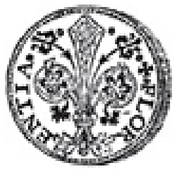
A
CRASH COURSE
IN
BUILDING
PERSONAL
WEALTH

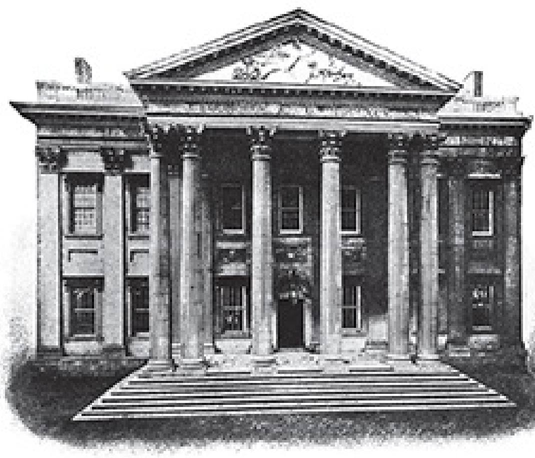


NOT A SINGLE MUTUAL FUND HAS GONE BANKRUPT SINCE 1940

SPECIALTY MUTUAL FUNDS COME WITH A HIGHER RISK, BUT THEY ALSO CARRY POTENTIALLY HIGHER REWARDS

INVESTING 101

FROM STOCKS AND BONDS TO ETFs AND IPOs, AN ESSENTIAL PRIMER ON BUILDING A PROFITABLE PORTFOLIO



GENERALLY SPEAKING, GROWTH STOCKS PERFORM BEST DURING BULL MARKETS, WHILE VALUE STOCKS PERFORM BEST DURING BEAR MARKETS

MICHELE CAGAN, CPA

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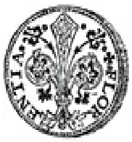

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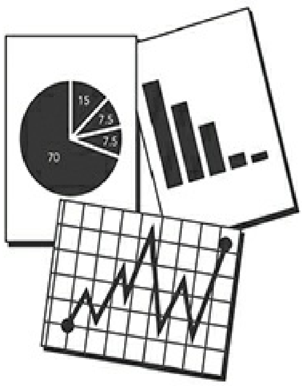

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INTRODUCTION

When you hear the word “investing,” you probably think first of stocks, bonds, or mutual funds. These are certainly among the most common forms that investments take, but there’s more to investing than that.

Investing is about getting your money to make more money. That’s the simplest definition of it. And there are all kinds of ways to do that. They include:

- Stocks
- Bonds
- Mutual funds
- Precious metals
- Exchange-traded funds
- Real estate
- Commodities
- Currency trading

In this book, you’ll learn about all these things and more. We’ll examine different investing strategies and get advice from some famous investors such as the Nebraska genius Warren Buffett and billionaire Peter Lynch. We’ll unlock the mysteries behind those terms you hear sometimes on television or see online: short selling, penny stocks, and economic indicators. You’ll learn about the various exchanges such as the New York Stock Exchange and the NASDAQ, as well as institutions such as the Federal Reserve and the Securities and Exchange Commission and how they impact investing choices.

You'll get advice on investing for education and for retirement. You'll learn how to evaluate your risk tolerance. And you'll learn some basics from the best investors out there.

Investing is a way of helping you reach your goals, whether those are paying for your education or that of your children; traveling and having new and exciting experiences; or financing a secure retirement. By investing wisely and well, you can expand your savings and make your financial dreams come true. There's an exciting world filled with money-making opportunities out there, and it's waiting for you to take advantage of it.

Welcome to *Investing 101*.

CHAPTER 1
BASIC ECONOMICS

Investing is about making your money grow. That can't happen unless the securities you invest in grow and pay out earnings. And that is directly tied in to the health of the economy.

The most basic premise of the economy is this: If consumers spend money, the economy can grow; if they don't, it can't. When the economy is sluggish, consumer spending lags, overall corporate growth stagnates, and investors see poor returns. When the economy is booming, people spend money, corporations prosper, and investments grow. In fact, consumer spending makes up most of our gross domestic product (GDP), and that keeps the economy flowing.

Understanding how the economy works, the cycles it goes through, and the impact changes have on the markets can help make you a more successful investor. In fact, investors who pay attention to the economy can be more successful because they can take advantage of impending changes. While everyone else is focused on what's happening right now, economically savvy investors can focus on what's coming—and profitable investing is all about future growth.

BUYING AND SELLING
The Lifeblood of the Economy

It's certainly the case that the economy today is a very complicated, fast-moving mechanism. How could it be otherwise? We live in a world inhabited by nearly seven and a half billion people who are engaged in a never-ending interaction with one another. Some are buying; some are selling; some are manufacturing; some are consuming. Economics as a system allocates the things we need to live.

Broadly speaking, if you're going to get involved in investing your money, you don't need to know a lot about how the economy works or the finer points of its more obscure corners. You do, however, need to understand some basic things about it.

"The intelligent investor is a realist who sells to optimists and buys from pessimists."

—Jason Zweig

Value and Price

Humans buy and sell things because those things have value. This value is partly what you use them for (for instance, you use food to survive, you use a car for transportation, and you use movie tickets for entertainment) and partly the monetary value that we assign to them (price).

Value isn’t constant, though. The value of some things changes quickly. For example, you probably have noticed that the price of gasoline isn’t nearly as high as it was several years ago. That’s partly because humans are generally using less gasoline for driving our cars. This means there’s a lower demand for gasoline, and the price, correspondingly, drops. It’s also because many oil-producing countries have stepped up their production, which means there’s overproduction, causing the price to drop. Gasoline prices fluctuate depending on demand and supply. If supply increases, prices fall. If demand increases, prices rise.

Here are some other basic concepts you need to keep in mind.

Income

Income is money you receive from different sources—your job, gifts, inheritances, investments—to buy what you need. Knowing your income is important, since this allows you to live within your means and not spend more than you have coming in. Economists consider various kinds of income, including national income, per capita income (that is, the average income a person has), and disposable income (the amount of money you and your family can spend after you pay your taxes).

Big changes in your life usually affect your income. One of the largest will come when you retire from your job (or jobs). At that point, you’ll lose a major source of your income, and you’ll need to replace all or some of it. Social Security will help, but this is also where your investments can play a key role in letting you maintain your lifestyle.

Consumption

This is what you and your family consume; that is, it's how much you spend on goods and services. Again, this is a very important thing for you to keep track of. If your consumption is going up but your income is remaining the same or declining, you've got a problem. On the other hand, if your consumption holds steady, more or less, and is in line with your income, you're sitting pretty.

Personal Consumption Expenditure

Economists track personal consumption expenditures (PCE). The Bureau of Economic Analysis (*www.bea.gov*) monitors and publishes PCE reports regularly. You can also find information at the Bureau of Labor Statistics (*www.bls.gov*).

Saving and Investment

Finally, we come to those things that families should do and don't: save and invest.

Americans used to be quite good at saving—during the 1960s, the average American saved 6–10 percent of her or his income. That declined in the 1990s, and today it hovers around zero. Obviously it's not in our interest to live paycheck to paycheck, but too many of us struggle to find ways to save and to increase those savings. This is the importance of investments. It's not enough to save part of your income; you've got to get that money working for you.

INTEREST RATES
Borrowing and Lending

Interest rates are the prices borrowers of money pay to the lenders. From stocks to bonds to real estate, every investment is somehow affected by interest rates, albeit to a different extent. To understand that impact, you first have to understand how interest rates work. For most of us, interest is just something we earn on our savings accounts, or (more often) more money we have to pay to credit card companies. For some, it's the mysterious number connected with mortgage payments. And that's where it ends for us; that's the direct impact of interest rates on our lives.

It begins, though, with the Federal Reserve.

The Fed

The Federal Reserve System was created in 1913 with the responsibility of creating and maintaining interest rates and administering U.S. monetary policy. Today, in addition to these things, it supervises and regulates banks and acts as a financial servicer for the U.S. government and various lending institutions.

The Federal Reserve has the power to manipulate the federal funds rate, which is the interest rate that Federal Reserve banks charge other banks like yours to borrow money. That rate sets the tone for all other interest rates, like the ones on your car loan, mortgage, and credit cards. The Federal Reserve uses this rate to control inflation. To keep inflation from spiraling out of control, the Fed raises its rate, which has the effect of limiting the amount of money available for consumer spending. Higher interest rates mean that more money goes to interest payments and less to shopping.

When people and businesses have to pay more in interest, which leaves them less to spend, investors can take a hit. So while a change in the federal funds rate doesn't immediately impact the markets, it does affect them indirectly, through both consumer spending and corporate bottom lines. When corporations have to pay more to borrow money, that's less money for the dividend pool and less money to put toward future growth. Plus, corporations with diminishing profits usually see their share prices drop right alongside the disappearing earnings. So even if nothing else changes, an interest rate increase can push stock prices down.

The Effect of Lower Rates

When the Fed lowers interest rates, the money supply increases. That often signals investors to buy stocks, as lower interest rates make stocks appear more attractive on the risk/return scale. Lower rates also aid economic expansion, which leads to corporate growth, which increases the value of corporate shares.

There's a flip side to this, though. A higher federal funds rate also means higher interest rates paid out on newly issued Treasury securities. These risk-free investments guarantee you steady returns, and when rates go up, you're guaranteed bigger interest payments on these government securities. This also has the effect of higher interest rates on newly issued municipal and corporate bonds.

ECONOMIC INDICATORS
Signposts in the Marketplace

Whether the economy is poised to take a turn or remains on course, there are special economic statistics that give us clues to what's about to happen. These clues are called leading indicators, and, as their name suggests, they take the lead in predicting which way the economy is headed. Then their cousins, coincident and lagging indicators, are used to confirm economic trends, illustrating where the economy stands now and where it's been.

"The idea that a bell rings to signal when investors should get into or out of the market is simply not credible. After nearly fifty years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently."

—John C. Bogle

Economic indicators are often tied with inflation. One reason for this is that inflation strongly influences the level of interest rates, which impact the stability of the economy. Some are also linked with production or foreign trade, both of which eventually impact consumer goods prices.

Indicators and You

While you don’t need a degree in economics to be a good investor, you need to understand how and when the economy can impact your portfolio. It makes sense for investors to have a thorough understanding of how the economy works and how economic activity is measured.

Leading Indicators

Though economists also look at coincident and lagging indicators, investors typically focus on leading indicators. For an investor, profits often come from future events and expectations. Knowing where the economy is headed can help investors (especially traders) make more profitable investment choices at the most opportune times.

Eight of the most important economic indicators are discussed here. You’ve probably heard of some of them, like the GDP, the consumer price index (CPI), the unemployment index, job growth, and housing starts. Others, such as the producer price index, consumer confidence index, and business inventories, are less widely known but are important all the same.

Gross Domestic Product

The GDP is the most important economic indicator published. Providing the broadest measure of economic activity, the GDP is considered the nation’s report card. The four major components of the GDP are consumption, investment, government purchases, and net exports. This lagging index takes months to compute and even longer to finalize. The GDP lets us know if the economy is growing or shrinking.

Consumer Price Index

The CPI, released by the Bureau of Labor Statistics (BLS), is directly linked with the inflation rate. This index tracks retail-level price changes by comparing prices for a specific basket of goods and services to base-period prices. Unlike some other inflation measures, the CPI covers both domestically produced and imported goods. Some critics say the CPI, and therefore the measured inflation rate, is purposely understated, as the CPI is the factor used to increase Social Security payments.

Consumer Confidence

The consumer confidence index monitors consumer sentiment based on monthly interviews with thousands of households. The consumer confidence index dropped drastically after the terrorist attacks of September 11, 2001. Then, for several years, the index remained fairly steady; consumers were maintaining buying patterns despite rising gasoline prices and interest rates. In fall 2008, the index dropped again, as news of home foreclosures, the credit crisis, struggling markets, and government bailouts frightened consumers into saving their money. In bad times or good, consumer confidence serves as a reflection of the nation's financial health. This index is particularly important to the financial markets during times of national crisis or panic. If consumers aren't confident, they aren't spending money, and the markets may slump further.

Job Growth

Second only to the GDP, the government's employment report is one of the most important economic indicators. Job growth statistics include employment information such as the length of the average workweek, hourly earnings, and the current unemployment rate. As such, this indicator sets the tone for the upcoming investing month. When job growth is up, consumers feel more at ease and tend to spend more. But when job growth shrinks, people get nervous—a strong indicator that the economy could be entering a downturn.

Unemployment Index

The unemployment index is a subset of the government's employment report. Unlike the total jobs data, which is considered a coincident indicator, the unemployment index is a lagging indicator; it changes following a change in the economy as a whole. Essentially, this makes the unemployment index less significant to investors, who are looking toward the economic future. However, several months of low unemployment rates can signal that higher inflation is right around the corner.

Housing Starts

The housing starts indicator measures the new construction of single-family homes or buildings each month. For the purposes of this survey, each individual house and every single apartment count as one housing start; a building with 150 apartments counts as 150 housing starts.

LEI Index

> There’s an index for everything, including one that measures the leading economic indicators (called the LEI), which purports to predict future economic activity. Basically, when the LEI moves in the same direction for three consecutive months, that suggests an economic turning point. For example, three positive readings in a row would indicate an impending recovery.

Why are housing starts important? The housing industry represents more than 25 percent of total investment dollars and about 5 percent of the total economy, as per the U.S. Census Bureau. Declining housing starts indicate a slumping economy, and increases in housing activity can help turn the tide and put the economy on the road to recovery.

Business Inventories

As a monthly running total of how well companies are selling their products, business inventories are like a big neon sign to economists and investors alike. The business inventory data are collected from three sources:

- Manufacturing
- Merchant wholesalers
- Retail reports

Retail inventories are the most volatile component of inventories and can cause major swings. A sudden fall in inventories may show the onset of expansion, and a sudden accumulation of inventories may signify falling demand and hence the onset of recession.