

Investigate Before You Invest

TEXAS INVESTOR GUIDE

Strategies for Investing Wisely
and Avoiding Financial Fraud



A Publication of the Texas State Securities Board
Regulating the securities industry and
protecting investors since 1957

Dear Texas Investor:

You have in your hands a valuable resource that can help you become a more informed investor and guard against the devastating effects of financial fraud.

This newly revised edition of the *Texas Investor Guide* describes the time-tested lessons for achieving financial goals. Like most investors, affording a comfortable retirement is undoubtedly near the top of your list.

The *Investor Guide* complements the regulatory duties the Texas State Securities Board performs in protecting investors.

The Agency regulates firms and individuals selling securities or providing investment advice to Texans. We conduct compliance examinations across the state to make sure firms are operating in accordance with securities laws and regulations. If they aren't, we can bring administrative actions in the forms of cease-and-desist orders, suspensions, and fines.

The Agency's enforcement division prosecutes investment fraud cases in dozens of Texas counties, winning stiff criminal sentences and orders of restitution to investors. Our staff regularly coordinates with federal and state authorities in criminal matters.

The best defense against investment fraud, however, is self-defense. The *Investor Guide* will help you on the path to financial well-being.

Sincerely,

A handwritten signature in black ink that reads "Travis J. Iles". The signature is written in a cursive, flowing style with a large initial 'T'.

Travis J. Iles
Securities Commissioner

Texas Investor Guide

*Strategies for Investing Wisely
and Avoiding Financial Fraud*



Texas State Securities Board

2019 Edition

TEXAS INVESTOR GUIDE

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INTRODUCTION

Investors have more responsibility than ever for achieving their financial goals.

When it comes to retirement, the days of corporations managing pension plans for their workers are dwindling, and have been for a long time. Social Security is expected to replace less and less of the income a retiree earned while working. Instead, workers increasingly have had to fend for themselves by setting up their own retirement accounts or participating in the retirement accounts offered by employers, such as 401(k) plans.

This shift in responsibility requires us to know a lot more about making investments, yet too few of us really feel equipped to make informed decisions about our financial future.

A Library of Congress report found that many investors “lack essential knowledge of the most rudimentary financial concepts” such as the differences between stocks and bonds, the role of the stock market, and the value of portfolio diversification.

Nor do investors appreciate how badly investment fees erode their long-term returns—or how to minimize those fees.

When it comes to financial fraud, investors are consistently attracted to shiny new things—very risky investments that promise to earn them big, big returns. And they don't pay enough attention to the alarm bells ringing in their head before putting their hard-earned money into one of the ever-evolving types of fraud.

“*When it comes to financial fraud, investors are consistently attracted to the shiny—and very risky—investments that promise to earn them big, big returns.*”

The *Texas Investor Guide* was written to help investors—beginning and more experienced—understand precisely these topics. And if you decide to seek a financial adviser, the *Investor Guide* will help you ask the right questions and do the necessary research to increase your chances of finding a financial professional you can trust.

To begin, let's address a basic question: Why Invest?

WHY INVEST?

Why invest? The answer can be summed up in three points:

1. You won't meet your financial goals by burying your money in the backyard. You invest so you can buy a home, send your children to college, start your own business, or expand your horizons by continuing your own education or traveling.
2. Your most important goal is likely to be enjoying a secure retirement. You help make that possible by investing regularly. Investing supplements your savings and helps you cover your day-to-day costs, including healthcare expenses, over what could be a decades-long retirement.
3. Investing helps provide financial security for your family, and for the people and organizations that depend on your generosity.

All investing carries some degree of risk, however, so it pays to learn the investment basics before you get started.

Before Investing, Develop a Plan for Family Money Management

It makes little sense to start investing before you take the steps needed to make sure your and your family's financial house is in order. If you're burdened by excessive debt that is making it difficult even to save money, then you should probably address that issue before stepping into the world of investments.

Setting your family's financial goals requires the same type of careful planning as investing does. Without a plan, it can take a long time to reduce excessive debt, whether from credit cards, a mortgage, car loans, student loans, or other amounts you may owe to creditors. Paying off credit card debt that carries an annual percentage rate of 18%, for instance, will give you a better return than most investments.

Besides reducing debt, families should try to build an emergency savings fund that would pay for at least three months of living expenses. This fund can help cover the cost of unexpected events, such as unemployment, repairs or replacement of a car or major appliance, prolonged illness of a family member, medical expenses not covered by insurance, and property taxes.

A publication from the Federal Reserve Bank of Dallas, [*Building Wealth: A Beginner's Guide to Securing Your Financial Future*](#), can take you step by step through the process of family budgeting, including building credit, controlling debt, preparing a spending plan, calculating your net worth, and knowing which types of insurance are needed to protect yourself from major financial losses. *Building Wealth* is free. Find out more at www.dallasfed.org/educate.

Inflation also does real damage to your savings, especially if the inflation rate is higher than the interest rate you're earning. If that's the case, your savings are actually losing rather than gaining value.

The Time Value of Money

The \$1 you have in your pocket today is worth more than that same \$1 will be worth next month or next year. That's the time value of money: The more time that goes by, the less value your money has.

Money loses value—or buying power—as a result of **inflation**. Almost anything you buy now costs more than it once did—and often more than you expect. Inflation is a big part of the reason it will cost you more to live in the future than it costs now. What makes things worse is that over the past 40 years the average inflation rate as measured by the **Consumer Price Index (CPI)** has risen much faster than people's average **disposable personal income (DPI)**. That means you have lost a lot of buying power during that time.

Inflation also does real damage to your savings, especially if the inflation rate is higher than the interest rate you're earning. If that's the case, your savings are actually losing rather than gaining value.

So what's the solution? You'll need a source of income in the future that will outpace inflation and close the gap between what things will cost and what you have to spend. Investments can provide that income.

The Rule of 72

The Rule of 72 shows how inflation can erode your income. Here's how it works: You divide 72 by the **annualized** inflation rate, which has averaged 3% since 1926. Since $72 \div 3 = 24$, you can expect your living expenses to double every 24 years.

That's an eye-opening number, since there's nothing unusual these days about a retirement lasting 24 years. It's critical, then, to have more income as time goes by. Keep in mind, too, that in some years inflation is higher than 3%. If inflation jumped to 6%, or soared past 12%, as it did in the late 1970s, then the damage to your long-term financial security could be severe.

The Rule of 72 is also a quick and accurate way to estimate how quickly the money you invest will double in value.

For example, if your investment portfolio provided a 6% annualized return, you could expect your account to be worth twice what you invested after 12 years ($72 \div 6 = 12$). That's even if you don't invest another cent—though ideally you would continue to add money to your portfolio every year.

One word of caution, though: No rate of return is guaranteed. The estimates provided by the Rule of 72 depend on assumptions about the rate of inflation and the rate of investment return, both of which could differ significantly from historical averages or your expectations.

Investing for Growth

If the value of your investment portfolio increases more quickly than inflation causes prices to rise, you'll increase your **net worth** and be more financially secure. One way to do this is to invest for growth, or to try to achieve an annualized rate of return on your investments that is higher than the annualized rate of inflation.

Investing for growth is different from putting your money in **certificates of deposit (CDs)**. With bank or credit union CDs, your money is safe because deposits are federally insured and the return is guaranteed. The rate of return, however, is generally lower than the rate of inflation. In fact, in the past several years, CD returns have been about as low as they have ever been and typically less than half the average rate of inflation. Some investors have probably felt that, except for the federal deposit insurance, they would have made out as well by putting their money under their mattresses.

The sooner you start to invest, the more time your money has to grow. But investing at any age helps you financially.

Just as the \$1 you have today is worth more than the same \$1 next year, so the \$1 you invest today has greater potential for growth than the \$1 you invest next year.

Investing for Growth	
ALICE	DAVE
<ul style="list-style-type: none">• Invests \$400 a month from age 25• Realizes average annual tax-deferred 6% return• At 65 her account is worth \$766,785	<ul style="list-style-type: none">• Invests \$400 a month from age 40• Realizes average annual tax-deferred 6% return• At 65 his account is worth \$271,832

As this illustration shows, starting a tax-deferred retirement account at age 25 paid off for Alice. Her account ends up being worth almost three times as much as Dave's, who started a similar account at age 40.

In fact, even if Alice had stopped putting money into her account when she turned 35—after just 10 years—and she continued to achieve a 6% annualized return, she would have accumulated \$440,390. She'd still have more in her account than Dave, even though he invested over 25 years. (Neither example takes into account investment costs.)

The sooner you start to invest, the more time your money has to grow. But investing at any age helps you financially.

By investing early, you benefit from the power of **compounding**. With compounding, you earn a return not only on the amount you invest but on the earnings you accumulate. That gives you a bigger base on which to grow future earnings.

Why People Don't Invest

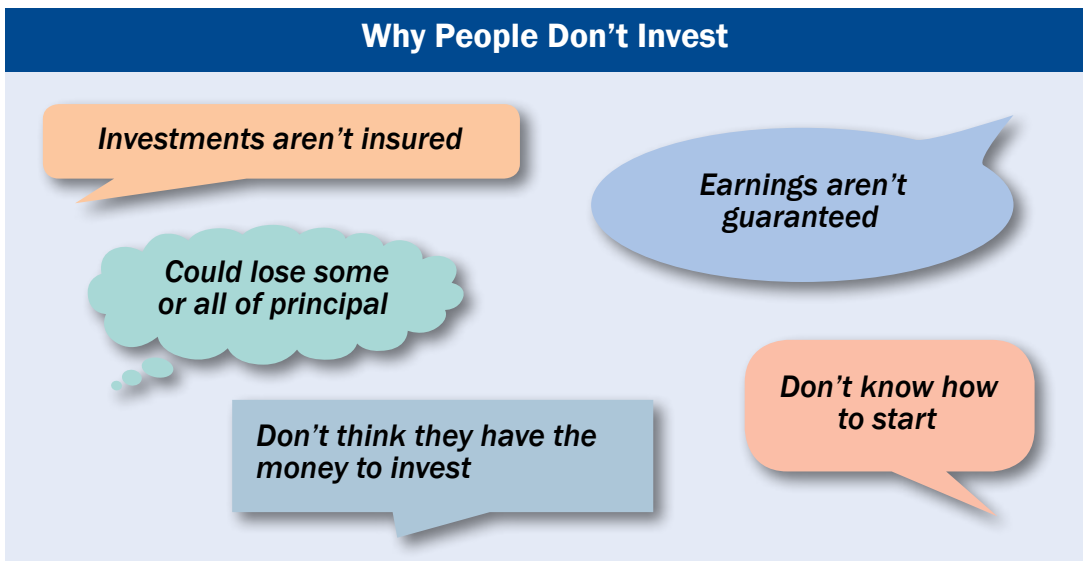
The arguments against investing are valid—to a point. Investments aren't insured, and your earnings aren't guaranteed. In some time periods, you will have to stomach the fact that the value of your investments has shrunk. You'll also need to avoid locking in your losses by selling in a panic.

The counterargument is that over extended periods of time—several decades, not one year or 10 years—you have a chance to achieve a much stronger rate of return, and much greater protection against inflation than CDs and money market accounts can provide.

For example, between 1926 and the end of 2017, the compound annual growth rate was 10.2% for large company stocks, 5.5% for U.S. Treasury bonds, and 3.4% for U.S. Treasury bills. (Remember inflation has averaged 3%.)

Those figures cover nine decades, though, and no one except the exceedingly optimistic plans to invest money for that length of time. There is no guarantee—in fact, probably very little likelihood—that your returns over 10 or 20 years of investing will closely track those historical returns. But since you have the potential for a rate of return that's higher than the rate of inflation, you may decide it's worth investing your assets in a mix of stocks and bonds.

Some people are understandably concerned that they don't know how or where to start investing, or simply don't have enough money. The best remedy is to learn more about investing and how it works, which is what the *Texas Investor Guide* is designed to help you do.



MAKING INVESTMENTS

It's tough to start investing when you're unfamiliar with the different types of investments you might make, and when changes in the investment markets sometimes seem irrational. But if you're willing to put in the time to learn the basics, you'll be much more comfortable taking the plunge.

The place to begin is by recognizing that every investment belongs to what is known as an *asset class*—a group of investments that have important features in common. What's more, most investors can focus on just four of these classes to help achieve their financial goals.

Asset Classes

What you need to know first is that each asset class puts your investment dollars to work in a different way, provides a different level of long-term return, and exposes you to different types of risk. Much of the time, each asset class reacts differently from the other classes to what's happening in the financial markets and the economy in general. For example, in a year when equities are increasing in value, fixed-income may be flat or even losing value. In a different year, it could be the other way around.



Equities

When you make an equity investment, you buy shares of stock in an individual corporation or shares in a **mutual fund** or **exchange traded fund (ETF)** that owns stock in a number of corporations.

There are two ways to make money with equity investments—by selling at a profit or by sharing in the corporation's earnings.

If the share price increases, you can sell your investment for more than you paid for it. Or you can keep the shares, increasing the value of your portfolio.

You may also be entitled to share in a company's or fund's profits. A corporation has the right to decide whether or not to pay a **dividend**, or a portion of its earnings. But a mutual fund must pass along to its shareholders the income it earns from its investments and the profits it makes from selling its holdings, after first subtracting its fees and expenses.

The risk with equity investments, particularly individual stocks, is that the prices may be volatile—they can change significantly in a short period of time—and neither their **market price** nor the income they may provide is guaranteed. This means you could lose some or all of your money in an equity investment if its price dropped suddenly and you sold your shares.

Fixed Income

When you buy a bond, you are making what's known as a fixed-income investment. You are effectively lending money to the issuer of the bond, whether it is a corporation, a government, or a government agency. The issuer of the bond pays you a predetermined—or fixed—amount of interest on a scheduled basis, and then pays the principal of your investment back to you at the bond's maturity date.

The U.S. Department of the Treasury issues bonds on behalf of the federal government. A city or state may issue bonds to help pay for new roads, schools or other public infrastructure. Corporations sell bonds to increase cash flow or to fund expansions into new markets.

Buying a bond can be a straightforward transaction. Let's say you buy a 10-year U.S. Treasury Note with a face value of \$5,000 and an interest rate of 3%. If you hold the bond to maturity, you would earn interest payments of \$150 a year and then receive your \$5,000 principal back at the end of 10 years.

Bonds are often bought and sold before maturity, however, so it's important to understand the impact of interest rates on the bond market. For instance, if interest rates rise, the market value of a bond that you already own will fall, meaning you would get less for it if you decided to sell it to someone else before maturity. That's because investors won't pay as much for a bond with a lower interest rate when they can buy a new bond with a higher rate.

Conversely, when interest rates fall, bond prices rise. A bond with a 3% interest rate is going to be more attractive to investors when new bonds are being issued with, say, a 2% interest rate.

Profit on a fixed income investment, or bond, includes the interest you earn and perhaps a **capital gain** if you sell it prior to maturity for more than you paid originally. Inflation, on the other hand, is the bane of bond investing, because inflation eats into the purchasing power of the fixed interest payments that bonds make over time.

Two types of government bonds can help protect investors from the effects of inflation: I-Bonds and TIPS.

I-Bonds are inflation-adjusted U.S. Savings Bonds. They earn interest based on the combination of a fixed rate and an inflation rate that usually adjusts twice a year. You can earn interest for up to 30 years, and cash out the bonds after five years with no penalty. You can also redeem these bonds after one year, but you pay a penalty of three months' interest.

The interest I-Bonds earn will always equal the rate of inflation, so the amount you invested will never decrease.

An investor can purchase up to \$10,000 in I-Bonds in one year, and because of how the interest and principal are taxed, it's often preferable to hold these bonds in taxable accounts instead of **individual retirement accounts** or other accounts that defer the payment of taxes until the money is withdrawn.

TIPS are Treasury Inflation-Protected Securities, but they shouldn't be confused with conventional Treasury bonds. TIPS pay interest every six months at a fixed rate, but the principal invested in TIPS is adjusted to reflect the rate of inflation as measured by the

Consumer Price Index (CPI). The interest payments, then, vary with the adjusted principal. Higher inflation results in higher interest payments. In the event of deflation, the interest payment decreases.

TIPS are issued in terms of 5, 10, and 30 years. When a TIPS matures, an investor receives the adjusted principal or the original principal, whichever is greater. You can also buy TIPS in a mutual fund or ETF.

The interest rate paid by TIPS has been near rock bottom for years, just as yields from other Treasuries have been at historically low levels. The prospect of 1% annual interest may not interest a lot of investors, but because TIPS are indexed to inflation, they provide income and protection from inflation—a rare comfort for investors who are averse to risk.

TIPS are best held in tax-advantaged retirement plans because of the method used to tax their returns.

Bond mutual funds. You can also buy mutual funds or ETFs that invest in a portfolio of fixed income securities, including municipal or corporate bonds, Treasury bonds, or TIPS. Unlike individual bonds, however, a bond mutual fund doesn't guarantee a particular interest rate, mature on a specific date, or promise the repayment of your principal. Rather, its performance, and your income or potential profit or loss, reflects the collective performance of the bonds the fund owns.

The benefit of bond funds is the broad diversification within the bond market they provide. Many investors lack the capital, time or know-how to research and assemble their own diversified basket of individual bonds. Bond funds offer a solution. In addition, profits from the funds in the form of dividends can be automatically reinvested for investors who want to build their fixed-income stakes.

Generally, it's safer to invest in a bond mutual fund that owns many different types of bonds—such as corporate, U.S. Treasury or municipal—instead of buying a small number of individual bonds on your own. Investing in just a handful of individual bonds exposes you to greater risk that one of the entities that issued your bonds will run into financial trouble, endangering its ability to repay you.

Cash and Its Cousins

Cash is the coins jingling in your pocket, the paper currency folded in your wallet and the daily balances in your checking and savings accounts. A cash equivalent, on the other hand, is any short-term investment that's both highly liquid, meaning it can quickly be converted into actual cash, and safe, meaning there's minimal risk of a loss of **principal**. Investments considered cash equivalents include short-term bank certificates of deposit, U.S. Treasury bills and money market mutual funds.

As you begin to educate yourself as an investor, you may come across the old maxim that “cash is trash” because of the low interest rates cash and cash equivalents earn. Ignore it. There are many good reasons to hold cash or cash equivalents, the most important being that life never unfolds completely as planned. You should try to build a cash reserve to cover at least several months of expenses. You may lose your job or crash your car. You or a loved one may get hit with big out-of-pocket medical bills.

Aside from just serving as a bulwark against the vagaries of life, a healthy reserve of cash or its equivalents will help you sleep better at night during the inevitable periods of stock-market turmoil. In addition, a reserve provides the “dry powder” you can deploy in the wake of such periods, to swoop in and pick up bargain-priced investments that less far-sighted investors have dumped in a panic.

To be clear, the interest rate you earn on cash is low. The interest rate on cash equivalents is generally better but still might not exceed the rate of inflation in some periods. When it falls short of inflation, you’ll have a negative real return. A real return is return minus the impact of inflation. So if you earn a 2% return on your cash or cash equivalent investment and inflation is 3%, your real return is negative.

Cash on hand brings tangible benefits and peace of mind, but you also should be aware your reserve won’t garner much in the way of investment returns. Only you can determine how big of a reserve fund you’re comfortable with, but calculating your average expenses over a six-month period is a good way to start thinking about it.

Cash equivalents expose you to limited investment risk. Bank CDs are insured by the Federal Deposit Insurance Corporation (FDIC) if the institution issuing the CD is FDIC-insured. (The FDIC insures accounts in banks and savings and loan institutions for up to \$250,000 per depositor, and the National Credit Union Association does the same for depositors in credit unions. Different types of accounts, such as retirement, trust, individual, and joint accounts are insured separately.)

U.S. Treasury bills are backed by the full faith and credit of the U.S. government. Money market funds invest to maintain their value at \$1 per share but are usually not insured and the \$1 value is not guaranteed. That’s an important way these funds differ from bank money market accounts, which are FDIC-insured.

Real Estate

By investing in real estate, we don’t mean flipping houses or buying rental properties, or even making improvements to your own home. You can invest in commercial real estate—office buildings, apartment complexes, shopping malls, warehouses, or other developments—by buying shares of a publicly traded **Real Estate Investment Trust (REIT)**.

The more varied a REIT’s properties are, either by type or geography, the greater the protection it has against downturns in the real estate market. Owning shares in a REIT is a type of equity investment. But a REIT is different from individual stocks, stock mutual funds, or stock ETFs since it must distribute at least 90% of its taxable income to its shareholders. However, that income isn’t guaranteed and could be less than expected.

In addition, the return on a REIT is not necessarily correlated with the return on other equity investments. That’s because real estate stocks may respond differently to changes in the financial markets or the economy as a whole than the stocks of companies providing other products and services. For example, equities often lose value as inflation increases while REITs may gain value because the properties that REITs hold can raise rents as prices increase.

While a REIT has the potential to provide significant income, that income is taxed at a higher rate than the rate that applies to dividend income from most stocks. For that reason, many people choose to hold REIT investments in tax-deferred retirement accounts.

Investing Through Mutual Funds and ETFs

Mutual funds and ETFs are similar in that they both invest in a basket of underlying investments, in most cases concentrating on a single asset class. And there are mutual funds and ETFs that invest in just about every major asset class in the world, including domestic and international stocks and bonds, REITs, and commodities. As a result, they provide an opportunity to invest more widely than you could otherwise do by buying individual securities.

Mutual Funds	ETFs (Exchange Traded Funds)
<ul style="list-style-type: none">• Portfolio of securities selected to meet fund objective or that reflect index being tracked• Price determined by NAV (net asset value) at end of day• Shares in fund purchased from fund or through a broker or adviser• Fund must buy shares to accommodate shareholder redemptions, with potential tax consequences	<ul style="list-style-type: none">• Portfolio of securities that reflect index being tracked• Price determined by market trading throughout the day• Shares bought and sold like stocks through a broker or adviser• ETF does not redeem shares a shareholder wishes to sell, enhancing tax efficiency

Mutual Funds

A mutual fund is formed when an investment company creates a group, or family, of mutual funds. Each fund has a specific objective, such as providing long-term growth, current income, or sometimes a combination of the two.

Once a fund is created, it sells shares to investors. You may be able to purchase shares online or by contacting a company representative. Fund companies have made it a lot easier to buy shares this way. You may also buy shares through sales people at banks and brokerage firms or by participating in an employer-sponsored retirement savings plan that includes the fund as one of its investment options.

Mutual funds also make it easy to invest. Initial minimum investments are relatively low and you can make additional investments of \$50 or \$100 on a regular basis—or any time you want. A mutual fund will also buy back any shares you want to sell based on the fund's price at the close of the business day. The price is called the **net asset value**, or NAV. Regardless of profit or loss, it's easy to liquidate your shares.

Each fund pools the money it raises from its shareholders to make its investments. The more shares the fund sells, the more money it has to build a broadly diversified portfolio—much larger and more diversified than you as an individual investor could afford. The varied portfolio of some mutual funds makes them less risky than buying individual stocks and bonds.

For example, a “total U.S. stock market” fund typically holds shares in the thousands of companies publicly traded on the major stock exchanges. Or, a stock fund might focus on one sector of the market—say, large-company stocks, as represented by the S&P 500 Index—or it might invest primarily in smaller companies it expects to grow rapidly.

International stock funds hold equities in non-U.S. companies, either by owning companies in developed markets such as Germany, Japan, and Australia, or in emerging markets like India and Brazil.

A bond fund might own a particular category of bond, such as municipal bonds, or a variety of corporate or government debt. “Total bond market” funds typically own all those types of debt.

The diversified portfolio of some mutual funds makes them less risky than buying individual stocks and bonds.

Exchange Traded Funds

Exchange traded funds are a bit more turbocharged than mutual funds because you can trade them at any time the market is open. This feature is good for active trading of investments. Whether active trading is good for the typical investor is another question, since it requires close attention, and the cost of frequent trading can eat into your profits or increase your losses.

There are advantages to exchange traded funds. They allow you to diversify into different niches of the world markets, they’re relatively inexpensive to buy and own, and some companies allow you to trade ETFs without paying a commission. The structure of ETFs can also limit the distribution of taxable gains to shareholders.

ETFs combine several attractive attributes of mutual funds and stocks. Like an index mutual fund, an ETF holds a portfolio of underlying securities determined by an index to which the ETF is linked. For example, the ETF named SPDR S&P 500 holds all of the stocks in the S&P 500 Index. ETFs linked to indexes can make asset allocation easy and they provide transparency, which means that you always know what securities the ETF is holding.

If you’re seeking diversification in the U.S. stock market, it’s usually preferable to invest in an ETF that tracks a broad market, such as the S&P 500 or the Russell 2000, which is an index of approximately 2,000 small-market stocks. ETFs that focus on a very narrow market, such as a specific industry or country, can play a role in an already well-diversified portfolio.

Like stocks, ETFs are traded on the exchange where they are listed throughout the day. That's not the case with mutual funds, which change hands only once a day at the close of trading. Each ETF has a NAV, or net asset value, which is calculated each day based on the changing value of the bundle of securities it owns. However, an ETF's market price, like the price of a stock, is determined by supply and demand and other market forces. The NAV of a mutual fund, on the other hand, is the same as its price before the commission, if any, is added.

Investments Cost, But Some a Lot Less Than Others

You can't avoid fees altogether. The fees on some types of funds are generally higher than the fees on other types. The fees on funds that invest in small companies tend to be higher than the fees of funds that invest in large, well-known companies. That's because identifying appropriate small companies takes more time and research.

Similarly, the fees on international funds that invest in countries around the world tend to be higher than the fees on funds that invest exclusively in U.S. securities. However, it can be smart to own small-company and international funds to diversify your portfolio.

Actively Managed vs. Index Funds

The biggest debate in mutual fund investing, however, is between actively managed mutual funds and passively managed, or index, funds.

Types of Funds	
ACTIVELY MANAGED FUND	INDEX FUND
<ul style="list-style-type: none">• Manager invests to outperform a specific benchmark index (e.g. S&P 500)• Higher fees than index funds• Over time, most funds underperform their benchmarks	<ul style="list-style-type: none">• Fund invested to replicate performance of a specific benchmark index• Lower fees than actively managed funds• Over time, more consistent performance relative to their benchmarks than individual actively managed funds

An actively managed fund tries to provide a stronger return than the benchmark index for the type of investments it makes. For example, a fund that invests in large-company stocks typically wants to outperform the S&P 500 Index. The fund's manager and his or her team research companies, choose investments, and trade stocks to achieve high returns. That increases the fund's costs, which are passed on to shareholders as fees.

An index fund invests to replicate the performance of the index it tracks, not to beat it. If the fund tracks the S&P 500, for instance, it owns the 500 stocks in that index. If a stock drops out of the S&P 500, the index fund drops that stock as well and buys whichever stock replaces it. Similarly, if a fund tracks an index of small-company stocks, as does the Russell 2000, the fund drops and adds stocks as the underlying index changes.

An index fund, then, does not have to pay a manager to choose investments. And there are few trading costs because the portfolio changes only when the index changes. The result is much lower fees for the fund's shareholders.

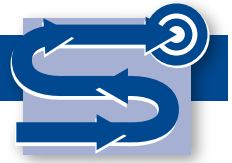
Index funds almost always provide stronger returns than actively managed funds over the long term, precisely because of their lower costs. The same is true of many ETFs, which tend to have lower fees than actively managed mutual funds, though you may pay a commission to buy or sell shares.

An actively managed fund might do significantly better than its benchmark in one or three or even five years, but it almost never does so consistently over the long term. One of the biggest traps investors fall into is picking an actively managed fund based on its recent track record of beating its index. Mutual funds that post stellar short-term returns rarely post such stellar returns over longer periods. In fact, funds that are the best performers one year usually fall from the top of the heap fairly quickly.

Since the performance of actively managed funds is inconsistent, investors should focus on the things that really matter to long-term performance—how much a fund charges in annual fees, transaction costs, and sales charges.

“*Index funds almost always provide stronger returns than actively managed funds over the long term, precisely because of their lower costs.*”

ESTABLISHING AN ACCOUNT



When you're ready to invest you can get started with a few simple steps. Contrary to what you may think, it's not that complicated. It may even be easier than figuring out your cable bill. But it will take some time and it does require some decisions on your part.

✓ **Step 1** is opening an account through which you'll purchase your investments. Mutual fund companies, banks, and brokerage firms offer a variety of investment accounts.

For retirement investing, many corporations and other businesses offer **401(k)** plans. Public sector organizations may offer **457** plans, and nonprofit organizations and schools, **403(b)** plans. If your employer doesn't offer a retirement plan, you can open an **Individual Retirement Account** and save for retirement on your own.

✓ **Step 2** is choosing investments, which may be your biggest challenge given the large number of investment products available. But you can start slowly, perhaps by opening an account at a mutual fund company and choosing a fund or two, and broadening your investment base from there.

✓ **Step 3**—reinvesting—is the easiest. As your investments provide earnings, you use that income to buy additional shares instead of spending the money. The reinvested amounts help build your account value. Since you can almost certainly reinvest automatically, especially with mutual funds, you won't miss the money you don't see.

✓ **Step 4** is continuing to invest, contributing new money to your account every month or quarter. One of the easiest and most effective ways to do that is by arranging for direct deposit from your paycheck, bank, or credit union account directly into your mutual fund or brokerage account.

If you're investing in an employer-sponsored plan that's available through your job, you defer a percentage of your salary each pay period. Once you get used to the idea, it's another easy way to invest without missing the money you don't see.

PRINCIPLES OF INVESTING

Investing is a balance between risk and return.

Return, in this context, means *investment return*, which is based on two things: change in investment value plus any earnings the investment produces. If you sell an investment for more than you paid for it, you'll have a gain, or positive return. But if you sell it for less than it cost you, you'll have a negative return, or loss.

Example	
You buy 100 shares @ \$20 per share	\$2,000
You sell 100 shares @ \$22 per share	\$2,200
Profit (\$2,200 - \$2,000)	= \$200
Company pays dividend of \$0.25 per share	+ \$ 25
RETURN (\$200 profit + \$25 dividend)	= \$225 (or 11.25%)

Of course, you could have had a negative return if the share price when you sold was less than \$20 a share.

The bottom line is that the higher your average annual return over time, the more likely you are to meet your financial goals.

Risk is the potential for losing money instead of making it, or making less than you had expected. Risk is also the possibility that the value of your return will be undermined by inflation, reducing your buying power.

Understanding the risk/return relationship is essential to making rational investment decisions. The more risk you're willing to take, the greater the potential for a substantial return, but also for experiencing a loss. On the other hand, if you take no risk, you'll have minimal return, if any.

For example, if you put \$1,000 in a five-year bank CD paying 2% compounded annual interest, your return will be \$104, giving you \$1,104. But if you bought shares of a stock mutual fund providing a 6% annual return, your return over the same five-year period would be \$338—more than triple the return from the CD—giving you a total of \$1,338.

“The bottom line is that the higher your average annual return over time, the more likely you are to meet your financial goals.”

While certain investments provide minimal return, the tradeoff is that they keep your principal safe. You can be confident that you'll be able to withdraw your \$1,000 investment in the CD at the end of the term. But at any point, your mutual fund could be worth far less than \$1,000. And if you sold it once it declined, you'd have a loss.

KEEP IN MIND



If you're rattled by the thought of losing money in a short period of time—with investing, five years is fairly short—then you may not be ready to invest. But keep in mind that it's entirely possible—though not guaranteed—that an investment that loses value at some point will regain its value over time and be worth substantially more than you invested. The longer you can hold onto your investments, the better your chances for success.

Investment Risk

The risk associated with investing typically fits into one of two categories: market risk or specific investment risk.

Market risk results from what's happening in the financial markets as a whole. If the economy is extraordinarily weak, as it was in 2008 and 2009, the markets can be extremely volatile—which means prices change dramatically over short periods of time. When that happens, investors tend to lose confidence in the markets and in investing in general. They stop making new investments and sell off the ones they own. This, in turn, helps to create a more severe downturn.

Investment risk, on the other hand, occurs when an individual investment loses value for one reason or another that's directly related to the investment itself.

For example, investment risk may result from poor management that reduces a company's earnings and drives its stock price down. Or sometimes a company crushes its competition by introducing a product that runs away with the market, reducing the value of the competitor's stock. Mutual funds, although generally not as risky as investing in individual stocks, can sharply decline in value if they hold stocks in one narrow sector of the market.

Investment Risk

May realize lower-than-expected returns

Fees and other costs may add up, reducing return

May lose some or all of your principal

Strategies to Manage Risk

While neither market nor investment risk can be entirely eliminated, there are strategies to help you manage the risks you face in investing. Three of the most effective are asset allocation, diversification, and cost control.

These strategies don't guarantee success or protect you from losses in a serious market downturn. But they can help you mitigate risk while maintaining the potential for a strong return.

Asset Allocation

Using asset allocation, you divide your investment principal among several different types of investments, or asset classes, on a percentage basis, rather than putting all of your proverbial eggs in one basket.

As we noted in **Part 2: Making Investments**, different asset classes—equities, fixed income, cash equivalents, and real estate—generally react differently to what's happening in the economy at any given time.

You can take advantage of this phenomenon by investing in several different asset classes at the same time.



Asset allocation lets you offset losses in one class with gains in another. There's no guarantee that comes with allocation—in a severe market downturn, all asset classes can decline sharply—but putting all your money into one asset class is much more likely to produce a major loss than spreading it across several classes. What's more, asset allocation helps you position your portfolio to take advantage of the ever-changing markets—not by investing all your money in this year's hot class, but by having some investments in every asset class every year.

If you invested only in large-company stocks in the decade of the 2000s, you would have posted an annualized return of negative -1% . (The decade's returns weren't helped by a whopping negative -37% return in 2008 alone—a free fall that had many panicky investors pressing the “sell” button near the *bottom* of the market.)

Balanced portfolios would have fared better during the same time period. A portfolio of 70% stocks and 30% bonds would have produced an annualized return of 2.1%, and a 50/50 stock-bond split would have returned 3.9%. Those are modest returns, but they are in positive territory and at or above the inflation rate at the time.

A long time horizon is important for investing because returns from all asset classes can vary widely.

There's no allocation that's right for everyone or that works perfectly in every market environment. But a handful of mutual funds that invest in different asset classes provide adequate diversification so that when one part of your portfolio falls in value it doesn't sink the ship. Once you consider the following factors and open an account with a mutual fund company or brokerage, it's easy to find the funds you need to start building your portfolio.

Factors to Consider in Making Investment Decisions

- **The length of time you have to achieve the different goals for which you're investing.** Investing for a mortgage you'll start to pay in five years is a lot different from investing for a retirement that will start in 30 years.
- **The amount of risk you are comfortable taking.** Even if you expect to work 30 or more years before retirement, you may not be able to stomach the risk that exists even in a diversified portfolio. "Sleeping well" was the investment criterion of the late Paul Samuelson, American's first Nobel laureate in economics.
- **Other investments or expected sources of income.** This includes Social Security, which provides lifetime benefits and therefore represents a significant financial asset for most Americans. You may also have earned a pension, or have a small business or income from family business interests. The amount of these assets can greatly influence the amount of risk you feel comfortable taking.

Diversification

Asset allocation helps you manage market risk. You can help manage investment risk by diversifying, or investing in several investments within each subclass of an asset class. For example, a large-company stock and a small-company stock are both equities, but belong to different subclasses.

Asset subclasses tend to differ from each other in some important ways, though they all share the core characteristics of their class. For instance, a large-company stock and a small-company stock tend to increase in value at different rates, react differently to changes in the economy, and expose you to different levels of investment risk.

Similarly, bonds have different **terms**, different **ratings**, and different interest rates. They also have different issuers: the U.S. Treasury, various cities and states, and corporations large and small.

It may be easier to understand diversification by understanding what it's not:

- You're *not* diversified if you own just a handful of stocks, or shares of a mutual fund that is concentrated in the financial sector or some other specialized corner of the market.
- You're *not* diversified if the only bonds you own are issued by the state in which you live or by the same U.S. government agency.

But your equity portfolio is diversified if you own three or four mutual funds that make different types of investments. For example, you can create a diversified portfolio with three low-cost index funds: the S&P 500, which tracks 500 large-company U.S. stocks, the Russell 2000, which tracks 2,000 small-company U.S. stocks, and the MSCI-EAFE, which tracks major large and mid-cap international stocks in 21 developed countries around the world, excluding the United States and Canada. And your fixed income portfolio is diversified if you own some corporate bonds, some municipal bonds, and some Treasury bonds.

Reallocating and Rebalancing

The old adage that the only constant in life is change certainly applies to investing. Once you've carefully allocated your investment portfolio across diverse asset classes, you've taken a big step toward gaining some control over your financial future. But you're not finished. Two concepts are extremely important to keep in mind: **reallocation** and **rebalancing**. You should embrace both.

Reallocation is merely the process of adjusting your asset allocation as your circumstances change. The allocation you picked as a single 25-year-old is likely too aggressive when you're 50 and facing the prospect of sending a kid to college. You may want to trim the amount you have in equities and other more risky investments, and beef up on safer fixed income and cash equivalents.

Regardless, you should periodically take stock of your financial goals and life circumstances, and then reallocate your portfolio accordingly.

Rebalancing, meanwhile, is the more regular process of adjusting your portfolio to account for swings in the financial markets. If one asset class has been doing either particularly well or particularly poorly over the past six months or year, it likely has skewed your portfolio away from your preferred allocation.

For instance, if you opt for an allocation of 60% equities and 40% bonds for your portfolio, over time the markets will skew that allocation. Stock market gains may increase your equity holdings to 70% and negative factors affecting the bond market may reduce your bond holdings to 30%. In that case, you should consider selling stocks and buying bonds in order to rebalance your portfolio back to your targeted percentages.

Alternatively, you could simply designate all of your new investment money to bonds until you have restored your 60%/40% balance. The benefits of rebalancing are significant. For one, the process helps provide you with the framework and discipline to sell high and buy low. In the above example, rebalancing by selling some of your booming equities stake will force you to lock in solid stock market gains.

If you rebalance by buying more of an asset class after it slumps, you'll lower your average cost in the investment and potentially set yourself up for future gains.

Rebalancing is also important because it restores your investment portfolio to the level of risk you decided you were comfortable with when you first established your asset allocation. In general, you should consider rebalancing when your allocation drifts about 10% from your targets.

There are many factors to think about when you begin investing and are deciding on an initial allocation for your portfolio. How old are you? How long will it be before you retire? What are your financial obligations, such as debt and dependents? What is your risk tolerance—meaning, how would you react if a market downturn sapped a large percentage of your investment assets? If the answer contains the word “panic,” you may want to stick mainly to safer investments, such as fixed income, and go easy on equities.

Portfolio Examples

It might be helpful to review the long-term returns of some established portfolios that substantial numbers of investors use as a starting point—but only a starting point—for deciding how to allocate their assets. The portfolios use between two and four mutual funds, making them easy to assemble. Investing, after all, doesn't have to be as complicated as putting together something from IKEA.

The returns are *real returns*, meaning they are adjusted for the rate of inflation. If a mutual fund returns, say, 8% in a year, and inflation during that time was 2%, the real return is 6%. Real returns give you the most accurate picture of what your investments are truly earning.

Allocation Using Low-Cost Mutual Funds	Annualized Returns 1970 – 2017
Classic 60/40 Split	
60% Total U.S. Stock Market	5.9%
40% Total U.S. Bond Market	
<i>Covering the waterfront with one mutual fund that invests in all U.S. stocks—approximately 3,500—and one that invests in the different types of bonds issued in the United States.</i>	
Three-Fund	
40% Total Stock Market	5.9%
20% Total International Stock Market	
40% Total Bond Market	
<i>Almost as simple as the 60/40, adding an index fund that holds shares in approximately 5,800 stocks of international companies in both developed and emerging markets.</i>	
William Bernstein (investment adviser and author)	
25% Large-Company Stocks	6.6%
25% Small-Company Stocks	
25% Developed International Stocks	
25% Short-Term Treasuries	
<i>Small-company stocks have over time done significantly better than large-company stocks, although they tend to be more volatile. Index funds in this asset class generally hold shares in about 1,500 companies.</i>	
Rick Ferri Core Four (investment adviser and author)	
48% Total Stock Market	6.9%
24% Total International Stocks	
20% Total Bond Market	
8% Real Estate Investments Trusts (REITs)	
<i>Adds REITs to the mix to invest in the nearly \$1 trillion U.S. commercial real estate market. A mutual fund usually holds shares in 150 or more REITs, a small percentage of the overall REIT market.</i>	

SOURCE: PortfolioCharts.com/portfolios. Returns assume the portfolio is rebalanced annually.

Now let's take a look at some investors of different ages, temperaments and experiences to see how they decide to allocate their portfolios:

Hannah, Single, 28

First, three cheers for Hannah, a 20-something who's saving for a retirement that may not begin for 40 years (no doubt a cheery thought for her fellow millennials). She is the assistant manager of a big-city catering company, and the job has room for advancement, but catering itself isn't an inherently stable business. Still, she wants to save regularly when her finances allow it, and she plans to invest some of her money to reap a potentially higher rate of return. Her minimal student loans are nearly paid off, and she has a small emergency savings account.

Hannah is a busy person, so she'd like to keep it simple. She's cost-conscious in her personal life and sees no reason to operate any other way as an investor. Index funds are just the ticket for Hannah. She opts to invest in just three—one tracking the domestic U.S. stock market, one tracking developed international markets, and one tracking the total U.S. bond market—that together provide all the diversification she needs at extremely low costs.

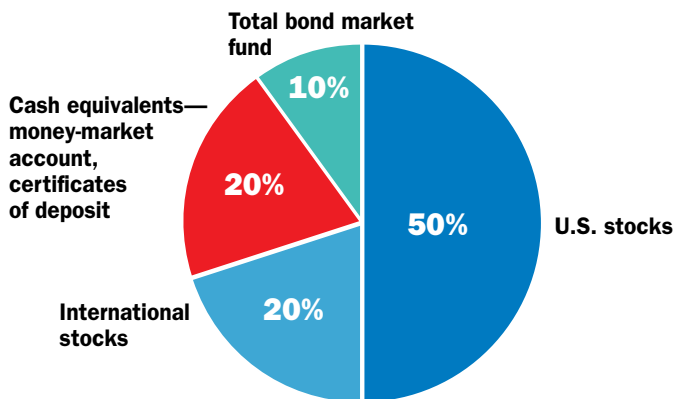
Since she's young and has plenty of time to ride out market downturns, Hannah chooses a relatively aggressive initial allocation, putting 50% of her assets in the domestic stock fund, 20% in the international stock fund and 10% in the bond fund.

But that's just her retirement portfolio. Because her job is a bit unstable and she wants to maintain a significant emergency cushion, she decides to keep 20% of her assets in non-retirement accounts, putting the money in money-market funds and short-term certificates of deposit.

Hannah's initial allocation probably will result in a higher rate of return over the long haul than if she reversed the percentages to focus more on fixed income. She's also smart to continue bolstering her emergency reserve.

But Hannah knows that as she gets older and her circumstances change, she'll have to revisit her allocation. As she nears 50, Hannah may focus more on safety, trimming holdings in the two equities index funds and beefing up her stake in the bond fund.

Regardless, every few quarters she definitely plans to rebalance her portfolio to return it to her targeted percentages, which will ensure she takes maximum benefit of market movements as the years go by.



Rich and Elizabeth, Married, Late 30s

Rich and Elizabeth are in their late 30s with two children in elementary school. Money isn't a problem. Rich is a firefighter—a job with a potentially lucrative pension—and Elizabeth is a well-compensated manager at an established and expanding healthcare technology company.

Like many couples, investment decisions are, unfortunately, driven by one person. In this case, it's Elizabeth, who is a big believer—maybe too big—in tech-oriented companies like her own. Rich, by contrast, doesn't exactly place a premium on long-term planning of any kind.

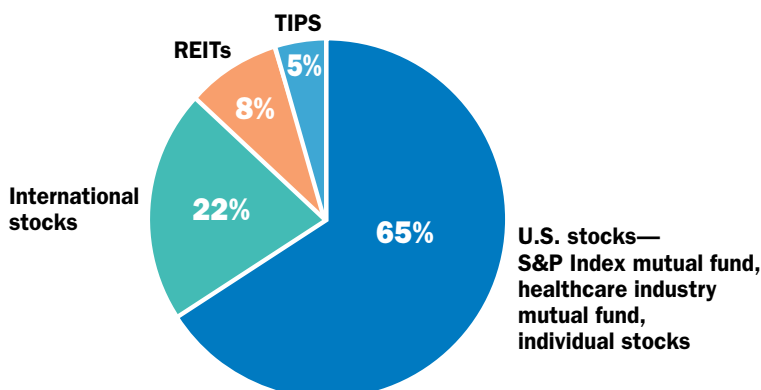
For Elizabeth, the perceived stability of her and Rich's jobs and earnings potential figures heavily in her investment choices, and she opts for an aggressive asset allocation. In addition, her belief in demand for healthcare services has spurred her to invest in several companies in those markets, as well as in an actively managed stock fund that focuses on healthcare.

The problem is that Elizabeth invested in a mutual fund whose fee is three times higher than comparable funds, eating into Rich and Elizabeth's returns and leaving them less money invested for the long term.

Elizabeth has added some ballast to the portfolio by including Treasuries and Treasury Inflation-Protected Securities in her fixed-income allocation. Due to her father's work in commercial real estate, she feels she knows enough to take a small position in a mutual fund holding shares of **real estate investment trusts**, a large sector of the economy many general investors don't put into their portfolios.

Rich and Elizabeth's relatively heavy investment in equities raises the question of how they will react to inevitable stock-market downturns. If Elizabeth panics, she may end up selling at low prices and locking in those losses. Rich took no interest in assembling their portfolio, but he may be surprised and angry—not justifiably, mind you—to find out how much their portfolio has shrunk.

Remember, the stock market lost half its value in 2007-2008, so in the short term there is always the potential for massive losses on paper. But if an investor is diversified and believes in his or her asset allocation, a market downturn presents an opportunity to buy an asset—stocks, for example—at a discount. Investors who sell in a panic have usually overestimated their risk tolerance to begin with.



Don and Rosa, Married, Early 50s

It's not unusual for investors to have more than a single goal in mind. Sure, it's a priority for them to build the assets they'll need for a comfortable retirement, but they'd also like to generate some investment returns to help with tight present-day finances.

Don and Rosa are in that camp. The couple is helping foot the bill for two children in college. Don, who struggled financially to finish college, is determined to pay as much of their kids' college costs as possible. He and Rosa also worry about ever-increasing healthcare expenses—Don's father was in poor health for years before he died—and they face another 10 years of mortgage payments on their house.

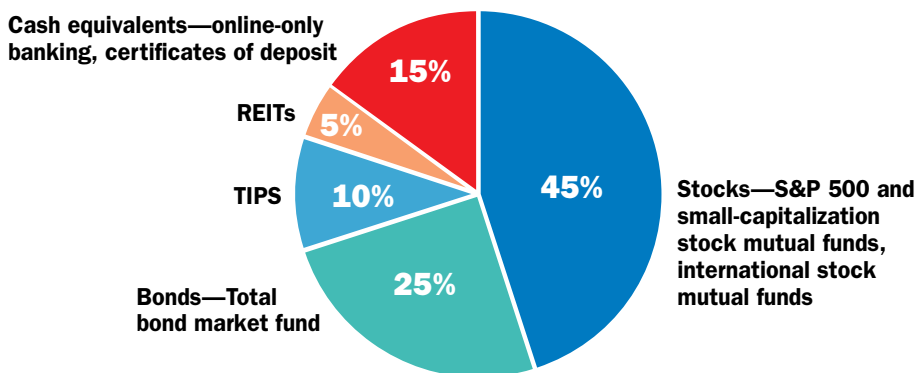
Don is an athletic director and history teacher at a private high school that offers a 403(b) plan, not a pension. Rosa is a manager at a “green building” construction company with a 401(k) plan.

They need their investment portfolio to generate current income, even as they recognize the importance of growing their retirement nest egg. They opt for an allocation that's relatively heavy on bonds, held through a total bond market mutual fund, and cash equivalents. The latter category includes an online bank account that pays more in interest than a money market account would. They can tap these assets for the cash they need and may not have to sell equities at a loss to help pay present-day expenses if the stock market takes a downturn.

They have 10% of their portfolio in TIPS, which aren't producing much of a return but offer a bulwark against inflation. But Don and Rosa are wise not to eschew equities entirely, particularly in their retirement accounts. Retirement is at least 15 years away, so they probably have time to ride out short-term market volatility.

Over the long term, the stock market has significantly outperformed either bonds or cash. Keeping a healthy percentage of their retirement portfolio in equities, such as a total U.S. stock market index fund, could boost their returns and make the difference between their having adequate income in retirement and finding themselves short.

Rebalancing will likely be in order as Don and Rosa finishing paying college costs, start to pin down their retirement plans, and estimate whether their retirement income—not just retirement plans, but Social Security and other sources—is adequate.



Juan, Single, 70

Juan retired from a Washington, D.C., trade association five years ago, returned home to Texas, and has been collecting a monthly, lifetime annuity from his corporate pension. The annuity payment is modest because he only worked for the trade group for the last 13 years of his career.

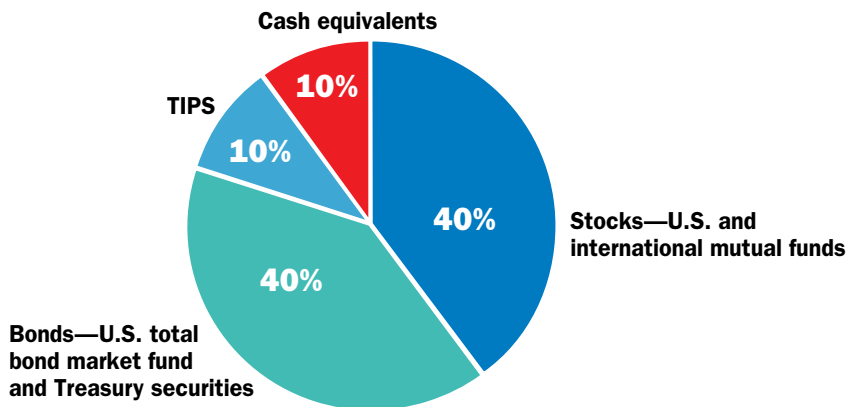
Juan's full retirement age for Social Security benefits was 66. To maximize the amount he receives from Social Security, he waited until he was 68½ years old to start receiving benefits. The delay means Juan is receiving 120% of the benefit he would have received at age 66.

Juan rolled over his 401(k) plans from his most recent job, and previous employment at newspapers, into an individual retirement account (IRA). He does a small amount of work as a freelance writer and photographer, giving him four sources of income—unusual for a retiree.

Juan's pension and Social Security income are fixed payments that will be made over his lifetime, so he could allocate the assets in his IRA any number of ways. For example, he could take a relatively large amount of risk by investing most of his portfolio in equities.

Juan, however, very much wants to minimize the chances of a big hit to part of his retirement funds. He keeps a reserve of cash or cash equivalents—a money-market account or a short-term bond fund—for easy access. Cash on hand feeds Juan's travel habit and allows him to help out his nieces and nephews with college and other expenses.

At this stage of his life, Juan prefers financial safety over the potential gains (and losses) that could come by investing aggressively. Still, low interest rates means Juan isn't earning much on his bonds and cash, which make up 50% of his portfolio. If inflation ticks up, he could even be faced with a negative real return on some of those assets. Juan may want to consider holding on to his inflation-protected TIPS and slightly increasing his allocation to equities to seek a higher return, and more money, for retirement expenses.



The above examples are based on investment decisions made by real people, but they aren't intended to be strict guidelines. There is no allocation that's right for every unmarried 20-something, or that every middle-aged couple with children in college should adhere to. Juan, for instance, is a risk-averse 70-year-old who'd rather spend his time traveling and helping out family members than monitoring the daily fluctuations of the stock market.

Your asset allocation is a personal decision that depends on many factors unique to your financial situation, your family circumstances and your temperament. Don't allow yourself to be pushed into something that you don't understand or that exceeds your tolerance for risk.

What's right for your brother-in-law, or for someone selling financial products, may not be right for you. There's nothing wrong with listening to someone's opinion, but ultimately you must do your own research and make your own decisions.

The same goes for the myriad online tools that promise to produce your optimum portfolio allocation once you've answered a couple of dozen questions. They can be fun to play around with, but they're not a substitute for understanding your own financial goals and temperament.

Investors of any age should **rebalance** their portfolio if any asset class has done particularly well or particularly poorly over a year or two. That's because the allocation you have chosen will probably have shifted—say away from 60% equities and 40% bonds to one that either increases or decreases the level of risk to which you're exposed. The goal of rebalancing is to restore the allocation you had selected.

If stocks had lost value, for example, and shrunk to less than 60% of the total, you might want to allocate any new investment money exclusively to stocks until you had restored the 60%/40% balance. (Rebalancing among several asset classes requires additional calculations, but the math is the same.)

Rebalancing isn't easy on the psyche—everyone wants to stay with a winner. Yet selling holdings that have soared in value and buying assets whose prices have declined is one way to bring your portfolio back into balance. Another approach is changing the way you allocate your new investment money, putting most if not all into the asset class that has lost value until you have restored your portfolio to the allocation you've chosen.

“ *Investors of any age should **rebalance** their portfolio if any asset class has done particularly well or particularly poorly over a year or two.* ”

Target Date Funds

If allocating assets, and rebalancing and reallocating your portfolio, seems complicated, or you've never rebalanced or reallocated the investment accounts you have, you may want to consider a target date fund (TDF).

If you contribute to a retirement plan at work, you probably have that option since employers are rapidly adding target date funds to their 401(k) investment choices. You can also select these funds for a college savings account, an individual retirement account (IRA), or a taxable investment account.

An investor selects a TDF pegged to his or her expected year of retirement or the year in which a child goes to college. If the expected year of retirement is 2040, for example, the

investor would select a 2040 TDF. The fund starts with a portfolio mostly in stocks and then shifts over time to increase the percentage of fixed income. In theory, the fund becomes less risky as retirement or college entrance approaches. The pace and timing of the reallocation is known as the fund's **glide path**—a reassuring term that implies a smooth landing.

Target date funds have a lot of advantages, and they are promoted, with some justification, as one-stop shopping for investors who are perplexed by what can seem like an overly complex financial marketplace. But they also expose you to potential risks, as all investments do.

Funds that share a target date—a 2040 retirement fund, for example—can have different allocations and different glide paths. So, in choosing a target date fund, it's important for investors to determine whether the allocation is appropriate for their goals and their tolerance for risk, rather than just picking one based on a certain year.

As with mutual funds in general, some target date funds cost more—a lot more—than others, resulting in a big difference in the returns they pay.

Many investors also have dangerous misconceptions about target date funds. A survey conducted for the Securities and Exchange Commission in 2012 found that nearly half of target date fund owners didn't understand that the funds *do not guarantee income* in retirement. These investors didn't realize that TDFs are just funds that invest in other mutual funds. That means all the risks of mutual funds are built into target date funds as well.

“Study after study has shown there is absolutely no evidence that higher-cost investments produce superior returns. In fact, the opposite is often true.”

The Impact of Fees

In addition to market risk and investment risk, you have to consider what you pay to buy and own investments, since these costs directly reduce your investment return.

Some investment costs are unavoidable. It costs money to handle transactions. It costs mutual funds to manage their funds. It costs brokers to maintain their offices and websites and provide research about investments. But there are ways you can avoid paying more than necessary:

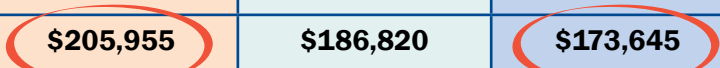
- When investing in a mutual fund, always check its **expense ratio**. To pay for its operating and marketing expenses, a fund annually charges a percentage of your account balance. If the expense ratio is 1%, for example, you will pay \$150 on an account value of \$15,000. The fund may also impose sales charges, called **loads**, which aren't included in the expense ratio. Both are published in a fund's **prospectus** and on the fund company's website. Many fund companies will sell you shares in their funds directly, with no sales charge. The point is to choose the least expensive of comparably rated funds.
- Choose lower-cost investment accounts. You might open an online brokerage account, where commissions can run less than \$10 per transaction. With this type of account, though, you may have to do more work on your own to identify investments and choose the right times to buy and sell since your broker will not be making suggestions.

The Impact of Fees

Assume you invest \$10,000 in a tax-deferred account, make monthly contributions of \$250 for 25 years, and realize an annual 6% rate of return. Also assume for this example that no taxes are being paid.

The theoretical total you would accumulate is \$212,813. However, the actual amount you end up with will depend on the investment fees and expenses charged by the fund in which you invest, as illustrated by the following fund choices.

	Fund 1	Fund 2	Fund 3
Value before fees and expenses	\$212,813	\$212,813	\$212,813
Expense ratio	0.2%	0.8%	1.2%
Upfront sales charge	None	None	4.75%
Effect of fees and expenses	-\$6,858	-\$25,993	-\$39,168
Actual value	\$205,955	\$186,820	\$173,645



In this example, if you invested in Fund 1 you would end up with \$205,955. But if you had invested in Fund 3, you'd have only \$173,645. That's a difference of \$32,310—a tidy amount that's better in your pocket than adding to a fund's revenues.

As you can see, the impact of fees and sales charges on your mutual fund investment return can be substantial.

Despite what you might think, and what a high-priced fund manager might tell you, study after study has shown there is absolutely no evidence that higher-cost investments produce superior returns. In fact, the opposite is true.

Keep in mind that the cost of investing doesn't stop with the expenses charged by the mutual funds themselves. If you invest in mutual funds and stocks through a brokerage account, you will likely pay commissions for trading securities and you could pay additional fees for account maintenance or failing to keep a minimum balance.

You have no control over many investment variables—the direction of the market, the rate of inflation, or the tax rate on your earnings. But you do have control over one of the most critical variables—what you pay to buy and own your investments.

The lesson is clear: The higher a fund's expense ratio and the more you pay in sales charges, commissions, and other fees, the smaller your return will be. Every dollar counts when maximizing your investment return.

INVESTING FOR A SECURE RETIREMENT

When you start thinking about retirement, one of the first things to consider is what it will cost you to live comfortably. That gives you a basis for determining the income you'll need.

Some things will probably cost less when you retire: You won't be commuting. Your mortgage may be paid off, or nearly so. Your children may be college graduates with jobs, not living in their old rooms. There may be other expenses that will drop as well.

On the other hand, certain things will probably cost more. Health insurance and out-of-pocket healthcare costs top the list. Real estate taxes and property insurance may go up. You may want to spend more on travel, hobbies, or other things you've been waiting to do until you had more time.

And you'll still be spending money on food, clothing, and other necessities.

The consensus is that in retirement you'll need at least 70% of your last working year's income to maintain your lifestyle after retirement. You will probably need more if you're single or the primary breadwinner in your family.

Inflation is a primary factor: Your costs will increase over time, some faster than others. Each year that you're retired you're likely to need more income than the year before.

Six Primary Sources of Retirement Income

- A **pension** from a private company or public organization
- Social Security benefits
- An annuity—a contract between you and an insurance company—that provides guaranteed income for a certain period of time
- Income from tax-sheltered retirement accounts to which you have contributed over the years—these include an employer-sponsored **401(k)**, **457**, or **403(b)** plan, and an **individual retirement account** (IRA)
- Income from taxable investment accounts
- Income from a post-retirement job

If you're concerned that you've gotten off to a late start in building your retirement assets, there are ways to catch up. The good times begin when you turn 50 because you can save more in a traditional or Roth IRA as well as in a 401(k) or similar plan offered by your employer.

Retirement Accounts

Any investment we have discussed so far—stock, bond, mutual fund, ETF—becomes a retirement investment when you own it in a retirement account. A retirement account may, in turn, be part of a broader retirement plan, such as the one sponsored by your employer.

For example, you can make retirement investments through an account in an employer-sponsored retirement savings plan, such as a 401(k), which is open to all eligible employees. If you participate, there is an account in your name in the plan. The money you put into the account is always yours, not the company's. You contribute to your account by deferring part of your salary and you can allocate the money to any of the investments available through the plan—typically mutual funds.

Similarly, you may make investments through an IRA that you open with a brokerage firm, bank, or mutual fund company that serves as a custodian of the account. The custodian keeps track of your account, sends you regular statements, and follows your instructions for investing your contributions. In fact, the types of retirement investments you want to make are an important factor in choosing where you open your IRA. You will want a custodian that offers the range of investments you're considering for your retirement portfolio.

Since investments themselves don't distinguish a retirement account from a non-retirement account, what does? It's the way that earnings in the accounts—and sometimes the contributions made to them—are taxed.

In a taxable account, income tax is due on all earnings in the year you receive them, although different types of investment income are taxed at different rates. If you collect \$100 in interest payments in a year, that \$100 is added to your other ordinary income, including salary or wages, when you file your return for that year and is taxed at the same rate.

Long-term capital gains and qualified dividends are also taxed in the year you receive them, though at your lower, **long-term capital gains tax rate**. Interest on certain municipal bonds is tax free.

In contrast, with a **tax-deferred retirement account**, such as a 401(k) or an IRA, income tax is not due on your investment earnings until you withdraw them from the account—typically over a period of years after you retire. If the contributions to the account were tax-deferred at the time you made them, as they would be with a 401(k) or an IRA for which you were eligible to deduct your contribution, tax is due on the full amount of every withdrawal, not just on the earnings.

The tax rate that applies to these withdrawals is the rate you pay on your ordinary income, though your rate in retirement may be lower than it was when you were working if your overall income is less.

*With a **tax-deferred retirement account**, such as a 401(k) or an IRA, income tax is not due on your investment earnings until you withdraw them from the account.*

Pension Plans

The amount you'll receive in pension payments depends on the years you worked, the compensation you received, and other provisions that are specific to your company's plan. You should check with your Human Resources department well in advance of your retirement about the plan details, including payout options and other decisions.

Social Security

If you have worked and contributed to Social Security, you can expect to receive benefits when you retire. How much you will receive depends on a number of factors, such as the number of years you participated, the amount you paid in to Social Security, and the age at which you start to collect.

As a rule, the longer you wait to begin collecting benefits, the higher your monthly payments. For people born in 1960 or later, 67 is considered full retirement age—the age when you start to collect full benefits. For people born between 1943 and 1954, the full retirement age is 66. For people born from 1955 through 1959, the age increases in two-month increments, from 66 and 2 months to 66 and 10 months.

Each year you wait until age 70, the bigger your benefit will be. If someone who is currently 62 waits until the full retirement age of 67 to claim benefits, he will receive a monthly benefit that is nearly 40% higher. If he waits until 70, the monthly benefit increases by another 25%. If you decide to take payments *before* the full retirement age, however, which you can do as early as age 62, your benefit amount will be permanently reduced based on your age when you began.

To help you determine at what age you should start taking your Social Security benefits, check the Retirement Estimator calculator and other information at www.socialsecurity.gov. You should also consult more comprehensive information about maximizing benefits. The Center for Retirement Research at Boston College (crr.bc.edu) publishes *The Social Security Claiming Guide*, and an increasing number of mutual fund companies and financial services firms offer free benefits estimators.

Annuities

Another possible source of retirement income is an annuity, which is an insurance company contract intended to provide regular income payments, often for your lifetime. There are essentially two types of annuities:

- An immediate annuity can convert a sum of cash into a steady stream of income. You typically pay for an immediate annuity with a single, upfront payment before the payout phase begins.
- A deferred annuity is typically purchased by paying premiums to the issuing company during your working years. The accumulated value of your account provides a source of regular income after you retire. Any earnings in your account are tax deferred until you start withdrawals.

KEEP IN MIND



If you're planning to purchase an annuity, you should speak with a knowledgeable, reliable financial professional to help you make appropriate decisions about annuities for your financial situation.

In Texas, annuities are generally regulated by the Texas Department of Insurance. Investors interested in annuities should at a minimum consult the TDI consumer guide "[Understanding Annuities](#)".

Annuities are complicated products with many different features and fees. While advocates point to the regular income that annuities guaranty, critics maintain that the costs eat into the benefits they provide. And there's always the risk that the company providing the annuity will be unable to meet its financial obligation to its contract holders.

401(k) Plans

When you participate in a 401(k) plan, you defer pre-tax earnings to your account every pay period, typically by designating a percentage of what you earn. The deferred earnings aren't included in the gross income your employer reports to the IRS, so contributing to a 401(k) actually reduces the income tax you owe for the year.

There is an annual cap on 401(k) contributions imposed by the federal government. The limit is \$19,000 in 2019, plus a "catch up" contribution of \$6,000 if you are 50 or older. You can usually contribute any amount up to the "max out" limit.

Since the salary deferral is handled automatically, making the contribution is easy—at least when you get used to the idea of trading off a bit less in your paycheck for more retirement savings for the future.

The harder part is selecting the investments for your account. Most employers provide a number of investment options, which are typically mutual funds or **annuities**, but may also include company stock. It's generally your responsibility to select from among those choices, which requires taking into account your investment strategy and the level of risk you are comfortable with.

There are compelling reasons to contribute to a 401(k) plan, but a few downsides to consider as well.

On the plus side, your employer may match a percentage of the money you contribute, perhaps even dollar for dollar, up to a certain limit. That's free money—always a good thing. There are also several other positive factors to consider:

- Your contributions reduce your current taxable income and the income tax you owe.
- Investing regularly helps you build your account balance.
- Tax deferral on your contributions and earnings allows your savings to compound faster than they would in a taxable account since you don't have to withdraw money to pay taxes.

In addition, 401(k) plans allow the highest contributions you're eligible to make to a retirement savings plan. That's a major selling point, especially if you can afford to contribute the maximum.

On the negative side, your employer-sponsored plan may offer you investment choices that run from mediocre to lousy, or choices so limited you can't properly allocate your assets. Equally bad, the fees and other charges it costs to own the investments may be high.

Individual Retirement Accounts		
IRAs	TRADITIONAL IRAs	ROTH IRAs
<ul style="list-style-type: none"> • Open to anyone with earned income • Tax-deferred earnings • You choose from available investments offered through custodians, who may be: <ul style="list-style-type: none"> • Banks • Mutual funds • Brokerage firms • Annual limit on contributions, with catch-up 	<ul style="list-style-type: none"> • Contribution may be deductible <ul style="list-style-type: none"> • Qualify based on your income (MAGI) • Reduces current taxable income • Both contributions and earnings taxed at withdrawal • Withdrawals mandatory after 70½ • No contributions permitted after 70½ 	<ul style="list-style-type: none"> • Eligibility to contribute based on MAGI • Contributions never deductible • Withdrawals never required and contributions after 70½ permitted • Earnings can be withdrawn income tax free if: <ul style="list-style-type: none"> • You're at least 59½ • Account has been open 5+ years

IRAs

If you receive a salary, wages, commissions, or other income for work that you do, you can contribute to an individual retirement account, or IRA. What you may not realize is that you can contribute to an IRA in addition to participating in a 401(k) or other employer-sponsored retirement plan. Or you can choose an IRA instead of those plans.

With an IRA, earnings in your account are tax deferred, and no tax is due as those earnings compound. You choose your own custodian—a mutual fund company, bank, credit union, brokerage firm, or other financial services company—and then select investments from among those the custodian makes available. If you invest with a mutual fund company, you will likely have more choices than a typical employer provides through a 401(k). You can buy and sell as often as you like without tax consequences, though you will pay trading costs.

Like employer-sponsored plans, IRAs have an annual contribution limit: In 2019 it is \$6,000. And like a 401(k), there is a catch-up provision—in this case, \$1,000, for a total contribution limit of \$6,500 if you are 50 or older.

You can make catch-up contributions from age 50 to age 70½, time enough to make up a lot of ground in saving for retirement. For example, if you had saved nothing for retirement up to age 50 but then contributed \$5,500 per year, which was the standard limit, until 2019 and earned a 6% annualized return, you would have accumulated \$135,700 by age 65. If you added a \$1,000 catch-up contribution every year from age 50 to 65, and earned the same rate of return, you would have accumulated \$160,371.

Traditional IRA

In a traditional IRA, your earnings aren't taxed until you withdraw them from your account, usually after you retire. If you are at least 59½, there is no penalty for taking the money out, even if you are still working.

You may qualify to deduct your contribution to an IRA based on your **modified adjusted gross income (MAGI)**. In 2019 you can deduct up to \$6,000 if you file as a single taxpayer or as a head of household and your MAGI is less than \$64,000. If your MAGI is between \$64,000 and \$74,000, you can deduct a gradually decreasing percentage, until your eligibility phases out with a MAGI over \$74,000. If you're married and file a joint return, you qualify for a full deduction up to a MAGI of \$103,000, with gradually phased out eligibility until your MAGI reaches \$123,000. Above that amount, you don't qualify to deduct.

You may also be eligible to deduct your contribution despite your MAGI if you are not covered by a retirement plan at work. However, there are limits if you're married, file a joint return, and your spouse is covered by a plan at work.

In years that you qualify, taking a deduction for your IRA contributions will reduce your taxable income. But remember, those contributions will be taxable, along with your IRA earnings, when you begin making withdrawals.

With a traditional IRA, you must begin to take **required minimum distributions (RMDs)** when you reach 70½, whether or not you need the money. You must also stop making IRA contributions at that age, even if you continue to earn income.

Roth IRA

A Roth IRA has the same contribution limits and provides the same tax-deferred earnings as a traditional IRA. But there are significant differences between the two.

With a Roth, you are not required to start making withdrawals at 70½ as you are with a traditional IRA. You can also continue to contribute as long as you have earned income, even if you're in your 90s.

Even better news is that you can withdraw your earnings tax free if you're at least 59½ and your account has been open at least five years. That's because your contributions to a Roth IRA are never deductible. They're always made with **after-tax income**.

There are eligibility requirements for contributing to a Roth IRA, based on your MAGI. In 2019 as a single taxpayer you're qualified to make a full contribution if your MAGI is less than \$122,000, and to make an increasingly smaller contribution until your MAGI reaches \$137,000. The comparable limits if you're married and filing a joint return are \$193,000 and \$203,000.



Saving for retirement, like everything in investing, is a matter of choice.



Employer Plan or IRA

Saving for retirement, like everything in investing, is a matter of choice. You can choose to participate in a workplace plan such as a 401(k), or you can forgo the employer-sponsored plan and simply establish an IRA, either traditional or Roth.

An IRA is likely to have more investment choices than a 401(k), 403(b), or 457 plan, and IRA fees may be lower, based in large part on the investments you choose. And while traditional IRAs, like a 401(k), 403(b), or 457 plan, may require you to take withdrawals after you turn 70½, you may have more control over managing how you take those withdrawals with an IRA than you do with an employer-sponsored plan.

On the other hand, employer-sponsored plans have much higher contribution limits, which allow you to build your retirement savings faster if you can contribute more than the cap on IRA contributions. Investing is probably easier with an employer-sponsored plan as well since all you need to do is sign up. Your contributions are automatically withheld from your pay and deposited directly into the investments you have chosen.

You have to do a little more upfront work with an IRA, including choosing a custodian, selecting investments, and arranging to have money from your paycheck or checking account transferred directly into your IRA on a regular basis.

Whichever retirement savings choice you make, you should not pass up this opportunity to save for retirement with tax-deferred earnings.

Employer Plan or IRA?		
	Employer Plan	IRA
Investment choices	Choices determined by plan	More, often better choices based on custodian
Fees	Generally higher	Generally lower, often significantly
Contribution limits	\$19,000 + \$6,000 catch-up	\$6,000 + \$1,000 catch-up
Withdrawal flexibility	Mandatory at retirement May roll over to IRA	Required after 70½ in traditional but not Roth IRA

Cash-Outs and Rollovers

If you participate in a workplace retirement account, the balance you've built up is a tempting source of ready cash. You can usually borrow from your account with favorable repayment terms. You may also qualify for a hardship withdrawal. And when you switch jobs you can cash out, putting all the money in your pocket.

Increasing numbers of workers are doing one or more of those things, sabotaging their retirement planning. If an employee cashes out a 401(k) and does not roll the money into another qualified retirement account, he or she faces stiff tax penalties, capital gains taxes, and possible income taxes. Workers also face tax penalties and other charges if they fail to repay a loan from a 401(k). And any money withdrawn from a retirement account, even temporarily, is no longer growing tax-deferred.

Similarly, public- and private-sector workers who participate in a pension plan don't always consider all the ramifications of withdrawing money from their pension accounts. Pension plans in solid financial shape can provide a monthly annuity payment for life—a valuable benefit available to fewer and fewer U.S. workers and one not to be surrendered lightly.

Pension benefits also attract unscrupulous investment salespeople who can reap a windfall in commissions and fees by convincing pension holders to roll over some or all of their money into other, supposedly higher-yielding investments. Pension holders run the risk of putting their money into an inappropriate, high-cost investment or, at worst, investing in a fraudulent investment program. As always, make sure you deal with a *registered* investment adviser and take the time to understand the fees and costs you may pay.

KEEP IN MIND



Before taking out a loan or a hardship withdrawal, consider your ability to repay the money without straining your family's budget.

Rolling over your 401(k) to a new employer is the best way to make sure your money continues to grow tax-deferred. Or, if you're comfortable with your former employer's plan, you may be able to keep your assets there. But cashing out your 401(k) will only damage your retirement savings.


AVOIDING SCAMS AND UNDERSTANDING HIGH-RISK INVESTMENTS

In 1906, American satirist Ambrose Bierce coined the word *impossible*, as in, “Two things are impossible when the world has scope enough for one of them, but not enough for both.”


That word perfectly describes the kind of mindset that makes investors susceptible to fraud—reaching for the “impossible dream” of high returns with very little or no risk.

The Warning Signs of Fraud


To safeguard against investment fraud, there are specific promotions to avoid and warning signs to heed:


 **Tips from those you know.** Churches, community organizations, retirement communities—all are fertile ground for what’s known as affinity fraud, where a con artist exploits an affiliation with a group as a way to win an investor’s confidence. The fraudster may be a member of the group or may just pretend to be. A fraudulent investment scheme may spread quickly among the group’s members and can often extend to trusting family members and friends.


Affinity fraud can turn into a Ponzi scheme, where early investors may—but not always—receive their promised returns with the money coming from later investors in the fraud.


 **Advertising—online and traditional.** The explosive growth of social media, and online communications in general, has provided more avenues for fraudulent investment promoters to hawk their wares. It doesn’t take much effort for a promoter to stake out a place on the internet and solicit funds for a fraudulent scheme. Investors should remember that the apparent sophistication of a promoter and the professionalism of a website or social media channel are meaningless when it comes to selling investments.


Traditional advertising hasn’t gone away, however. Advertisements for investments that range from inappropriate and misleading to downright fraudulent are still common on the radio and in the print and online formats of newspapers and magazines.


 **Free lunch offer.** Speaking of mail, if you’re older than 50, you may receive a steady stream of invitations to supposedly educational “free lunch” and dinner seminars. It’s less of a hassle to eat elsewhere. At best, these invitations are pure marketing. They can also serve as a sales pitch for a high-cost, unsuitable investment, and at worst they’re a breeding ground for fraud.

 **Unsolicited calls.** “Boiler rooms”—the term for a roomful of salespeople making unsolicited phone calls to try to hook investors—remain plentiful. The wonders of call screening make it easy to reject unsolicited offers. Hanging up works, too.

 **Junk mail.** For mail solicitations, buy a shredder, and use it.

 **Pressure to act.** Never be pressured into making hasty investment decisions—a legitimate investment isn't like a one-day-only sale at a department store or a short-term window to buy inexpensive plane tickets. If it's a good investment today it will still be a good investment when you've had time to evaluate it.

 **Things you don't understand.** Never hesitate to ask hard questions if you are unclear about the investment offer, or if the responses to your questions are confusing or evasive. A salesperson may be able to make the most convoluted investment sound reasonable—even irresistible—while keeping the details vague. Ask yourself if you really understand how the investment works.

 **All talk, no documents.** Financial promoters must explain the costs, risks, and obligations of the investment. No paperwork that provides that breakdown? Don't invest.

KEEP IN MIND



The best warning for investors is the old cliché: If an investment seems too good to be true, it probably is. And depending on your financial situation, even some legitimate investments should be avoided if they are not suitable for your financial goals.

You can defend yourself against crooks by being aware of the tactics they use, by carefully checking all the investment material they provide, and by investigating their credentials before you act. Ultimately, you are responsible for avoiding fraud, just as you are for the other investment decisions you make.

Dealing with Registered Brokers and Advisers

Be sure to investigate any financial professional you are considering working with until you're satisfied that he or she is legitimate. Most importantly, deal only with registered salespeople or advisers.

Generally, anyone wanting to sell securities must be registered to do so—a fact many investors don't realize. An unregistered person or company selling investments is likely violating the law.

Registering with the Texas State Securities Board involves testing requirements, background checks, and periodic inspections. To see if a person is registered to sell investments or provide investment advice in Texas, visit the Agency's website at www.ssb.texas.gov. You can also call us at 1-888-663-0009.

You can also check on the registration of brokers and investment advisers through the [Texas State Securities Board's website](#), which is discussed in the next section, **Part 6: Finding a Financial Professional You Can Trust**. A simple phone call can save you from sending money to a fraudulent investment promoter.

It's not just brokers and investment advisers in Texas who need to be registered with the Texas State Securities Board. If they are located in another state but have clients in Texas, they are required to be registered with the Agency.

BEWARE OF PUNDITS

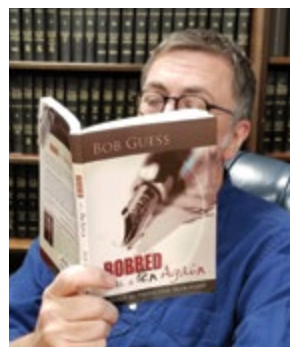


The Economist magazine has described them as the “ghastly gurus”: self-proclaimed experts who appear on television, radio, social media—any public outlet will do—to say they can put you on the safe and secure path to wealth.

Bobby Eugene Guess fit the profile. His radio show, “Dollars & Sense,” was heard on various stations in the Dallas-Fort Worth area. He hosted invitation-only “educational” dinners where the main course was a big steamy plate of financial marketing for his investment business. And he wrote a book: *Robbed with a Pen Again: A Guide to Protecting Your Assets*.

While portraying himself as a financial maven, Guess illegally sold high-yielding promissory notes and other investments that he said would yield 9% to 12% annually, with no risk. Among the investments sold: millions of dollars of securities in a worthless internet company.

That fraud netted Guess a 12-year state prison sentence in 2018.



Guess is an extreme example, but other television and radio personalities have had serious regulatory run-ins. A Fort Worth investment adviser who had a regular radio show had his registration revoked for fraudulent practices and his firm's failure to disclose the grossly excessive fees it was charging clients.

Other financial “pros” who have done radio broadcasts in Texas have promoted themselves as investment experts without disclosing regulatory problems that include suspensions, fines, and dismissals from financial firms.

Approach pundits with skepticism. Some base their advice on risky investments, like real estate or commodities or cryptocurrencies, that aren't suitable for most investors. Others don't disclose they may be paid by financial firms to tout certain investments.

Appearing on your own radio show, or online videos, or having published a book, doesn't confer any special authority or expertise. Sound investing isn't a gimmick, and it isn't a game. It's best to tune out the noise that makes it harder to invest wisely.

When You Suspect Fraud

If you suspect a violation of the law or believe you have received grossly inappropriate financial advice, you can contact the Texas State Securities Board with general questions or you can file a formal complaint. The Agency responds to all inquiries, both written and oral.

For a formal complaint, gather relevant information, including:

1. The name of the account holder
2. The type of investment involved
3. The name of the salesperson or representative who sold you the product
4. A chronological list of events, starting with the initial contact made by the company
5. Copies of documents in support of the complaint, including statements, letters, forms, and applications
6. A description of how you want the company to rectify the situation

The complaint form is on www.ssb.texas.gov.

The Agency's mailing address is:

Texas State Securities Board
P.O. Box 13167
Austin, TX 78711-3167

The Agency's physical address is:

208 E. 10th St., 5th Floor
Austin, TX 78701

Telephone: (512) 305-8301 Toll-free: (888) 663-0009

Generally speaking, information provided to the Texas State Securities Board as part of a complaint is confidential. But in certain instances, a copy of the complaint, or portions of it, may be sent to a registered firm or individual who is the subject of the complaint.

If the Agency determines that a violation of the Texas Securities Act has occurred and that an enforcement action is appropriate, it may initiate administrative proceedings against the issuer or sellers, or request that civil or criminal action be taken.

In some civil suits, a company suspected of fraud can be placed in receivership by a state or federal judge, who then generally appoints a lawyer or financial expert to oversee the operations of the company.

Investors rarely recover significant portions of their losses in a receivership proceeding, however. So if you are seeking restitution of funds, you should consult with private attorneys to determine what remedies may be available to you.

WARNING

WARNING

WARNING

WARNING

Top Threats to Investors

Certain types of investments raise red flags and always require careful scrutiny. While it's always important to thoroughly read the contracts and offering documents for any investment, it's especially important for complex investment strategies with which you may not be familiar. If an investment sounds too exotic, or complex, or the salesperson promises big returns with minimal risk, consider just saying no.

When it comes to investing, the vast majority of people, most likely you included, are best served by sticking with a handful of index funds tracking the major stock and bond markets. If gambling is your thing, budget for a trip to Vegas. But don't wager your savings on a "can't-miss" investment fairy tale.

Unregistered Individuals

Investment promoters who are not registered to sell securities are a three-story-tall red flag for investors. Generally, anyone acting as a sales agent for a company selling stocks, bonds, or other investments to the public must be registered to do so—a fact many investors don't realize. An investment promoter can't simply set up a website or YouTube channel and sell investments unless the investments are registered with the SEC or qualify to be sold under one of the limited number of exemptions from registration.

Registering with the State Securities Board involves qualifications testing, background checks, and periodic review. To see if a person is registered to sell investments, visit the [Agency's website](#) or call 1-888-663-0009. A sales agent who isn't registered is likely violating the law. Almost all criminal actions undertaken by the State Securities Board involve unregistered persons.

Promissory Notes and High-Yield Investment Programs

Low yields on safe and secure products such as certificates of deposit and money market accounts have prompted some investors to look at alternative sources of income. Promissory notes are one way that investment promoters—both registered and not—entice those investors.

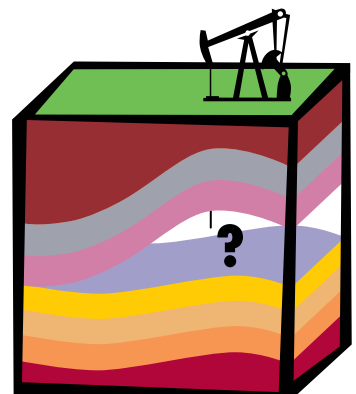
But promissory notes often turn out to be scams when broadly marketed to the public. Promissory notes are basically IOUs from companies or individuals who generally have limited operating histories. The notes are sold to fund everything from property development to oil and gas exploration, or as a way to buy interests in a business partnership. As an individual investor, you probably won't be able to assess their creditworthiness, or evaluate the project that is supposed to generate enough revenue to pay the promised returns.

Legitimate promissory notes are generally marketed to sophisticated or corporate investors, who have the resources and expertise to evaluate the terms and conditions of notes and the companies behind them.

Also questionable are high-yield investment programs marketed as everything from "secured debt obligations" to investment contracts that promise to pay extraordinarily high returns.

Drilling for Riches

Oil and gas investments are highly speculative and complex. It is difficult for a potential investor to investigate a promoter's claims about how much oil or gas will be produced or the time it will take to start production. The structure of the investment will affect revenue and potential profits. In addition, not all investors in oil and gas projects have the expertise to decipher geological maps, production reports, and filings with state energy regulators.



Investors should not rely solely on the promoter’s promises about any aspect of the investment. It’s also critical to know the background of the promoters—some may be inexperienced or have repeatedly failed in previous ventures, but have not disclosed those facts to investors.

Even if the underlying project is legitimate, any revenue realized can be negated by high commissions and other fees or expenses skimmed off by the managing partner, who typically sets the terms and timing of payments to investors. Interests in general partnerships or joint ventures are often non-transferable and illiquid, meaning your money is locked up for a period of time.

Private Placement Offerings

Private placements are used to raise capital without having to comply with the registration requirements of securities laws. The exemption from registration allows companies to raise an unlimited amount of money, but only from investors who meet the definition of “accredited”—net worth of \$1 million, excluding the value of the primary residence, or annual income of \$200,000 or more (\$300,000 if married). That high bar doesn’t prevent some promoters from trying to sell private placement offerings to any investor, regardless of their income or assets.

Companies raising money through private placements often have a limited operating history and the investments themselves generally lack transparency. They are among the most common products or schemes that lead to regulatory enforcement actions.

There is no longer a ban on general solicitation of investors in private offerings. That means the offerings can be advertised on the internet, in publications, and through free dinner seminars, telemarketing, cold-calling—you name it. The offerings can still only accept funds from accredited individuals, but the removal of the advertising ban increases the chances that more illegitimate offers of private placements will be made, putting more investors at risk. Investors should be careful they’re not putting money into an unlawful private placement or dealing with a promoter who is trying to rope in unaccredited investors.

Currency Trading

Foreign exchange (forex) investing involves trading the currencies of other nations. As you can imagine, it’s extremely difficult to earn profits by executing forex contracts in the currencies of dozens of countries with different political systems and economies.

Investors should keep in mind the enormous complexity of forex whenever they hear an investment promoter say he has the can’t-miss trading formula to earn sky-high returns.

Foreign currency is a vast global market where prices are volatile, and losses can pile up in a few hours. An individual is taking a huge risk by buying into an investment promoter’s promise that he can predict currency prices and lock in enormous profits with little or no risk. Currency traders must be registered with one or more federal regulatory agencies and in most cases licensed by the Texas State Securities Board to sell investments based on forex trading.



Real Estate

Investment opportunities are often sold through investment contracts, notes, and other securities. Promoters promise steady returns from a variety of investments. Examples include the purchase, rehabilitation and sale of distressed houses and other property; the purchase of mortgage notes and real estate assets; and the development of shopping centers and other projects.



Investors should be skeptical of claims that real estate investment carries minimal risk because it is backed by a “hard asset.” Depending on the structure of the offering, risk factors may include the illiquidity of the investment; the impact of changes in interest rates on the profitability of the investment or the ability to sell or refinance property; and the potential effect of demographics, property valuation, and rental rates on the revenue generated. Some promoters of fraudulent real estate investments also claim to have special expertise that guarantees investors unrealistically high returns on investment.

Another type of investment is a non-traded **Real Estate Investment Trust (REIT)**, which invests in the same assets as publicly traded REITs—large pieces of real estate in everything from hotels and hospitals to shopping centers and apartment complexes. Non-traded REITs, however, have additional risk factors not found in REITs listed on the major stock exchanges:

- They are highly illiquid, long-term investments that must be held for 7 to 10 years on average. Some non-traded REITs have limited redemption programs, but they are not required and may be suspended at any time.
- Non-traded REITs and brokerage firms charge significant front-end fees and commissions, reducing the amount of money that is actually invested in real estate. High commissions can motivate high-pressure sales tactics.

Non-traded REITs generally require investors to meet certain minimum net worth and/or annual income standards. Check the prospectus to make sure you meet those standards.

Overseas Investments

International investments are often sold with the promise of profits to be made by selling much-needed products in untapped markets.

Investors should ask themselves if they really understand how money will be made. The State Securities Board has issued sanctions in cases involving real estate in France, medical testing kits in Southeast Asia, and bank deposits in West Africa and the Philippines.

How much could an individual investor possibly know about those investments? And if an investor’s money is deposited in an overseas bank, what are the odds of getting that money back? Too often, investors make decisions based solely on the profits they have been promised.

At the same time, there are mutual funds and ETFs that invest in international markets and stocks that are issued by corporations that are headquartered outside of the U.S. Some investment in international markets can be an important component of a diversified portfolio.

The “Genius” Trader

Who doesn't want to get rich quick? The genius trader promises he can make it happen.

Say an investment promoter promises you a return of 3% a week by trading foreign currencies on your behalf. All you need to do is invest \$1,000 a month until you're 58 and you'll be...let's see, interest compounded biweekly, move the decimal point two places to the right, carry the “1”...a zillionaire!

That math doesn't make any sense. Neither do the investment pitches by promoters who promise huge returns from trading in “alternative” products like forex, stocks, options, arbitrage, gold and silver and other commodities...the list goes on and on.

Conventional investing—for most of us that means mutual funds—requires disciplined saving, knowing how much risk we can take, and a willingness to accept inevitable declines in the markets. It takes time. (See “Making Investments,” page 5.) The genius trader typically promises investors a trifecta of quick results, unrealistic returns, and low risk. The genius' favorite terms are “no risk,” “safe and secure,” and “guaranteed.”

You will, however, take an enormous risk investing with traders who say they can produce almost instant profits. That is an invitation to fraud.

Stream-of-Income Investments

These investments involve a company acting as a middleman for buyers and sellers. Companies introduce investors to individuals who may want to sell the income received on pension payments or government disability payments. These transactions hold risks for both buyers and sellers.

Laws may prohibit the assignment of the stream of income/benefits. The seller typically maintains the legal right to redirect the payment, and if the seller does redirect the payment, the investor may be left with an unenforceable contract right.

In addition, the benefits are contingent on the life of the seller, and even life insurance policies on the seller's life may be cancelled and do not protect an investor if a seller simply redirects the income stream. Persons who sell their benefits are often veterans and disabled persons. These individuals may be solicited when they are in financial distress and convinced to sell future benefit payments at a significant reduction to their actual value.

SPENDTHRIFTS

In a financial fraud, investors rarely recover their funds. Some fraudsters use the money to keep their scams going. Others spend it in ways unimaginable to most of us. Based on cases the Texas State Securities Board has worked, here's a small sampling of what fraudsters did with investors' money:

- 15-carat diamond ring
- Lamborghini, Maserati, Bentley, Aston Martin, Ferrari
- Child support payments
- Wedding expenses
- A Picasso drawing
- 1959 Gibson Les Paul Sunburst Left-Handed Guitar
- Floor seats at American Airlines Center, home of the NBA's Dallas Mavericks
- Down payment on a house in Nicaragua (very limited extradition treaty with U.S.)

A convicted oil-and-gas scammer even used investor funds to build a pool and patio for his mother—who didn't swim.



Cryptocurrency Offerings Reach Main Street Investors

In late 2017, the price of bitcoin reached a record high of nearly \$20,000, an increase of about 1,900% for the year. The internet was alive with the sound of cryptocurrency investing scams.



Within weeks bitcoin had crashed to below \$7,000 and stayed around that level for most of 2018, except for a big slide to below \$4,000 in December.

Whether the prices of bitcoin and other cryptocurrencies are spiking, sinking, or steady, there has been a steady stream of investment promoters looking to take advantage of investors who have been hearing about virtual currencies as a quick path to wealth.

Investors who were once only comfortable purchasing stocks, bonds and mutual funds are now using online marketplaces and social media to identify investments tied to cryptocurrencies.

Even seniors and retirees, who traditionally prioritize security over speculation, are being introduced to such things as initial coin offerings and cryptocurrency mining pools.

Our [Cryptocurrency Resources](#) section is regularly updated with enforcement actions involving cryptocurrency offerings, Investor Alerts, educational webcasts, and a glossary.

Through its investigations and enforcement actions, the State Securities Board has identified how many promoters of fraudulent cryptocurrency investments lure unwary investors into their schemes:

- Promoters emphasize guaranteed, secure profits while concealing basic facts, such as the names of their principals and even the physical address of their office. In these instances, investors are transferring funds to anonymous parties operating from undisclosed locations—and they will have little recourse if their money is stolen.
- Technology can create the illusion of professionalism, expertise, and success. Promoters manipulate video to falsely show they maintain cutting-edge facilities, use stock photographs to fictitiously represent company officials, and spoof email to represent that established businesses are recommending their securities offering.
- In the riskiest cryptocurrency-related offerings, promoters do not provide audited records or other financial information to back up their claims of extraordinarily high profits.
- Promoters' claims of "secure" cryptocurrency-related investments and "guaranteed" profits should be approached with caution: Cryptocurrencies tend to be extremely volatile and investors may be unable to quickly liquidate products tied to them.

Most important, deal with *registered* parties. The state of Texas' rigorous registration requirements apply equally to traditional securities, such as stock, bonds and mutual funds, and emerging securities such as products tied to cryptocurrencies.

Texas Case Studies of Investment Fraud

Each year, investors in Texas lose hundreds of millions of dollars through outright fraud or inappropriate investments. What follows are several case studies that the Texas State Securities Board investigated or prosecuted in criminal, civil, and administrative courts. We hope the facts of these cases will help investors recognize the warning signs of fraud and the importance of thoroughly investigating any investment before committing money.

Retirement Wrecking Ball

You work hard, save diligently, and with a little luck have enough money for a comfortable retirement.

Then you run across someone like **Timothy Lloyd Booth** of McKinney. Booth is a former pastor—let that sink in for a moment—who stole \$23 million from individuals who invested in Stamedia Inc., an internet advertising company in Dallas.

Most of Booth's victims were elderly and had invested significant portions of their retirement accounts.

The impact was devastating. During the three-day trial, certain victims testified that they had to return to work after losing their money in the Stamedia fraud.

Others testified that they had to forego medical treatments for their family members due to a lack of money.

Booth lured investors with the false claim that investments in Stamedia were backed by a digital media patent valued at up to \$85 million. Booth promised a guaranteed 9% annualized return—an attractive proposition to retirees who want a steady source of income—and paid millions of dollars to sales agents to pitch the investment.

Booth also told investors that Stamedia had contracts with AT&T Inc. and The Home Depot Inc., among other large companies, but Stamedia never generated any revenue.

Booth, his family, and the co-owner of Stamedia, Shawn Sandifer, ran wild with investor funds. They purchased or leased luxury automobiles including several Mercedes, a Land Rover, an Aston Martin, a Lamborghini, and multiple Ferraris.

Investors also paid for trips Booth and family took to Vail, Co., Cancun, Mexico, Hilton Head, SC, and New York City. And Booth purchased both floor seats and a suite at the American Airlines Center in Dallas, the home court of the NBA's Dallas Mavericks.

In May 2018 Booth was sentenced to 68 years in state prison after his conviction in the 296th District Court of Collin County on first-degree felony charges of theft and securities fraud. The case was prosecuted by the Collin County Criminal District Attorney's Office with the assistance of State Securities Board attorneys who served as special prosecutors.

Always Look for a Registered Adviser

Any individual or firm who sells securities in Texas must generally be registered with the Securities Commissioner.

If you do business with an investment promoter who is not registered, you're taking a big risk.

Consider what happened when investors dealt with **Gabriel Claudio Jr.**, who was registered to sell securities in Texas—but only from 1997 to 2002.

The problem is that Claudio kept selling investment products long after his registration lapsed. Selling, and stealing.

In one instance, two clients of Claudio, a married couple in Alice, had invested in indexed annuities through his firm. In 2010, however, Claudio falsely told the couple that they could no longer invest in annuities directly with the insurance companies selling them.

Instead, Claudio told the clients they had to write their checks to him, not the insurers. Between 2010 and 2016, the couple wrote 19 checks to Claudio totaling \$2,393,567 to invest in indexed annuities.

The investigation found that Claudio did not make any payments to the insurers with that money. In court documents, Claudio admitted to the victims that he had “squan-

dered” their money and had provided them with “bogus” spreadsheets that supposedly reflected the purchases of annuities he had made with their money.

Claudio defrauded other clients, according to the investigation. From 2009 to 2013, Claudio sold fraudulent investments to at least nine victims, totaling \$600,000.

Where did all that investor money go? A partial list: gambling in Las Vegas (\$300,000); child support payments (\$193,000); home expenses (\$169,211); jewelry (\$151,646); and cash withdrawals of \$656,394.

It's easy to check to see if an individual or firm is registered with the Securities Commissioner. Go to Registration Checks on the front page of our site, www.ssb.texas.

Claudio was sentenced to 25 years in prison in August 2018 after pleading guilty to first-degree felony offenses of theft, money laundering, and misapplication of fiduciary property. The sentence, issued in the 79th District Court of Jim Wells County, also ordered Claudio to pay \$2,795,254 in restitution to victims in five South Texas counties. The Jim Wells County District Attorney's Office prosecuted the case with the assistance of a State Securities Board enforcement attorney who served as a special prosecutor.

Uncle Jim Has a Real Estate Deal for You

James Elton “Jim” Warr, in his 60s, brought a laid-back, unhurried approach and rumpled appearance to his YouTube videos that pitched no-risk real estate investment deals.

Austin-based Warr Investment Group's (WIG) real estate deals were a safe alternative to traditional investments like stocks or certificates of deposit, Warr told prospective investors. In one video he said, “I'm like having an uncle in the finance business.”

Some uncle. Warr stole \$1.1 million from individuals who bought investment contracts in unregistered real estate notes offered by WIG. The notes were supposedly backed by income-producing properties.

Warr promised investors they would earn 8% annual interest compounded monthly – an extraordinary return for what Warr said was a “no-risk” investment.

Warr told investors that all their money would be used to purchase property or real estate notes. Warr said he would take his share of the profits only after the investors were paid.

Warr never invested in enough properties to generate the promised returns. Instead, he used investor funds to pay commissions to at least one unregistered sales agent and buy a Mercedes Benz, among other expenses unrelated to the real estate investment program.

Warr was never registered to sell securities, and the WIG investments were not registered for sale.

Warr's deceit extended to encouraging investors to transfer their funds to a self-directed Individual Retirement Account that was not independent, but instead was in his daughter's name and secretly controlled by Warr.

The Deputy Securities Commissioner entered an Emergency Cease and Desist Order against Warr and WIG in 2010.

Working with the State Securities Board, the Office of the Texas Attorney General in 2011 filed a civil case requesting that WIG and a related company be placed in receivership. A Travis County state district court agreed and froze the companies' assets. The receivership returned to investors 44% of their money, an unusually high recovery in an investment fraud case.

Warr was sentenced to 15 years in state prison in December 2017 after his conviction in the 299th District Court of Travis County on four felony counts, including first-degree securities fraud. The Travis County District Attorney's Office prosecuted the case with the assistance of State Securities Board attorneys who were appointed special prosecutors.

Bit by BitConnect, This Cryptocurrency Fell to Earth

Online advertisements for the cryptocurrency BitConnect read, "GET IN ON THE BITCOIN CRAZE!!!!"

Which raises the question: Should you invest your money in something that describes itself as a "craze"? Or that uses a "trading bot" to generate returns as high as 40% a month?

Some perspective: The last time the U.S. stock market returned 40% in a year was 1958.

Lending Amount	Interest (Accrued Daily)	Capital Back
\$100-\$1,000	Volatility Software Interest (up to 40% per month)	After 299 Days
\$100-\$5,000	Volatility Software Interest + 0.10% Daily (up to 40% per month)	After 239 Days
\$100-\$10,000	Volatility Software Interest + 0.15% Daily (up to 40% per month)	After 179 Days
\$100-\$100,000	Volatility Software Interest + 0.20% Daily (up to 40% per month)	After 120 Days

BitConnect website

BitConnect found willing investors, however. Supposedly based in England, the company issued its own currency, called BitConnect Coins, and said it placed millions of them into the online cryptocurrency marketplace.

At one point, BitConnect claimed its coins had a total value of nearly \$3 billion.

The company required individuals to use bitcoin, an established cryptocurrency, to invest in various programs. In the BitConnect Lending Program, for example, investors bought BitConnect Coins, which were then provided to a "BitConnect Trading Bot" to generate those 40% monthly returns.

Despite providing no information on how it would make money for investors—including the algorithms behind the Trading Bot—BitConnect touted its investments as a "safe way to earn a high rate of return."

BitConnect disclosed virtually nothing about its principals, financial condition, or strategies for earning profits for investors.

The company recruited sales agents, which it called “affiliates.” The company paid them commissions for referrals that resulted in investments in BitConnect programs.

The sales agents targeted Texas residents, as well as residents of other states, through websites, social media, and online marketplaces like craigslist.

The sales agents were not, however, registered as agents of BitConnect to sell securities in Texas.

The Securities Commissioner’s action followed BitConnect’s announcement that it would hold an Initial Coin Offering (ICO) in the U.S. on Jan. 9. Companies use coin offerings, also called token sales, to raise capital.

In an ICO, investors buy virtual tokens from a company, which uses the proceeds for business development. In keeping with its strategy of non-disclosure, BitConnect did not indicate how it would have used the proceeds from token sales in the upcoming ICO.

The Securities Commissioner entered an Emergency Cease and Desist Order against BitConnect on Jan. 4, 2018, for violating the Texas Securities Act. On Jan. 16, citing the emergency action, BitConnect shut down its lending platform. By early February 2018, the value of BitConnect coins had decreased by 98%.

In December 2018 an unknown entity attempted to further defraud BitConnect investors by telling them they could receive partial refunds of their investment if they submitted a \$250 fee in advance. The entity falsely claimed the State Securities Board had authorized partial refunds to BitConnect investors.

FINDING A FINANCIAL PROFESSIONAL YOU CAN TRUST

At some point you may turn to a financial professional for help with investing decisions, particularly if you're trying to achieve different goals—such as retirement, children's education, and buying a home. Before you can begin the search for someone you can trust, you need to identify the type of help you need. To do that, it pays to understand the distinction between two basic types of financial professionals—**investment advisers** and **brokers**.

Investment Advisers

Investment advisers help you make investment decisions and manage your portfolio, and have a **fiduciary duty**, or legal requirement, to act in your best interest, not for their own personal gain. Investment advisers (IAs) may work as sole practitioners or, more commonly, at advisory firms that employ a number of advisers. (Investment advisory firms are also called **registered investment advisers**, or RIAs, and the advisers who work for them are known as investment adviser representatives, or IARs.)

Unlike brokers, who earn a commission on trades they make on your behalf, investment advisers charge a fee for their services, sometimes based on a percentage of the money they manage, sometimes on an hourly basis, and sometimes on a retainer basis for a package of services.

In selecting an adviser, be sure to do your homework. Advisers must provide you with key information, such as their credentials, years and type of professional experience, the services they provide, how they are compensated, and any conflicts of interest that may apply. You should also ask about a prospective adviser's work with other clients whose financial situation may be similar to your own.

Investment advisers are required to be registered with one of two regulatory authorities, depending on the size of their business:

- Investment advisers who manage less than \$100 million in total assets—referred to as assets under management or AUM—must be registered with and inspected by the Texas State Securities Board.
- IAs with more than \$100 million in assets under management must register with the U.S. Securities and Exchange Commission.

Before you can begin the search for someone you can trust, you need to identify the type of help you need.

Form ADV: Essential Adviser Information

Investment advisers are required to provide their background information on **Form ADV**, which is split into two parts.

Part 1 is a check-the-box form with information about the IA's business, employees, ownership, clients, and any disciplinary actions involving the IA or its employees.

Part 2 is a narrative that serves as the primary disclosure document for investment advisers. It contains information about:

- The IA's business practices and any significant changes the firm has undergone recently
- Fees and compensation
- Multiple costs folded into a "wrap fee" charged to clients
- Conflicts of interest that the firm has or may have in representing you
- Firm's social media accounts
- Types of clients the firm has
- Disciplinary information, if any, about the firm and its employees
- When and how the firm reviews client accounts
- Financial information about the firm

Investors should thoroughly review Parts 1 and 2 of Form ADV before doing business with an investment adviser. Both parts of Form ADV are available to the public at the [SEC's Investment Adviser Public Disclosure](#) website.

You can also reach the IA disclosure site through the Texas State Securities Board's website, www.ssb.texas.gov.

Brokers

The terms **broker** and **broker-dealer** are legal terms that refer to people and firms who are in the business of buying and selling securities on behalf of customers.

Individual salespeople employed by brokerage firms are called stockbrokers and are officially referred to as **registered representatives**. But these individuals use other unofficial titles, too, including financial consultant, financial adviser, and investment consultant. In recent years, brokerage firms have offered a broader range of investment planning services in addition to trading securities.

Many brokers' compensation is based on the commissions clients pay each time they buy or sell a security—a potential conflict of interest that could mean investors end up paying more than they should when brokers trade excessively or sell products for which they receive exceptionally high commissions.

Unlike investment advisers, brokers are under no legal obligation to act as fiduciaries or in your best interest. They are required to recommend only assets that are **suitable** for you, based on your financial situation, needs, and other securities you hold.

Brokers also have no legal responsibility to inform you of conflicts of interest. In fact, other parties—specifically, the companies offering the securities or the firms that brokers work for—may compensate brokers for selling you certain investments.

And when some less-than-scrupulous brokers stand to earn high commissions on certain investment products, they may not adhere to the suitability standard. Remember to make sure your investments are appropriate for your investing needs and how much risk you're comfortable taking.

Brokers may be required to be registered with more than one regulatory authority, depending on where they live, to whom they offer securities, and the type of business they operate. Brokers engaged in the offer and sale of securities in Texas, for example, are required to be registered with the Texas State Securities Board. These brokers may also be subject to the oversight of the Financial Industry Regulatory Authority, a self-regulatory body for the industry.

It's not a common occurrence, but it will sometimes take months or years for both investment advisers and brokers to report disciplinary actions and other red flags, such as customer complaints, civil court cases, and bankruptcies. Failure to report relevant information in a timely way, which generally violates securities regulations, means potential investors don't have all the information they need when considering hiring an adviser or broker.

Researching A Broker

To research a broker, start with the Financial Industry Regulatory Authority's [BrokerCheck](#), a database that holds licensing and registration information for registered representatives and securities dealers and brokerage firms in the United States. The BrokerCheck report will tell you about a dealer's or agent's track record, including:

- Employment history for the past 10 years
- Disciplinary actions that have been taken by federal, state, and self-regulatory organizations
- Whether the broker or agent holds other professional designations such as a Certified Public Accountant or Certified Financial Planner
- Civil judgments and arbitrations in securities disputes
- Pending written complaints
- Criminal convictions or indictments
- Bankruptcy filings
- Outstanding liens and judgments

The BrokerCheck report may not be a complete record, however. It relies on self-reporting by registered firms and individuals, not all of whom submit to FINRA every document they should.

Robo-Advisers

Investors who are comfortable handling financial matters online have another option for help: a so-called robo-adviser that provides automated but still personalized investment guidance.

You can start the process of enlisting a robo-adviser by filling out an online questionnaire on the website of one of the dozens of firms that offer this service. You'll be asked to detail your financial goals, income, assets, risk tolerance, short- and long-term goals, and investing time horizon.

Using a variety of high-tech tools—including advanced software and algorithms—your robo-adviser then crunches the data you've provided and churns out what it determines to be the most appropriate mix of assets for your portfolio.

Robo-advisers can handle single accounts, such as an Individual Retirement Account, as well as multiple portfolios of taxable accounts, college savings accounts, or other categories of investment accounts.

Fees for robo-advisers typically are less than those charged by traditional advisers because the service is largely automated. In addition, robo-advisers use low-cost index funds and ETFs to build portfolios.

Since not everyone is comfortable getting all their advice online, some robo-adviser services have expanded to offer a dose of human interaction. The cost of the expanded service varies, depending on whether you want to talk to someone online or on the phone, and how often. For example, you may be comfortable with a robo-adviser most of the time but want to speak with a human expert to discuss strategy during periods of market turmoil.

One thing you should make sure you're clear on is how often your robo-adviser rebalances assets in your account to ensure that the overall mix of investments doesn't significantly differ from your target allocation.

Rebalancing, which involves selling some assets and buying others to keep your portfolio aligned with your investment strategy, can also affect your taxes. For example, if the robo-adviser updates your portfolio frequently, you could have large short-term gains that are taxed at the same rate as your regular income rather than at the lower rate that applies to long-term gains. To qualify for a long-term gain, you must hold an asset for more than a year before selling it.

Finally, be sure to consider a robo-adviser's approach to investing before signing up. Just like their human counterparts, robo-advisers have varying investing styles and offer different investment products. The final decision on how to allocate assets in your portfolio is up to you.

Firms that offer robo-advisory services are typically registered with either the Securities and Exchange Commission or a state regulator like the Texas State Securities Board. Robo-advisers are required to file the same Form ADV as investment advisers.

Form ADV requirements, which include a detailed breakdown of fees, are explained on page 50.

Financial Planners

Unlike the terms investment adviser and broker, *financial planner* is not a legally defined term. It generally refers to someone who develops, and may also implement, comprehensive financial plans for clients based on their long-term goals.

A financial plan typically covers such topics as estate planning, tax planning, insurance needs, and debt management, in addition to more investment-oriented objectives, such as retirement and college planning. But you'll want to be sure to ask about a planner's experience and credentials before you sign a contract to work with him or her.

KEEP IN MIND



Regardless of the type of financial professional you choose to help you, there is one absolutely critical step to take beforehand: *Read the contract*. That sounds like obvious advice, but it's advice that some investors do not heed. Knowing the precise terms of the contract can forestall misunderstandings, disagreements, and even lawsuits down the line. Clear up any questions with the prospective financial professional ahead of time, and if necessary, consult with a lawyer, accountant, or trusted third party to review the contract terms.

Alphabet Soup of Designations

A financial professional may use various titles, whether or not he or she is registered or licensed with a regulatory authority. The problem is that there are at least 150 designations in use. According to an investor bulletin from the SEC and the North American Securities Administrators Association: "The requirements for obtaining and using [professional designations] vary widely, from rigorous to nothing at all."

Some designations fit no one's idea of rigorous. The Chartered Senior Financial Planner designation, for example, requires a three-day course and one exam.

To become an Accredited Retirement Adviser, an applicant can buy a study guide for a 100-question, multiple choice test. There's no coursework, and no way to check disciplinary actions or submit a complaint.

There are, of course, many designations that require extensive testing and continuing education, and whose oversight body may impose disciplinary sanctions. Earning the Chartered Financial Analyst (CFA) designation requires hundreds of hours of study to pass three six-hour exams, and four years of work experience. Earning the Certified Financial Planner (CFP) designation requires the completion of seven courses and three years of financial planning experience.

Investors need to look beyond the acronym or designation to determine what's behind it: the exams, ethical standards, and oversight body, as well as the continuing education required to maintain the designation.

One resource is FINRA's "[Understanding Professional Designations](#)" site, which provides a snapshot description of more than 100 designations. The site is not comprehensive, and does not allow a comparison of the designations. But it's a good place to start.

The proliferation of "senior adviser" certifications targeting elderly clients is a growing problem, according to the U.S. Consumer Financial Protection Bureau (CFPB). There are more than 50 such designations in use, with many of the titles practically identical. That's confusing for investors, on top of the typically wide variance in training and education these professionals receive.

If a financial professional tells you that he or she has a certain credential, ask some direct questions:

- Who awarded you the credential?
- What are the training, ethical, and other requirements to qualify for this credential?
- Do you have to take a course and pass a test?
- Does the designation require a certain level of work experience or education?
- To maintain the designation, are you required to take refresher courses?
- How can I verify your standing with this organization?

KEEP IN MIND

As a reminder, investment advisory firms are required to provide their clients with a brochure about their employees in Form ADV. If an employee claims to have a professional title, the brochure supplement must include an explanation of the minimum qualifications for the title. This is not the case with brokerage firms or financial planning firms.



QUESTIONS TO ASK



Once you've researched prospective investment advisers and brokers, it's time to ask questions. In *The Little Book of Smart Money* (Wiley & Sons Inc., 2010), author Jason Zweig, personal finance writer for *The Wall Street Journal*, recommends you sit down with the candidates and ask these questions:

- What made you want to become a financial adviser?
- Do you focus primarily or exclusively on asset management, or do you also have expertise in taxes, retirement, and estate planning, as well as budgeting and debt management? What education, training, experience, and licenses do you have in these practice areas?
- What is your philosophy of investing? Do you rely mainly on lower-cost index mutual funds? (If the answer is "No," ask to see evidence that the alternatives actually have worked as well or better.)
- How high an annual return on my investments do you think is feasible? (Anything above 10% suggests the adviser is either delusional or dishonest. Answers below 8% start to make sense.)
- How do you manage risk?
- What needs and goals does your typical client have?
- How many clients do you have, and will you personally manage my account? How much time should I reasonably expect you to devote to me over the course of a typical year?
- Describe something you achieved for a client that makes you proud.
- What's the worst mistake you've made with a client?
- How do you go about resolving conflicts with clients?
- Describe the process you have in mind for helping me to achieve my goals. How will you monitor our progress?
- When recommending investments, do you accept any form of compensation from any third party? Why or why not?
- What are your services likely to cost me in a typical year? What percentage of my assets will you charge in annual fees? How do you report your fees and commissions?
- May I see a sample account statement, and can you explain it to me clearly?
- Can you provide me with your resume, both parts of your Form ADV, and at least three references?

QUESTIONS TO ASK (CONTINUED)



As you ask these questions, take written notes not just on how the adviser seems to respond to your queries but also on how the answers make you feel. Do you sense that this person is trustworthy? You should come away feeling that you would have no concerns about sharing a close secret with this person—because sooner or later, you probably will. If you have any doubts, find another adviser.

You, in turn, should be prepared to openly and honestly answer questions from financial advisers:

- Why do you think you need a financial adviser?
- How knowledgeable are you about investing and financial matters, and how confident are you in your knowledge?
- What does money mean to you?
- What are your biggest fears? What are your fondest hopes?
- How much time and energy are you willing to invest in any financial plan we develop?
- What would it take for you to feel our working relationship is successful?
- When someone presents you with evidence that your opinions may be mistaken, how do you respond?
- How do you deal with conflicts or disputes?

Invest time in picking a good financial adviser. It will be one of the most important decisions you make and one of the most significant relationships you ever have.

TEXAS STATE SECURITIES BOARD

Divisions and Duties

The **Enforcement Division** investigates suspected violations of the Texas Securities Act, initiates administrative and civil enforcement actions, and works closely with other law enforcement authorities to bring criminal and civil enforcement actions.

The **Registration Division** performs comprehensive, timely, and responsive reviews of prospectuses and related documents submitted with securities registration applications. The reviews are intended to eliminate unfair elements of securities offerings. The Division also reviews applications by brokers, broker-dealers, agents, investment advisers, and investment adviser representatives for registration in the State of Texas.

The **Inspections & Compliance Division** conducts comprehensive reviews of records to make sure registered financial professionals are complying with the Texas Securities Act. The Division brings administrative actions to ensure compliance, which may include fines and suspensions for violations of the Act.

The **Office of the General Counsel** is the legal counsel for the Agency.

The **Staff Services Division** is responsible for human resources, information technology, budget, accounting, purchasing, and accounts payable functions.

Electronic News and Alerts

The Agency distributes news and alerts that serve the public and registered financial professionals. You can sign up for any of the publications through the Agency's home page at www.ssb.texas.gov. Just look for "Sign Up for News & Updates".

News Releases inform the public about recent criminal convictions, civil lawsuits, and administrative actions.

Investor Alerts warn the public about trends in fraud and feature the latest in research in investing.

Enforcement Alerts are breaking news alerts on cease and desist orders and other sanctions against registered individuals and actions against unregistered investment promoters.

Rulemaking updates keep the public and industry informed about proposed and adopted rules and regulations.

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Reading List

If you read two or three of these books, you will know more about investing and money management than most investors, and perhaps more than a lot of financial professionals.

Investing

Bernstein, William J. *The Investor's Manifesto: Preparing for Prosperity, Armageddon, and Everything In Between*. Wiley, 2010.

Bogle, John. *Common Sense on Mutual Funds*. Wiley, 2009.

Malkiel, Burton G., and Charles Ellis. *The Elements of Investing*. Wiley, 2013.

Morris, Virginia B., and Kenneth M. Morris. *Guide to Money & Investing*. Lightbulb Press, 2017.

Olen, Helaine, and Harold Pollack. *The Index Card: Why Personal Finance Doesn't Have to Be Complicated*. Portfolio, 2017.

Zweig, Jason. *The Little Book of Safe Money*. Wiley, 2010.

Money Management and Planning

Aliber, Robert Z. *Your Money and Your Life: A Lifetime Approach to Money Management*. Stanford University Press, 2011.

Federal Reserve Bank of Dallas. *Building Wealth: A Beginner's Guide to Securing Your Financial Future*. www.dallasfed.org/microsites/cd/wealth/.

Tobias, Andrew. *The Only Investment Guide You'll Ever Need*. Mariner Books, 2016.

Social Security

Kotlikoff, Lawrence, Moeller, Philip, Solman, Paul. *Get What's Yours: The Secret to Maxing Out Your Social Security*. Simon & Schuster, 2016.

Saving for College

Morris, Virginia B., and Kenneth M. Morris. *Guide to Saving for College, and Guide to Understanding 529 Plans*. Lightbulb Press, 2017.

GLOSSARY OF TERMS

401(k) retirement savings plan

You participate in a 401(k) retirement savings plan by deferring part of your salary into an account set up in your name. Any earnings in the account are federal income tax deferred.

If you change jobs, 401(k) plans are portable, which means that you can move your accumulated assets to a new employer's plan, if the plan allows transfers, or to a rollover IRA.

With a traditional 401(k), you defer pretax income, which reduces the income tax you owe in the year you make the contribution. You pay tax on all withdrawals at your regular rate, determined by your filing status and tax bracket.

403(b) retirement savings plan

A 403(b) plan, sometimes known as a tax-sheltered annuity (TSA) or a tax-deferred annuity (TDA), is an employer sponsored retirement savings plan for employees of not-for-profit organizations, such as public school districts, colleges, hospitals, foundations, and cultural institutions. (Despite the names by which 403(b)s are known, participants are not required to invest in annuities and usually can choose from mutual funds and other qualified investments.)

Some employers offer 403(b) plans as a supplement to—rather than a replacement for—defined benefit pensions. Others offer them as the organization's only retirement plan.

Your contributions to a traditional 403(b) are tax deductible, and any earnings are tax deferred. Contributions to a Roth 403(b), which some but not all employers offer, are made with after-tax dollars, but the withdrawals are tax free if the account has been open at least five years and you're 59½ or older.

457 retirement savings plan

The tax-deferred retirement savings plans known as 457 plans are available to state and municipal employees.

Like traditional 401(k) and 403(b) plans, the money you contribute and any earnings that accumulate in your name are not taxed until you withdraw the money, usually after retirement. The

contribution levels are set each year at the same level that applies to 401(k)s and 403(b)s, though 457s may allow larger catch-up contributions.

You also have the right to roll your plan assets over into another employer's plan, including a 401(k) or 403(b), or an individual retirement account (IRA) when you leave your job.

Accredited investor

An accredited investor is a person or institution that the Securities and Exchange Commission (SEC) defines as being qualified to invest in unregistered securities, such as privately held corporations, private equity investments, and hedge funds.

To be an accredited investor you must have a net worth of more than \$1 million excluding the value of your primary residence, or a current annual income of at least \$200,000 with the anticipation you'll earn at least that much next year. If you're married, that amount is increased to \$300,000.

Asset allocation

Asset allocation means dividing your assets on a percentage basis among different broad categories of investments, called asset classes. Stocks, bonds, and cash are examples of asset classes, as are real estate and commodities.

Most financial services firms suggest particular asset allocations for certain categories or groups of clients and fine-tune those allocations for individual clients.

The asset allocation model—specifically the percentages of your investment principal allocated to each investment category you're using—that's appropriate for you at any given time depends on many factors, such as the goals you're investing to achieve, how much time you have to invest, your tolerance for risk, the direction of interest rates, and the market outlook.

Bitcoin

A specific currency in an electronic payment system that acts as an alternative to fiat currencies like the U.S. dollar. It exists only on computers and the internet. It is not backed by a government, and its price is not set by a centralized authority.

Broker

A broker acts as an agent or intermediary for a buyer or a seller, or, less commonly, for both. The buyer, seller, and broker may all be individuals, or one or more may be a business or other institution. For example, a stockbroker works for a brokerage firm, and handles client orders to buy or sell stocks, bonds, commodities, and options in return for a commission.

Broker-dealer

A broker-dealer (B/D) is a brokerage firm that holds a license granted by the Securities and Exchange Commission (SEC) to act as a broker, or agent, to buy and sell securities for its clients' accounts. The firm may also act as principal, or dealer, and trade securities for its own inventory.

Some broker-dealers act in both capacities, depending on the circumstances of the trade or the type of security being traded. For example, your order to purchase a particular security might be filled from the firm's inventory provided you are notified that this has happened.

A broker-dealer must evaluate whether or not an investment is suitable for a particular client and may advise clients on investment choices. Most charge clients a commission to execute a trade.

Capital gains

A capital gain is the difference between the purchase price and the sale price of a capital asset when the sale price is higher than the purchase price.

For example, if you buy 100 shares of stock for \$20 a share and sell them for \$30 a share, you realize a capital gain of \$10 a share, or \$1,000 in total.

If you have owned the stock for more than a year before selling it, you have a long-term capital gain. If you hold the stock for less than a year, you have a short-term capital gain, which incurs greater taxes than a long-term capital gain.

Certificates of deposit (CD)

Certificates of deposit (CDs) are time deposits with fixed terms, typically ranging from three months to five years. On traditional bank CDs, you earn compound interest at a fixed rate, which is determined by the current interest rate and the CD's term. Adjustable-rate and market-rate CDs may also be available, though specific terms and

conditions apply. When you purchase a CD from a bank, your account is insured by the Federal Deposit Insurance Corporation (FDIC) up to the per depositor limit.

You usually face a penalty if you withdraw funds before your CD matures. With a bank CD, you often forfeit some or all of the interest that has accrued up to the time you make the withdrawal.

Compounding

Compounding occurs when your investment earnings or savings account interest is added to your principal, forming a larger base on which future earnings may accumulate.

As your investment base gets larger, it has the potential to grow faster. And the longer your money is invested, the more you stand to gain from compounding.

For example, if you invested \$10,000 earning 8% annually and reinvested all your earnings, you'd have \$21,589 in your account after 10 years, including earnings of \$11,589.

If instead of reinvesting you withdrew the \$800 in earnings each year, you would have collected \$8,000 over the 10 years. The \$3,589 you didn't earn represents the benefit of 10 years of compound growth.

Consumer Price Index (CPI)

The consumer price index (CPI) is compiled monthly by the U.S. Bureau of Labor Statistics and is a gauge of inflation that measures changes in the prices of basic goods and services.

Some of the things it tracks are housing, food, clothing, transportation, medical care, and education.

The CPI is used as a benchmark for making adjustments in Social Security payments, wages, pensions, and tax brackets to keep them in tune with the buying power of the dollar. It's often incorrectly referred to as the cost-of-living index.

Cryptocurrency

A digital currency secured through cryptography, or codes that cannot be read without a key.

Disposable personal income (DPI)

Disposable personal income (DPI) is the amount that's left after income taxes, FICA taxes, and other required amounts are withheld from gross income.

DPI is the money you have available to spend on your essential and discretionary household expenses, to save, and to invest.

Diversification

Diversification is an investment strategy. When you diversify, you spread your investment dollars among different sectors, industries, and securities within a number of asset classes.

A well-diversified stock portfolio, for example, might include small-, medium-, and large-capitalization domestic stocks, stocks in six or more sectors or industries, and international stocks. The goal is to protect the value of your overall portfolio in case a single security or market sector takes a serious downturn.

Finding the diversification mix that's right for your portfolio depends on your age, your assets, your tolerance for risk, and your investment goals.

Diversification may help protect your portfolio against certain market and management risks without significantly reducing the level of return you realize. But it does not guarantee you will realize a profit or insure you against losses in a market downturn.

Dividend

A dividend is a portion of a corporation's earnings that the board of directors may choose to pay out to shareholders as a return on investment.

These dividends, which are often declared quarterly, are usually in the form of cash, but may be paid as additional shares.

You may be able to reinvest cash dividends automatically to buy additional shares if the corporation offers a dividend reinvestment program (DRIP) or direct purchase plan (DPP).

Dividends are taxable income unless you own the investment through a tax-deferred account, such as an employer-sponsored retirement plan or individual retirement account. This rule applies whether you reinvest the dividends or take the money.

Equity

In the broadest sense, equity is ownership. If you own stock, you have equity in the company that issued the stock even if your stake is very small. Equity also refers to the difference between an asset's current market value—the amount it could be sold for—and any debt or claim against it.

Exchange traded fund (ETF)

Exchange traded funds (ETFs) resemble open-ended mutual funds but are listed on a stock exchange and trade like stock through a brokerage account.

You buy shares of the fund, which in turn owns a portfolio of stocks, bonds, commodities, or other investment products. You can use traditional stock trading techniques, such as buying long, selling short, and using stop orders, limit orders, and margin purchases.

The ETF doesn't redeem shares you wish to sell, as a mutual fund does. Rather, you sell in the secondary market at a price set by supply and demand. ETF prices change throughout the trading day rather than being set at the end of the trading day, as open-end mutual fund prices are.

Each ETF has a net asset value (NAV), which is determined by the total market capitalization of the securities or other products in the portfolio, plus dividends but minus expenses, divided by the number of outstanding shares issued by the fund.

Expense ratio

An expense ratio is the percentage of a mutual fund's or variable annuity's total assets deducted to cover operating and management expenses.

Those expenses include employee salaries, custodial and transfer fees, distribution, marketing, and other costs of offering the fund or contract. However, they don't cover trading costs or commissions.

For example, if you own shares in a fund with a 1.25% expense ratio, your annual share is \$1.25 for every \$100 in your account, or \$12.50 on an account valued at \$1,000.

Expense ratios vary widely from one fund company to another and among different types of funds. Typically, international equity funds have among the highest expense ratios, and index funds among the lowest.

Fiduciary

A fiduciary is an individual or organization legally responsible for managing assets on behalf of someone else, usually called the beneficiary. The assets must be managed in the best interests of the beneficiary, not for the personal gain of the fiduciary.

However, the concept of acting responsibly can be broadly interpreted, and may mean preserving principal to some fiduciaries and producing reasonable growth to others.

Executors, trustees, guardians, and agents with powers of attorney are examples of individuals with fiduciary responsibility. Firms known as registered investment advisers (RIAs) are also fiduciaries.

Financial adviser

Financial adviser is a generic designation for someone who provides financial advice. There is no credential or accreditation associated specifically with the term. However, people who describe their services as providing financial advice may have some other credential, such as registered representative (RR), certified financial planner (CFP) or similar designation, or they may work for a registered investment advisory firm (RIA).

Glide path

Glide path is the approach a target date fund takes in reallocating its portfolio as time passes.

Each fund company's glide path varies somewhat from those of its competitors, based on the company's investment strategy and risk profile.

What is similar is that all target date funds have a specific time horizon. They invest to achieve growth in the early phases of their life span, gradually reallocating to produce income and protect principal as their target dates approach. What differs is the rate and timing of the re-allocation, in particular how much of the fund remains invested for growth at the target date.

Target date funds are often retirement investments, using target dates such as 2025 or 2040. Or they may be used in 529 college savings plans, where they are described as age-based tracks.

Individual retirement account (IRA)

Individual retirement accounts are one of two types of individual retirement arrangements (IRAs) that provide tax advantages as you save for retirement.

Everyone with earned income may contribute to a tax-deferred IRA. Those whose modified adjusted gross income is less than the annual cap for his or her filing status qualifies to contribute to a Roth IRA.

There are annual contribution limits, catch-up provisions if you're 50 or older, and restrictions on withdrawals before you turn 59½. Tax-deferred IRAs have required minimum distributions (RMDs) after you turn 70½.

Earnings withdrawn from a traditional IRA are taxed at the same rate as your ordinary income. So are the contributions if you are qualified to deduct them for the year they were added to your account.

Contributions to a Roth IRA, in contrast, are not tax-deductible, but the withdrawals from Roth accounts are tax-free.

Initial Coin Offering (ICO)

In an ICO, an entity issues virtual coins, often called tokens, to raise capital. A "token sale" is simply distributing a new cryptocurrency to investors, who typically pay for tokens in bitcoin or another established cryptocurrency.

Investment adviser

An investment adviser is a financial professional who provides guidance to investors to help them make investing decisions. The adviser may also manage an investor's portfolio.

Loads

A load is the sales charge, or commission, you may pay if you buy mutual fund shares through a broker or other financial professional.

If the sales charge is levied when you purchase the shares, it's called a front-end load. If you pay when you sell shares, it's called a back-end load or contingent deferred sales charge. With a level load, you pay a percentage of your investment amount each year you own the fund as an ongoing sales charge.

Long-term capital gains tax rate

A long-term capital gain is the profit you realize when you sell a capital asset that you have owned for more than a year at a higher price than you paid to buy it.

Unlike short-term gains, which are taxed as ordinary income, most long-term gains on most securities are taxed at rates lower than the rate that applies to ordinary income.

You can subtract any long-term capital losses you realized in the same tax year from your long-term capital gains to reduce the amount on which potential tax may be due.

Modified adjusted gross income (MAGI)

Your modified adjusted gross income (MAGI) is your adjusted gross income (AGI) plus exclusions or deductions you may have taken for housing expenses or income earned outside the United States or for income received as a resident of American Samoa or Puerto Rico.

If your MAGI is less than the annual minimum and maximum levels set by Congress for your filing status, you qualify for various tax adjustments, deductions, and credits. Some of these include the right to subtract student loan interest, take a deduction for your contributions to a tax-deferred IRA, make contributions to a Roth IRA, and take the American Opportunity, Lifetime Learning, and adoption tax credits.

Money market mutual fund

Money market mutual funds invest in stable, short-term debt securities, such as commercial paper, Treasury bills, certificates of deposit (CDs), and other short-term instruments.

The fund's management tries to maintain the value of each share in the fund at \$1.

Unlike bank money market accounts, money market mutual funds are not insured by the Federal Deposit Insurance Corporation (FDIC).

However, since they're considered securities at most brokerage firms, they may be insured by the Securities Investor Protection Corporation (SIPC) against the bankruptcy of the firm. In addition, some funds offer private insurance comparable to FDIC coverage.

Mutual fund

A mutual fund is a professionally managed investment product that sells shares to investors and pools the capital it raises to purchase investments.

A fund typically buys a diversified portfolio of stock, bonds, or money market securities, or a combination of stock and bonds, depending on the investment objectives of the fund. Mutual funds may also hold other investments, such as derivatives and cash.

A fund that makes a continuous offering of its shares to the public and will buy any shares an investor wishes to redeem, or sell back, is known as an open-end fund. An open-end fund trades at its net asset value (NAV).

Net asset value (NAV)

Net asset value (NAV) is the dollar value of one share of a mutual fund or exchange traded fund (ETF).

NAV is calculated by totaling the value of the fund's holdings plus money awaiting investment, subtracting operating expenses, and dividing by the number of outstanding shares.

A fund's NAV changes regularly, though day-to-day variations are usually small. With a mutual fund, the NAV is reset at the end of each trading day, while with an ETF, the NAV changes throughout the day.

The NAV is the price per share an open-end mutual fund pays when you redeem, or sell back, your shares. With no-load mutual funds, the NAV and the offering price, or what you pay to buy a share, are the same. With front-load funds, the offering price is the sum of the NAV and the sales charge per share and is sometimes known as the maximum offering price (MOP).

Net worth

To figure your own net worth, you add the value of the assets you own, including but not limited to cash, securities, personal property, real estate, and retirement accounts, and subtract your liabilities, or what you owe in loans and other obligations.

If your assets are larger than your liabilities, you have a positive net worth. But if your liabilities are more than your assets, you have a negative net worth.

Pension

A pension is an employer plan that's designed to provide retirement income to employees who have vested—or worked enough years to qualify for the income.

Defined benefit plans promise a fixed income, usually paid for the employee's lifetime or the combined lifetimes of the employee and his or her spouse.

The employer contributes to the plan, invests the assets, and pays out the benefit, which is typically based on a formula that includes final salary and years on the job.

You pay federal income tax on your pension at your regular rate, so a percentage is withheld from each check. If the state where you live taxes retirement income, those taxes are withheld too.

However, you're not subject to Social Security or Medicare withholding on pension income.

Principal

Principal can refer to an amount of money you invest, the face amount of a bond, or the balance you owe on a debt, distinct from the finance charges you pay to borrow.

A principal is also a person for whom a broker carries out a trade, or a person who executes a trade on his or her own behalf.

Prospectus

A prospectus is a formal written offer to sell stock to the public. It is created by an investment bank that agrees to underwrite the stock offering.

The prospectus sets forth the business strategies, financial background, products, services, and management of the issuing company, and information about how the proceeds from the sale of the securities will be used.

The prospectus must be filed with the Securities and Exchange Commission (SEC) and is designed to help investors make informed investment decisions.

Each mutual fund and variable annuity provides a prospectus to potential investors, explaining its objectives, management team and policies, investment strategy, and performance. The prospectus also summarizes the fees and analyzes the risks you take in investing.

Qualified dividends

A qualified dividend is a dividend that is taxed at a taxpayer's long-term capital gains tax rate rather than at the rate that applies to his or her ordinary income.

A dividend is generally qualified if two conditions are met. First, it must have been paid on stock issued by a U.S. corporation or eligible non-U.S. corporation. However, certain dividends are never qualified including those paid by real estate investment trusts (REITs) and regulated investment companies.

Second, the person who owns the stock on which the dividend has been paid must have owned it for at least the minimum holding period. The holding period in most cases is at least 61 days during the 121-day period that began 60 days before the ex-dividend date.

Real Estate Investment Trust (REIT)

A real estate investment trust (REIT) pools investors' capital to invest in a variety of real estate ventures.

There are three types of REIT: Equity REITs buy properties that produce income. Mortgage REITs invest in real estate loans. Hybrid REITs usually make both types of investments.

REITs may be publicly traded corporations. In that case, after the REIT has raised its investment capital, it trades on a stock market just as a closed-end mutual fund does. Other REITs are private, nonlisted investments available to qualified investors who wish to be limited partners.

All REITs are designed to be income-producing investments, and by law 90% of a REIT's taxable income must be distributed to investors. This means the yields on REITs may be higher than on other equity investments although the income is not guaranteed. REIT income distributions are taxed as ordinary income.

Reallocation

Reallocate, in the context of an asset allocation strategy, means to change the percentage of investment assets assigned to specific asset classes.

The purpose of reallocation is to reposition a portfolio to improve the potential for meeting a particular objective. For example, you might reallocate in response to a major change in the economy or if you married, divorced, or had a child.

You might also reallocate as you get closer to retirement and wish to put greater emphasis on producing income and less on seeking growth. In that case, you might increase your allocation to fixed-income investments and income-producing stock and decrease your allocation to small-company stock, stock mutual funds, and stock ETFs.

Real return

Real return adjusts the percentage return on an investment or investment portfolio to account for the impact of inflation.

For example, if the return on a stock investment is 6% in a year that the rate of inflation is 2%, the real return is a positive 4%. But if the return on an investment is 3% in a year the rate of inflation is 4%, the real return is a negative 1%.

Real return is useful in evaluating whether or not your investments are providing returns that increase your purchasing power or at least keep it stable. Flat or negative real returns are a major argument against investing too conservatively for the long term. Any investment can produce negative real returns in a flat or falling market.

Rebalancing

Rebalance, in the context of an asset allocation strategy, means to bring an investment portfolio's current asset allocation back into line with the portfolio's intended allocation.

You might rebalance, for example, after a period of strong stock market performance that has increased the percentage of your portfolio invested in stock and decreased the percentage invested in bonds.

When the actual allocation of your portfolio deviates too much from your intended allocation, you may be exposed to more risk than you are comfortable with or assume less risk than may be required to produce the return you seek. Those are the situations in which rebalancing may be required.

Registered investment advisers

A registered investment adviser (RIA) is a firm that is paid for providing investment advice, registers with the Securities and Exchange Commission (SEC), and is generally subject to regulation by states or the SEC, depending on how much money the firm manages.

Firms registered with the SEC have more than \$100 million under management. Firms with assets up to \$100 million register with the state securities agency in the state or states where they operate.

An RIA's employees, called investment adviser representatives (IARs), are bound by a fiduciary standard in recommending securities to their clients. They may manage clients' investment portfolios and earn a fee, or sometimes a fee plus commission, for their advice.

An RIA must file a two-part Form ADV. Part 1 provides basic information about the firm. Part 2 is a detailed narrative explanation, in Plain English, about how the firm operates, how it does its analysis, what it charges, and any material disciplinary actions.

Registered representatives

Registered representatives are licensed to act on investors' orders to buy and sell securities and to provide advice relevant to portfolio transactions.

They may be paid a salary, a commission—usually a percentage of the market price of the investments their clients buy and sell—or in some cases by fees figured as a percentage of the value of a client's account.

Registered reps, more commonly known as stockbrokers, work for a broker-dealer that belongs to the exchange or operates in the market where the trades are handled. The reps must pass a series of exams administered by FINRA to qualify for their licenses and are subject to FINRA oversight. FINRA is the acronym for the Financial Industry Regulatory Authority, a self-regulatory organization for the securities industry.

Return

Your return is the profit or loss you have on your investments, including income and change in value.

Return can be expressed as a percentage and is calculated by adding the income and the change in value and then dividing by the initial principal or investment amount. You can find the average annual return by dividing the percentage return by the number of years you have held the investment.

For example, if you bought a stock that paid no dividends at \$25 a share and sold it for \$30 a share, your return would be \$5. If you bought on January 3, and sold it the following January 4, that would be a 20% annual percentage return, or the \$5 return divided by your \$25 investment.

But if you held the stock for five years before selling for \$30 a share, your average annual return would be 4%, because the 20% gain is divided by five years rather than one year.

Robo-Adviser

A robo-adviser is an automated service that creates and manages a portfolio based on an investor's answers to an extensive online questionnaire. Robo-advisers generally include a level of interaction with a human adviser. The cost depends on the level of access.

Robo-advisers are usually part of a registered investment advisory firm.

Suitability

Suitability is a measure of whether or not an investment is an appropriate portfolio choice, based on an investor's net worth, financial goals, risk tolerance, and time frame.

What's suitable differs from investor to investor. Just because an investment is unsuitable for one person doesn't mean it's a bad investment.

Broadly speaking, suitability is about the right asset allocation for each investor's portfolio at any given time. An older investor probably wouldn't want to put 75% of her assets into volatile small-company stocks, for instance.

Suitability also depends on whether an investor understands the product. Even if a complicated position in derivatives might add balance to an investor's portfolio and be compatible with her appetite for risk, it's an unsuitable investment if she doesn't understand how it works and what it costs.

Standard & Poor's 500 Index (S&P 500)

The Standard & Poor's 500 Index, widely referred to as the S&P 500, tracks the performance of 500 widely held large-cap U.S. stocks in the industrial, transportation, utility, and financial sectors.

Target date funds

A target date fund is a fund of funds that allows you to invest in a portfolio with a particular time horizon, typically your expected retirement date.

In fact, each target date fund characteristically has a date in its name, such as Fund 2025, Fund 2030, or Fund 2040, and so on. You choose one whose date is closest to the date you plan to retire.

A target date fund aiming at a date in the somewhat distant future tends to have a fairly aggressive asset allocation, with a focus on equity funds. As the target date approaches, the fund is reallocated to become more conservative to preserve the assets that have accumulated and provide income. The pace of that reallocation is known as the fund's glide path.

Tax-deferred retirement account

Tax-deferred means that any tax that may be due is postponed until a later date.

For example, a tax-deferred retirement savings account, such as a traditional 401(k) or 403(b), allows you to postpone income tax that would otherwise be due on employment income you contribute to the account and any earnings on those contributions until some point in the future.

Then tax is due on amounts you withdraw, at the same rate you pay on your regular income. The balance remaining in the account continues to be tax deferred.

A big advantage of tax deferral is that earnings may compound more quickly, since no money is being taken out of the account to pay taxes. But in return for postponing taxes, you agree to limited access to your money before you reach 59½.

U.S. Treasury bills

U.S. Treasury bills are the shortest-term government debt securities. They are issued with a maturity date of 4, 13, 26, or 52 weeks. The par value is \$100, which is also the minimum purchase.

The interest a T-bill pays is the difference between the purchase price and par value, which is repaid at maturity.

The bills are sold weekly by competitive auction to institutional investors, and to noncompetitive bidders through Treasury Direct for the same price paid by the competitive bidders. Non-competitive bidders can purchase up to \$5 million in bills in a single auction.

T-bills are described as risk-free investments. Because they are backed by the full faith and credit of the U.S. government, they pose virtually no credit risk. And, because their terms are so short, they pose little or no inflation risk.

U.S. Treasury Bonds

U.S. Treasury bonds are long-term government debt securities with 30-year terms.

These bonds are considered among the world's most secure investments since they are backed by the full faith and credit of the U.S. government.



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