Written by Nick Sanders
Monday, 26 August 2013 00:00

Let's start this off with the obvious. I am not a certified financial planner. I am not a certified investment counselor. Anything I know about investing, I've learned by making mistakes, not by taking classes. In fact, the last formal class I took on investing was in 1982. I learned then that the stock market was a "random walk," and that anytime somebody told me they could predict the market's future, they were either mistaken or lying.

To be clear: I claim no insight or insider knowledge or any expertise in this area whatsoever. So feel free to ignore my investing advice. I really have *no business* writing about the topic.

And yet, when I discuss investing with my friends, it seems they feel I have something to say—something of value that is worth hearing and thinking about. So, with more than a little trepidation, here is Nick Sanders' investing advice.

First things first. Are you contributing to your employer's 401(k) plan? Are you maxing out your annual contribution? What I mean is are you investing as much as you possibly can, and not just the four percent or six percent that will get you the company match? Currently, the IRS permits you to contribute up to $17,500 annually to your 401(k) plan—are you hitting that ceiling?

If you are over age 50, you get another $5,500 in "catch-up" contributions. Are you taking advantage of that additional amount?

Remember, you get a current year tax deduction for your 401(k) contributions. That means your taxable income is reduced by those contributions (you pay taxes on the withdrawals). My first piece of advice: *take maximum advantage of the 401(k) rules*. Contribute as much as you can, right up to the ceiling. If finances are tight, contribute until it hurts—at least as much as your employer will match, if not more.

Second, save some money. Have some cash on hand to cover emergencies such as auto repairs, appliance replacements, etc. How do you do this? You've got to *live within your means*. If you aren't making well into six-figures, then don't act as if you do. Don't drive more car than you can afford. Remember to factor-in both auto insurance and repairs into your affordability calculations. Don't buy a more expensive house that you can afford. Remember to factor-in homeowners insurance, repairs and property taxes into your affordability calculations. The goal is to save 10 percent of your paycheck. Sure, that's a hard goal to reach, and some months you'll spend more than you make, just because. But try to put money away.

Let's talk about credit cards. *Don't*. Credit cards are a trap and you can easily drown in credit card debt. I know whereof I speak. At one point I had $22,000 in credit card debt. (I'm now debt free.) Even a little bit of credit card debt is an albatross around your neck—being debt free makes you feel so much lighter and less apprehensive.

So pay off your credit cards *first*. Pay them off as soon as possible. Make a plan and *do it now*. Don't invest a single dime in anything other than your 401(k) until you are living free of credit card debt. And never, ever, allow yourself to get behind on credit cards. To that end, cancel as many as you possibly can.

Here's the thing: you are paying a finance company lots and lots of interest on that credit card debt. How much? Go look and calculate that number yourself. It could be hundreds of dollars per month! Now picture yourself not paying a finance company that money and, instead, investing that same amount into the stock market. Pretty soon, you'll have several thousands of dollars' worth of investments!

Let's put it this way: if you are paying 18 percent interest on your credit card debt, then paying off that debt means you've just earned 18 percent! It's very, very difficult to find any investment that will pay you 18 percent—so paying off your credit cards may in fact be the best investment you will ever make.

Now, assuming you're debt free and maxing out your 401(k) and saving a few bucks here and there for a rainy day, the next step is to start investing your money. Where to invest?

Here's a link to a very informative **government website** that will help you get started. But I also have some opinions, which I will share below.

CD’s pay next to nothing. If you’re lucky, you can make 1.0 percent. And that amount will be taxed. But the good news is, your principal is protected. You’ll make the promised return and you won’t have to worry about it. But the fact of the matter is that 1.0 percent (taxable) isn’t really much of a return; in fact, it’s a pathetic return. If all your money is in CD’s, then you are likely to be *losing money*, especially in an inflationary environment.

Ditto savings bonds, T-Bills, and money market accounts. You are making right next to nothing on those investments, and what you do make may be taxed.

Municipal bonds, especially tax-free bonds, may look attractive. But remember, the value of the bonds will decline as interest rates increase. You can make your money if you hold the bond until maturity, but if you need to sell it before maturity then you run the risk of losing money.

So pretty much it’s going to be the stock market. You will need to find some way to open an investment account and invest some money in the market. You can open an independent account where you’re in charge of where the money goes, or you can sign up with certified financial planner or some other kind of financial advisor who can guide you.

My experience has been that the best way to go is to sign up with a name-brand company and with a guide whom you trust. How do you find such a guide? The best way is to ask your friends and co-workers for recommendations. Are they happy with their advisor? If so, why? If not, why not?

One way to tell the good ones from the bad ones is to sit down and talk with several. The ones who do all the talking, telling you what you should do and what you need, are not the good ones. The good ones are those who ask a lot of questions about you and your situation and your needs. They don’t try to sell you anything; instead, they seek to match investments to your real needs—after you’ve told them.

Also: annuities. I’ve had annuities for more than a decade and I finally dumped the last one this year. As my guy pointed out, I had been trading lots of investment returns for principal protection that was both somewhat illusory and had never been needed. Even in the stock market crash of 2007 – 2010, I had never needed that protection … and so I was paying for something I didn’t need. All that money is now working for me in the stock market.

Once you’ve gotten your account opened and funded, the next question is where to put the money. Normally, the choice is between mutual funds and individual equities. There is no right answer, because your decision depends on the size of your account (i.e., how much you can diversify on your own) and your risk tolerance. Also, your time horizon matters. How much time will you give your investments to generate a return? Those factors (and others) will help you to determine whether you are going with one or more mutual funds (and which ones), or will be buying individual equities (stocks).

About mutual funds: many of them underperform their benchmark indices year after year, and charge you for the privilege. Before you invest in any mutual fund, make sure you understand the overall goal/philosophy of the fund, what its annual fees will be, and what its Top 10 holdings are. Where do you get that info? From the fund’s prospectus. Don’t invest until you’ve read the prospectus.

Stock index funds are a cheap way to go. Those funds basically mirror their benchmark index (such as the S&P 500) and they don’t charge very much in the way of annual fees.

Exchange Traded Funds (ETFs) are also fairly cheap, but perhaps more volatile than index funds.

When you buy shares of an ETF, you are buying shares of a portfolio that tracks the yield and return of its native index. The main difference between ETFs and other types of index funds is that ETFs don't try to outperform their corresponding index, but simply replicate its performance. *They don't try to beat the market, they try to be the market.*

I own a mix of stock index funds and sector-specific ETFs. I also own a lot of individual stocks.

I want to talk about investing in individual stocks. Most people I know are nervous about investing that way, because they think that they will lose money if the stock share price goes down. Well, maybe. And maybe not.

If you have sufficient investment funds available, investing in a broad mix of different individual stocks makes a lot of sense to me. In fact, I own 50 or 100 shares of a lot of different stocks. I'm not rich—you too can buy 100 shares of Ford right now for $1,700 or so. You can buy 100 shares of Bank of America for $1,500 or so. You can buy 100 shares of Cisco Systems for $2,400 or so. So for less than $6,000, you can have a stock portfolio that includes an American auto manufacturer, a finance company, and a technology company. That's not too shabby, in terms of diversification.

I've learned a few things about stock investment recently. I say "recently" because it's taken years and years for these concepts to percolate through my brain, so that I can now say "I get it."

One of the things I've learned is that I haven't lost any money when the stock price falls, because you never lose (or make) any money *until you sell the stock*. I bought 10 shares of Apple at $650/share, which seemed like a good buy at the time, as the stock fell from its high of $700/share. I then watched as the share price fell below $400/share. On paper, I had lost $2,500—but in real life I had lost *nothing* because I continued to hold onto the stock. Today Apple is trading at about $500/share, so I'm still down, but not as much—and it's all still on paper.

Ideally, when your favorite company's stock price falls, you shouldn't think about selling: *you should think about buying more*. This assumes, of course, that you like the stock for the long-term, which is the correct way to look at things. Most every time I've tried to think short-term, I've ended-up losing money. Even when I've made short-term money, I didn't make as much as I would have, if I'd held on for a few months longer. Plus, don't forget that short-term gains are taxed at a higher rate than long-term gains—so it definitely pays to think long-term.

I've also learned that there are two ways to make money in the stock market. The first way (which is what most people think about) is price appreciation, or growth. Buy low, sell high. Buy Apple for $100, sell at $700 – make $600 per share profit! And that's all true. Especially if you hold the stock for at least a year, in which case you get very favorable long-term capital gain tax treatment.

But the other way to make money is through income, or payment of dividends. Many stocks pay dividends to their shareholders. Also, it's important to note the dividends may be subject to preferable tax treatment if you've held the stock for the right length of time. The ratio of the annual dividend pay-out to the current share price is called the yield. That's a really important concept to get, and it's one that I didn't grasp until quite recently.

Let me summarize my investment philosophy this way: when I invest, I'm looking for a *return* on that investment. The return can come in the form of either income or growth—preferably both. But I'll take it however I get it.

Let's look at Apple again. Assume you bought 100 shares of Apple at $700 and it's currently trading at $500. On paper, you've lost $20,000. But while you've been holding the stock, Apple has been paying you quarterly dividends at a rate of $3.05 per share ($12.20/year). You're getting $305.00 each quarter from Apple, just for holding the company's stock. That's $1,220 per year—which is what you receive in return for not selling the company's stock because the price has fallen. Sure, that's much less than the $20,000 you may have "lost" on paper—but that's real honest-to-goodness money in your pocket every three months.

Too many people don't consider dividends when investing in the stock market. But Warren Buffet knows about dividends. His Berkshire Hathaway gets quarterly dividends of $0.14 per share from Coca Cola. Sounds like nothing much, right? But Berkshire Hathaway owns *400 million* shares of Coca Cola. That's an income stream of $56 million every three months. So dividends definitely need to be considered when calculating your return on your investments.

In my investing career, I've sold several stocks (and mutual funds) at a loss—generating a capital loss deduction that reduced my taxes. But often, when I look at the dividends I've received over the length of my ownership, I've actually had a positive return on those investments.

Looking at yields, some of them are quite favorable when compared to other investments (such as CD's), especially when the tax benefits are taken into account. For example, right now Intel is trading at roughly $22.00 per share, and it's paying a dividend of $0.90 per share each year, for a yield of just over 4 percent. Compare that to your CD that's paying you 1.0 percent, or less—and which is fully taxable as ordinary income. Unless you think Intel is going to go bankrupt sometime in the future, why wouldn't you own it? Do the math.

Let's say you have $10,000 to invest. You put it in a CD paying 1.0 percent and after a year, you've got $10,100, less taxes on the $100 in interest you earned. But what if you took that $10,000 and bought 450 shares of Intel and held it for that same year. Maybe the stock price goes up and maybe it goes down. But over that year, Intel has paid you $405 in dividends—which may have qualified for preferential tax treatment.

Sure, you have to consider commission payments. Commissions and other investment fees can definitely eat into your returns. That's why choosing the type of investment account you open is so important. You want to have the right account. But putting that aside, the investment returns offered by the stock market seem to make it a no-brainer, especially if you have a long-term view of your investments.

To sum up, I'm not recommending any particular investment or any particular stock. I just wanted to pass on some of my hard-won lessons learned, because some people have told me my approach makes sense to them. I hope you agree.