CHAPTER

1

New Rules for Investing

In this chapter, you explore:

- What has gone horribly wrong with investing
- A new strategy based on new investment vehicles
- Six Steps to Worry-Free Investing

The conventional wisdom about investing says that a diversified portfolio of stocks is not risky in the long run. The conventional wisdom is wrong! It has caused much grief and pain to millions of investors, who have lost billions of dollars because they have relied on that advice.

Take the case of John and Joan Parker, people very much like you, who in March 2000 were looking forward to retirement in two years. **John, a marketing executive, would be 62 at the**

end of 2002. If the stock market gave just 10% per year for those years, John would have enough, with early Social Security, for a comfortable retirement income of more than $90,000 a year for himself and Joan.

That would have been enough for them to move from their two-story, four-bedroom, long-paid-for Trenton, New Jersey, home to a new, less-expensive two-bedroom house with lower property taxes on the outskirts of Greenville, North Carolina. There John could easily drive to either the Bradford Golf Club or the Lee Trevino signature Ironwood Golf Course. Not that John had done more than gather stacks of pamphlets and fly down to play the courses twice (he'd even taken a few lessons to lower his handicap by three strokes and was eyeing a new set of titanium clubs). Joan had already picked out an affordable home that looked ideal (she was gathering swatches of cloth samples and having long talks with a friend who'd once been an interior designer).

With the two kids grown and gone—John, Jr., self-sufficient after getting his MBA and a position with a Fortune 500 company, and Caroline, just graduated with a computer engineering degree and a good job in the Seattle area—they no longer needed the bigger house. It seemed like a good time to start over for the senior Parkers, in a location where food prices were a bit lower and the climate was milder.

Early retirement looked like a sure thing. John's 401(k) was 80% in stock mutual funds, and the market was going gangbusters, as it had for the previous several years. John was a bit concerned because he knew some financial advisors said he should already have reduced his exposure to the stock market. A popular rule he kept hearing was that the proportion in stocks should be equal to 100 minus your age. In John's case that meant 40%. In the end, John decided to stay in the market because everyone he knew was racking up big gains. Stock experts on television were saying the economy had been changed by technology and the market could continue climbing indefinitely. He knew he would feel foolish if he took his money out and watched while everyone else was making big gains. **John decided to wait until he retired to make any changes in his asset mix. That was a bad decision.**

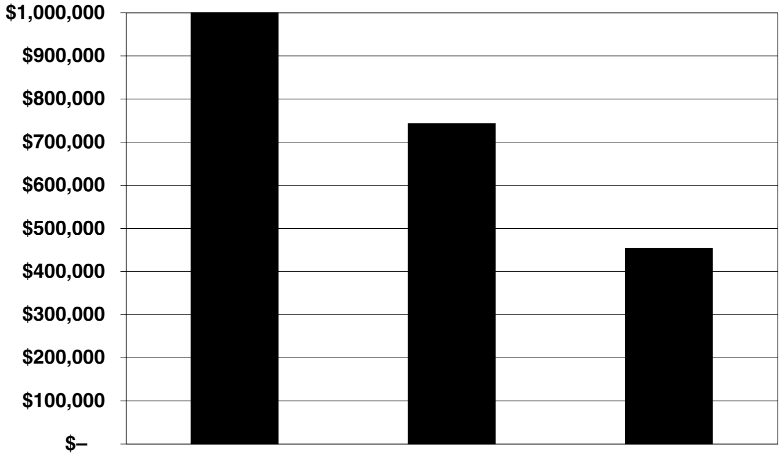
By March 2002, the stock market collapse had changed the Parkers' world. Their retirement portfolio was worth only half the sum they had projected. John and Joan took a long hard look at their financial picture, considered every step open to them, even to selling Joan's lifelong stamp collection on eBay. John cancelled his session with his golf pro scheduled for that weekend, and Joan quietly packed up her sample swatches of materials. **John's mouth settled into a firm line as he reluctantly faced the fact that he would have to work a few more years. Joan went off to another room to be alone.** The freshly decorated cozy new home in North Carolina moved farther away for Joan, and those imagined sunny days on the golf courses would have to wait for John.

But it could have been worse. At least the Parkers were relatively well diversified. Bob and Sandy Adams, of Toledo, Ohio, believed they had their son Chuck's college tuition all taken care of through a mutual fund account invested in growth stocks. Instead, they saw their college fund fall by 80%. Suddenly, Chuck's dream of going to Princeton was about to shift to Ohio State. Even with a student loan, Princeton's tuition looked out of reach now.

Don't forget about already-retired Betty Sue Hampton, former Enron employee in Houston, Texas, whose entire 401(k) was in company stock. She saw her entire retirement fund disappear in a cloud of scandalous dust. A widow, she had to sell her beloved lifelong home and move into an apartment complex.

This was not the first time that an uncooperative stock market had upset people's retirement plans. Back in 1973, the picture would have been even more difficult for John and Joan Parker. With 100% invested in stocks, they would have lost half of their retirement savings over the two years 1973 and 1974. (See Figure 1.1.) In addition, the high inflation of those years would have eroded the purchasing power of what remained. That would have been true whether it was invested in stocks or conventional bonds.

As it was, the Parkers decided that after the results of 2000 and 2001 (see Figure 1.2), they would not only save more for a few extra years, they would reconsider their whole approach to investing. They were determined to find an investment strategy that would not force them to change their retirement plans again.



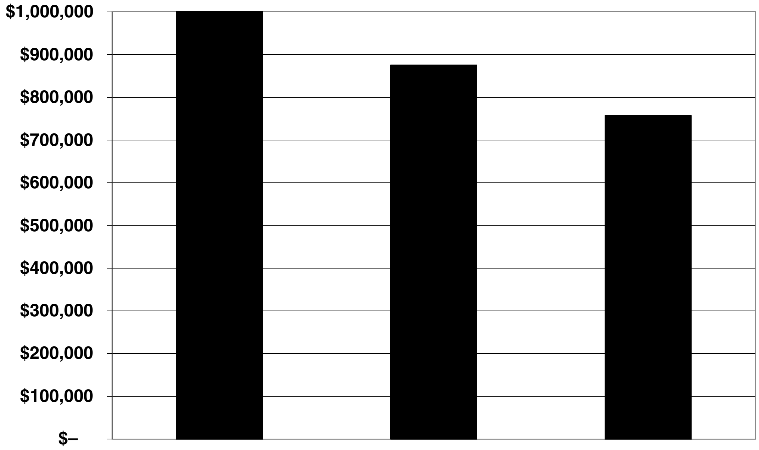
	Jan. 73	Jan. 74	Jan. 75
■ Real Wealth	$1,000,000	$742,800	$453,108

Figure 1.1
Shrinkage of real value of $1 million invested in the stock market in 1973–74.

They wanted the assurance that once retired they would not have to take part-time employment to make ends meet.

A New Strategy

There is a strategy, and this book explains it to you. It is guaranteed to succeed even in the worst bear market. You will see how to achieve your goals—a comfortable retirement, a child's college education, or even a cruise around the world—with far lower risk. You'll get step-by-step instructions on how to invest enough in inflation-protected bonds and other



	Jan. 00	Jan. 01	Jan. 02
■ Real Wealth	$1,000,000	$875,132	$756,493

Figure 1.2
Shrinkage of real value of $1 million invested in the stock market in 2000–2001.

risk-free investments to reach your goals exactly when you have planned.

If you want to sleep nights secure in the knowledge that you will achieve your savings goal, you must invest in a way that eliminates the possibility that inflation will undercut your efforts. If you try to do it by saving less and expecting the stock market to do the heavy lifting, you may not get there at all. Relying on the stock market to provide a major part of your retirement income is relying on chance—like the rolling of the dice. The odds are better in the stock market, but it's still risky.

Bad Advice

John and Joan Parker, Bob and Sandy Adams, and millions of investors like them, were victims of the conventional wisdom—and that was based on dangerous misinformation. They were taking big risks of which they were totally unaware. They and multitudes of others were expecting the stock market to give them so much return that they could afford a comfortable retirement without having to really tighten their belts to save. They took the risk because the experts told them that if you diversify your portfolio across stocks of many different companies and hold those stocks long enough, there is little risk. The experts also said that the only way to earn a real return on your investments—a return greater than the rate of inflation—was to invest in the stock market. All of this was the conventional wisdom—and still is.

Bob and Sandy Adams plunged into stocks to build Chuck's college fund, attracted by the high returns the stock market had provided over the previous 15 years and reassured by those experts that said if they held stocks long enough they would not be risky. In fact, some experts argued stocks were *less* risky than bonds. Those experts were right if the comparison was with conventional bonds, but dead wrong if the comparison is with the new inflation-indexed bonds issued by the U.S. Treasury.

Conventional wisdom is wrong. Stocks don't always produce the highest return, diversification doesn't always protect you against loss, and the risk of owning stocks does not always decline the longer you

hold them. Stocks are risky, and remain risky, no matter how long you own them.

Until 1997, investors had little alternative because there was no risk-free way to earn a decent real rate of return that would not be eroded by inflation. Ordinary bonds were chewed up by inflation during the 1970s, so they weren't an alternative to stocks for those saving for retirement or to put a child through college. Real estate generally performed well during the 1970s, but then it got clobbered during the 1980s as well.

In 1997, the U.S. government introduced inflation-indexed bonds—and these have changed all the rules. Unfortunately, most people have never heard of inflation-indexed bonds, and very few of those who have realize their implications.

Because these new bonds and other inflation-protected investments have come along, you can invest *without worry*. You can use them to safely achieve your goal of paying for a child's college education or your own retirement. **You can be certain of the amount your investments will return, no matter what the rate of inflation before and during your retirement, and no matter what happens to the stock market.**

Most important, these new investments aren't difficult to understand or buy.

New Investments

Inflation-indexed bonds come in two varieties, I Bonds and Treasury Inflation-Protected Securities (TIPS). While they do basically the same job, there are significant tax differences. All investors should invest at least some of their retirement money in these inflation-indexed bonds. **We believe employers should make them available to employees within 401(k) and other voluntary tax-advantaged plans.**

There are circumstances when you will want to take calculated risks by investing in the stock market in the hope of increasing your future income or wealth. We will discuss these circumstances in later chapters. But if you want to hit specific targets for certain, then worry-free investing with inflation-protected securities is the way to go.

Six Steps to Worry-Free Investing

The essence of this book's worry-free investment approach can be summed up in the following six-step process:

1. **Set goals.** Make a list of the specific goals you want to achieve through your saving and investment plan. For example, "I want to continue to live at my customary standard of living after I retire," or "I want to pay for my children's college tuition at Harvard."
2. **Specify targets.** Determine the amount of money you will need to achieve each goal. These amounts become the

targets of your plan. The very definition of risky or safe investing will depend on the target. TIPS and I Bonds have substantially lowered risk if the goal is retirement, but for college saving, special tuition-linked accounts are safer.

3. **Compute your required no-risk saving rate.** Figure out how much you need to save as a fraction of your earnings on the assumption that you take no investment risk. For many people, it is appropriate to count your house as a retirement asset.
4. **Determine your tolerance for risk.** Using as your benchmark the lowered-risk plan you have created in Steps 1–3, evaluate how much risk you are willing to take. Your capacity to tolerate investment risk should be related to the riskiness of your projected future earnings and your ability and willingness to postpone retirement if necessary. The safer your job and your future earnings, the greater your tolerance for risk in your investments. The more willing you are to postpone retirement if your risky investments perform badly, the greater your tolerance for risk.
5. **Choose your risky asset portfolio.** After deciding how much of your wealth you are willing to put at risk, choose a form for taking the risk that gives you the greatest expected gain in welfare.
6. **Minimize taxes and transaction costs.** Make sure that you are not paying any more in taxes, fees, or other investment costs than is necessary.

SUMMARY

You have been reacquainted with what now may seem the obvious uncertainty of investment (though this was less obvious in those heady bull market times). You looked at ways to deal with inflation and reduce risk. You briefly considered Six Steps to Worry-Free Investing that you should use when considering your investments. We will develop these steps further throughout the book.

In the following chapters, you get all of the information you need to understand and accomplish each of the steps outlined above. In Chapter 9, we pull it all together for you in an easy-to-understand action plan that you can implement right away or bring to a professional advisor for review before taking action.

For now, take a look in Chapter 2 at how you can lower your risk and costs of investing.