in companies that have exhibited greater-than-average gains in sales or earnings over the last few years and are expected to continue their high levels of growth. Over the long haul, they tend to perform better than income or blue chip stocks. They are riskier and more volatile, with higher P/E ratios and lower yields. They also have the greatest potential for capital gain.

Preferred Stocks are popular with institutional investors. The yield is higher than most common stocks, and unlike common stocks, the dividend remains fixed from year to year. They are an equity investment that behaves like a bond: rising in price when interest rates fall and falling in price when interest rates rise.

Bonds

At one time, bonds were considered one of the safest investments around. Lately, however, they have become as volatile and complex as stocks. If you buy a bond for face (or par) value when it is issued and hold it to maturity, your yield or return on investment will be the stated coupon rate.

All bonds, whether corporate or governmental; work on the same basic principle. A bond is a contract between a borrower (issuer) and a lender (the bondholder) in which the borrower agrees to pay a fixed rate of interest according to a set schedule. The borrower must also repay the principal of the bond when it matures: anywhere from one to forty years after the original issue. The bondholder can usually sell the bond on the open market at any time. (U.S. Saving Bonds are the exception :they cannot be resold.) Bonds are called fixed income securities because they pay a fixed rate of interest on a regular basis.

Two things can affect the value of a bond: a change in its rating or a change in interest rates. When a bond's rating increases, it has been judged to be more credit worthy and consequently its value to potential investors increases. Therefore, a buyer may be willing to buy a bond for more money than you originally paid to purchase it. A bond changes in value as interest rates fluctuate. If the interest rates fall, people will be willing to pay more for an old bond with a higher interest rate. Long-term bond (or principal) prices fluctuate with interest rate fluctuations; for short-term bonds, the income will fluctuate with interest rate changes.

Individual bonds can always be held to maturity to get your principal back in full, at least in nominal terms. Throughout most of this century, the return on bonds has been less than half that of stocks.

U.S. Treasury notes and bonds are a major source of government funding, offered in both intermediate-term (2 to 10 years) and long-term (10 to 30 years), and are sold in amounts of \$1,000 and up. They are the highest quality of all fixed-income investments and have a relatively low rate of return. For example, if you buy a 20-year \$1,000 bond paying 7 percent, you earn \$70 a year for 20 years. The yield: the return on investment: is also 7 percent and you get your \$1,000 back.

U.S. Treasury bills, the largest component of the money market, are offered in a short term (13 to 52 weeks), and sold in \$10,000 lots. They have the maximum safety but a low return and investors can reinvest for up to two years without a new application.

Mutual funds provide an inexpensive, nearly effortless way to diversify your bonds. You can invest \$2,500 and own shares of 50 to 200 different bonds. Mutual funds (discussed later) can also invest in both stocks and bonds; they are "balanced" funds.

Investing in a bond mutual fund is quite different from purchasing individual bonds. If you have limited funds, you should consider bond mutual funds that have no date of maturity and can always be sold at net asset value. Nevertheless, if you have to sell your shares when interest rates have gone up and prices are low, you might not get back what you put in.

Bond funds are a favored form of investment among conservative investors who want:

- Sufficient income to maintain an acceptable standard of living.
- More diversity.
- Professional management of their investment.

Understanding the Risks

Interest Rate. Bonds are called fixed-income securities because they pay a specified amount of interest at set intervals, usually every six months. The total annual interest payment divided by \$1,000 is called the coupon rate. Bonds pay this interest for a fixed number of years until they reach maturity. In the bond market, when interest rates fall, the prices of existing bonds rise. When rates rise, prices fall. In the secondary (or resale) market, you can buy or sell a bond

through a broker and pay a higher price or a *premium* for a higher paying bond or a *discount* for a bond selling below par. For a bond that is no longer selling at par value, that equivalent rate is called the yield-to-maturity rate, because it reflects the present value of the eventual loss or gain when the bond matures.

Credit Risk. Corporates and municipals, unlike Treasuries, pose a risk that the borrower may default on interest payments or be unable to pay the principal on time. Rating services attempt to grade bonds. Typically, the lower the rating, the higher the yield and risk.

Maturity Risk. The life of the bond gives it maturity risk. Longer term bonds pose greater maturity risk and other related risks such as *call risk*. Call risk occurs when the provisions of the bond give the borrower the right to repay the debt before maturity: when interest rates fall sharply, the borrower would repay. Securities of the Government National Mortgage Association (GNMA or Ginnie Mae) and other mortgage-backed securities are subject to maturity risk.

Inflation Risk. The purchasing power of money is affected by the inflation risk. Longer term bonds have a greater risk of losing purchasing power. Issuers of bonds build an inflation premium into the interest rate they offer to investors. If the premium is too low, you could lose your profit and some of the purchasing power of your initial investment.

Tax-Exempt Bonds

Interest on municipal bonds issued by states and other political subdivisions is generally exempt from federal income tax as well as from state and local income tax in the state where they were issued. Federally issued government bonds are subject to federal income tax but are exempt from state and local income taxes.

Interest rates on municipal bonds are lower than those offered by taxable, corporate bonds. But be sure to calculate the after-tax yield. You may find that municipal bonds offer a better after-tax rate. Tax-exempt bonds may be subject to alternative minimum tax (AMT), so consult your CPA.

Caution

Remember that the long-term historical averages, which are more likely to prevail, show stocks comfortably beating fixed-income investments.

Real Estate

The first real estate investment most people make is their home. But other real estate investments are available, including residential commercial and industrial property, and land. Direct investments in real estate should be considered very carefully. Transaction costs and management expenses are high and you need to commit your time and money for a long time in order to see substantial returns.

Real estate is not considered a liquid investment because, in order to sell quickly, you may have to sell at lower than the market value. Certain real estate investments, such as historic landmarks and low-income housing, offer investment tax credits that can reduce your tax bill.

Real Estate limited Partnerships and Real Estate Investment Trusts

Real estate investments have risks and rewards. There are two options that might make sense for your portfolio:

Real Estate Limited Partnerships. These investments are organized by a general partner who buys and manages property. Investors (or limited partners) contribute money to share in any profits and losses. Limited partners have no management responsibility and no liability beyond their investment.

Real Estate Limited Partnerships (RELPs) usually are intended to last for a certain period of time and to distribute proceeds to the partners after, say, seven to twelve years. RELPs are very illiquid and if you have to sell prematurely, you may not get back what you invested. It is easier to sell your interest if it was structured to generate income rather than capital appreciation. High upfront costs have made many of these investments under perform.

Real Estate Investment Trusts. Unlike RELPs, these investments provide liquidity and are similar to a mutual fund. That is, you put money into a fund, with other investors, and the real estate investment trust (REIT) buys or finances income-producing or growth-oriented properties such as apartment buildings and shopping complexes. The value of REIT shares can fluctuate. REITs are far from foolproof. Check out the real estate and market conditions before investing.

It is also important to know what you are investing in. Equity REITs buy properties that produce income or have growth potential, mortgage REITs invest in real estate loans and start-up offerings, and blind pool REITs do not specify the properties they intend to invest in before their shares are offered for sale. If you have faith in the manager running the blind pool, then you should consider the investment. REITs are listed on the New York Stock Exchange (NYSE), the American Exchange (AMEX), and the OTC market, in which securities are bought and sold through dealers, not on the floor of an exchange.

Mutual Funds

A growing number of investors are turning to mutual funds. A mutual fund is an investment company that sells shares to raise money and then makes investments. Investors pool their resources and buy a basket of stocks, bonds, and other assets in quantities much larger than most investors could ever afford to acquire on their own. Mutual funds hire experienced professionals to manage the fund's investments. With mutual funds, you rely on the expertise of experienced professionals to manage your investment. Your investment is pooled with funds from other individuals and invested in a wide range of investment vehicles, such as stocks, bonds and other securities. Mutual funds offer an easy and inexpensive way to achieve diversification. Your only decision is which of the thousands of funds to choose.

Another advantage is liquidity. Most mutual funds redeem existing shares on demand. The share price equals the current market price of the fund's investments divided by the number of shares outstanding (called the net asset value), plus any sales charges. Funds with no sales or redemption charges are called no-loads. Your job as an investor is to pick funds that match your goals and objectives.

As with individual stocks, you can find the value of your mutual fund holdings at any time by looking up the share prices (or net asset values) in the mutual fund quotations page of your local newspaper's business section.

Investment Style

For many investors, the most confusing aspect of fund investing is the distinction between growth funds (which seek attractive returns from stocks that emphasize potential capital gains) and value funds (which seek attractive returns from stocks with above average dividends). Knowing the difference can be helpful when putting together a diversified portfolio of mutual funds.

Among value managers, there are generally four strategies for picking stocks. First, some value investors look for stocks that are undervalued based on corporate assets. Second, value investors like stocks that are cheap compared to current earnings. One widely used yardstick is a stock's P/E ratio. Thus, if a company earned \$3 a share over the past year and its stock was trading at \$45, it would have a P/E ratio of 15, which is derived by dividing the stock price by the earnings. Historically, stocks have traded at around fourteen times earnings. Value investors typically buy stocks with below-average P/Es. Third, some value investors put a lot of weight on cash flow. Finally, some value investors like to buy stocks with above-average dividend yields.

By contrast, growth-stock investors will buy stocks that trade at lofty P/E ratios and pay little or nothing in dividends. Growth funds will buy companies that are adding new stores, offices, or equipment. Changes in earnings are the biggest factor driving stock prices. As a result, a successful growth company can see its stock price post healthy price gains each year.

Much time is spent debating the merits of growth and value investing. Value funds tend to be less volatile than growth funds because they favor stocks that are cheaper relative to earnings and dividends and they often perform better during market crashes. As a result, value funds are often favored by retirees and more conservative investors. Over time, however, growth funds can post spectacular gains, so younger investors tend to favor these. Whatever your age, it is advisable to have money in both growth and value funds so that your portfolio performance will not depend on just one investment style.

Types of Funds

Different funds are designed to meet different investor objectives. You can find a fund's goals by reading its prospectus. The prospectus also lists the stocks currently in the fund's portfolio, its fees, and its sales charges. The following are the main types of funds.

Capital Appreciation Funds are also known as aggressive growth funds. These funds are managed for maximum growth of capital, often make big moves between stock and cash, and use sophisticated investment techniques, such as leverage and options.

Growth Funds are aimed at capital appreciation. These funds own stocks that have a potential for above-average earnings growth: often rapidly growing companies which have modest or no current earnings but the potential for future earnings. They may also look for well-established companies whose profits are expected to grow for the next few years or whose stock is selling for significantly less than the fund manager thinks it is worth.

Growth and Income Funds aim for steady and rising dividends and growth potential. Since rising dividends tend to lift stock prices growth and income are likely to go hand in hand.

Balanced Funds own a mix of stocks and bonds. A high priority is to conserve capital. Many of these funds maintain a fixed allocation, usually 60 percent stocks and 40 percent bonds, but some funds vary the percentages depending on whether the fund managers think stocks are cheap or expensive.

Fixed Income Funds invest primarily in bonds and related securities, such as preferred stocks and mortgage securities. Fixed income funds may specialize in

government-backed mortgage certificates, government bonds and notes, or money market securities.

International Funds: unlike global funds, which hold some United States stocks: invest exclusively in foreign stocks. Foreign stock markets usually behave differently from United States markets.

Precious Metals Funds keep most of their assets in stocks of gold-mining companies as well as in gold coins and bullion. Silver and other precious metals are sometimes represented. Many investors use gold as a hedge against inflation.

Index Funds attempt to emulate the performance of an index, like the Standard & Poors 500 Stock Index, or Wilshire 5000 Index.

Sector Funds invest in the stock of a single industry sector, such as health care, electronics, energy, chemicals, or technology.

Putting It Together

One way to choose a fund is to review past performance. Compare the returns of several funds of the same type over the same period of time. Past performance is a good indicator of how well the fund was managed, although it is no guarantee of future returns: Managers change. Also keep in mind that some funds do particularly well in up markets but perform very poorly in down markets. Other funds show moderate returns in up markets but do an excellent job of protecting these gains when the market goes down.

Do not allow yourself to become overwhelmed in your search for top-performing funds. There is no need to look at every fund, fearful that you might miss out on the next superstar. The thought of discovering the next superstar may be enticing, but a better objective is to avoid white elephants and find above-average long-term performers.

Do not be too impressed with a "hot" fund you've read about in a magazine. Look for one that has done consistently well over a period of years. Funds are ranked by publications and services, such as *Barron's*, *Business Week*, *Fortune*, *Forbes*, *Investor's Business Daily*, *Kiplinger's Personal Finance*, *Money*, *Consumer Reports*, *Morningstar* and *ValueLine*. With hundreds of funds to choose from, a CPA financial planner can suggest the types of funds that are consistent with your investing goals.

Look at a fund's annual portfolio turnover, which reflects how much buying and selling a fund manager does. Growth funds typically do a lot of trading and have a turnover of 100 percent and above, while value funds will generally have much lower turnover. Sometimes turnover changes dramatically from one year to the next, so look at the numbers for the past three years.

Consider the fund's annual expenses, formally known as the fund's expense ratio. Expressed as a percentage of fund assets, usually in ranges between .2 and 2 percent. It includes a management fee paid to fund's investment adviser, 12b-1 fees, and the costs of servicing shareholder accounts, such as fund sales charges and sales commissions. Look for moderate annual expenses.

More Selection Factors

Apart from performance, turnover, and annual expenses, the answers to the following questions are additional factors that should be considered in picking funds:

- Can you get into and out of the fund without paying a sales commission, such as a front-end load, a back-end load, or a redemption fee?
- Does the fund have moderate annual expenses?
- Has the fund changed fundamentally? Is there, for example, a new fund manager or a dramatic increase in size?
- Do your investment objectives match those of the fund?
- If your investment objectives change, do you have the flexibility to switch to different funds without incurring more than a nominal charge? Can you switch by telephone?

Doing It Automatically: Dollar Cost Averaging

Some mutual funds waive their investment minimums if you agree to invest a certain amount of money each month. You sign up for an automatic investment program, in which money is automatically deducted from your bank account on a particular day each month. Automatic investment programs force you to save and practice the investment technique of dollar cost averaging. Your fixed sum of money goes into the investment, and you end up buying more shares when the price goes down and less shares when the price goes up.

This well-known, but not often used technique is based on a solid assumption, which has held up very well throughout this century, that stock prices trend steadily upward over long periods despite frequent short-term ups and downs. In the long run, mutual fund performance has reflected the long-term movements of the markets.

Because mutual fund prices tend to go up over time, you end up owning fund shares that are worth more than the price you paid for them. This simple technique is an effective approach to investing for the long haul. It provides a straightforward way to build wealth.

Other Investment Opportunities

Cash in on the benefits of a tax-deferred investment vehicle, like an individual retirement account (IRA), a Keogh, a SEPP-IRA, a 401(k) plan or a 403(b) plan. The advantage of tax deferral is clear: Every dollar not taken out of your investment in taxes accumulates even more for you.

Individual Retirement Accounts

In most cases, an IRA account must be funded with after-tax dollars, but the income it generates can be accumulated on a tax-deferred basis.

If your income is low enough or you are not in a qualified employer plan, your IRA contributions will be funded with pre-tax dollars and will also be tax deferred.

401(k) Plans

One way you can accumulate wealth is by contributing to a 401(k) plan, which allows you to put away pre-tax dollars. This gives you a threefold tax advantage:

- Your investment has the effect of lowering your annual tax bill.
- The money grows but remains tax deferred until withdrawal.
- Under special circumstances, you may borrow up to 1/2 of the plan's assets to a maximum of \$50,000, paying the plan interest.

A 401(k) is an employer-sponsored plan in which a portion of your salary is deducted and invested each pay period. Not only do 401(k) plans force you to save, but you may also earn a matching contribution from your employer. If your company does not offer a 401(k), funnel money into an IRA.

Keogh and Simplified Employee Pension Plans

Keogh and Simplified Employee Pension Plans (SEPP-IRA) are designed for small business owners and people who are self-employed. Deposits to these funds are tax-deductible and are allowed to grow tax-free until they are withdrawn.

403(b) Plans and State Deferred Compensation Plans

Many nonprofit organizations and State and Local Governments have 403(b) plans and other deferred compensation plans available for their employees to defer additional amounts of their compensation in tax deferred investment vehicles. These plans should usually be favored over after-tax investing.

Choosing Your Asset Allocation

If you are like most investors, you just seem to drift into the all-important decision of choosing your asset allocation. Asset allocation accounts for a whopping 92 percent of your portfolio results; actual stock picking and other security selection accounts for only 3 percent of performance, and market timing accounts for just 2 percent of performance.

When it comes to making investment decisions, everyone has an opinion, and misconceptions abound. These misconceptions are most prevalent and dangerous in the area of asset allocation policy. The good news is that the problem has a solution; asset allocation decisions are the primary determinate of your portfolio's risk and return characteristics. By designing better portfolios and remaining committed to an asset allocation process, it is possible for you to remain committed to a path that moves you toward realization of your financial objectives.

Asset allocation, which means that you do not put all of your assets in any one type of investment, is clear common sense. Changing economic conditions affect various types of investment assets differently. By diversifying among different types of assets, the value of your portfolio will not fluctuate as much.

Asset allocation is based on your vision of the efficient frontier: your assumptions about risk and return for each asset. For example, portfolios aiming for higher rewards and risk will allocate more assets to equities such as stocks, real estate and commodities than do portfolios seeking income and stability of principal.

Keeping Your Balance

Each year, you have to realign your portfolio to maintain your asset allocation. You should make it a point to calculate how much your investments are worth at December 31 each year. Based on

that calculation, figure out what proportion of the overall portfolio is accounted for by each investment and then make additional investments over the next twelve months so that you get your portfolio mix (the proportions) back in line with your asset allocation.

For example, if the value of your stocks falls 25 percent, you would need to buy more stocks to bring the stock portion back to your target. If the stock market soars and stocks now constitute 70 percent of your overall portfolio, you may need to sell a portion of your stocks to bring the overall portfolio back on target. If you are considering selling to get your portfolio into balance consider the tax implications in nontax deferred accounts.

A Final Word

Taking that first step into the world of investments is usually the hardest. To help you make it successfully, contact a CPA financial planner.

By taking all components of your financial life into consideration, a CPA can help you set up a financial plan that is consistent with your goals.

Ten Investing Tips

1. Before investing in a mutual fund, be sure to read its prospectus carefully. This will tell you about the fund's investment approach, its objectives, and its track record.
2. Before buying municipal bonds, review major rating services to determine the financial stability of the issuing governments.
3. Calculate the difference in yield between a taxable and a tax-free vehicle before you select an investment. For example, for someone in the 28-percent tax bracket, a taxable bond yielding 9.7 percent before taxes is equivalent to a tax-exempt bond yielding seven percent.
4. Review your investments periodicals to determine if they are performing as you expected.
5. Buy stocks in areas that you know about. For example, look for trends in your own business or hobbies. You probably know more than you think you do.
6. Invest in the stock market for the long run. A good stock may be down after a year but will balance itself out over time. But don't hold onto a stock out of habit. If the price plunges steadily, consider selling. Many people make the mistake of holding a stock too long.
7. In the beginning, stay away from assets that are volatile over a short period of time, for example, futures, contracts, or metals. Once you are more comfortable with the investment process, you might find a place for these in your portfolio.
8. Diversify your portfolio by buying growth and value stocks, by investing in small and large companies, and by buying U.S. and foreign stocks. An index fund enables you to pick up both growth and value stocks, and if you index the entire U.S. market, you buy small and large companies.
9. In any investment, if a deal sounds too good to be true, it probably is. Do not get taken.
10. CPA financial planners can help you identify your goals and can provide

planner for help.