Making the Markets Work for You

by Bob French, CFA

FINANCE 101: MAKING THE MARKETS WORK FOR YOU

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Begin with the Basics: Why You Should Understand Finance

The world of finance may seem complicated, but it doesn't need to be. In fact, it can be incredibly simple if you ignore irrelevant noise and only focus on the elements that actually matter.

Separating the elements that matter from the irrelevant noise tends to be a challenging tasks for investors, but it comes down to what moves you toward your financial goals. We call this "making the market work for you." In order for that to happen, you need a basic understanding of not only your financial goals, but also the finance world. Don't worry, we're not going to wander into the deep end of financial theory. We're sticking to the basics.

The Four Steps of Making the Markets Work for You

Understanding how to make the markets work for you is a four-step process:

1. Understanding why you're investing
2. Understanding the basics
3. Understanding financial markets
4. Understanding what you need for your portfolio

Each step builds on the previous ones. If you don't know why you are investing, you won't understand how the basics of investing impact your goals. If you don't understand the basics, the internal workings of the financial markets will go right over your head. And if you don't understand how the financial markets work, you won't know what your portfolio needs.

So let's begin with why you are investing.

Step One: Why Are You Investing?

It's easy to lose yourself in the ups and downs of the market. After all, every days brings new opportunities to invest and seemingly endless possibilities. The financial media is always announcing the next Golden Child or disaster of the market, making it all but impossible to take a sensible approach to investing.

Investing is not about getting the high score - it's about helping you reach your goals.

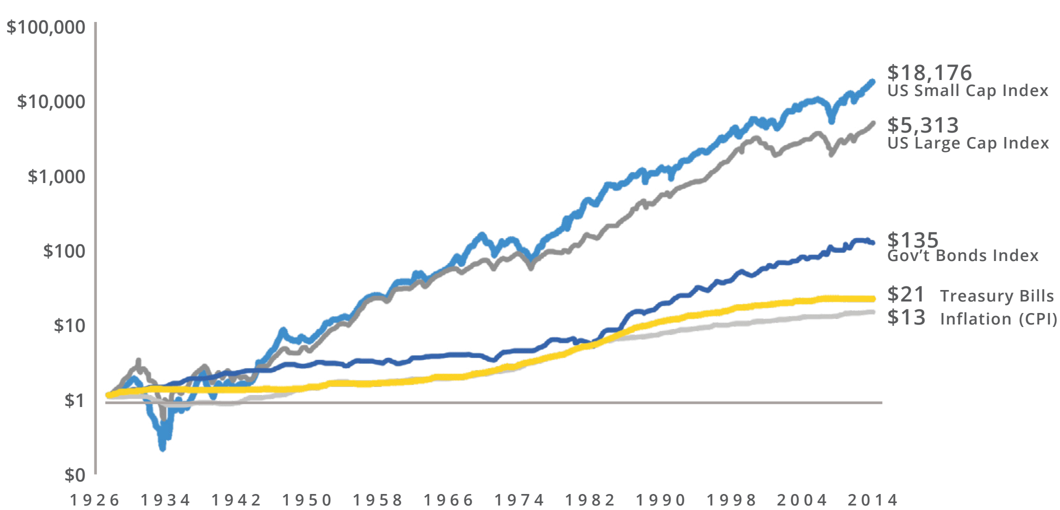
But you need to step back and remember why you're investing. Retirement? Education costs? Estate planning? Whatever your reason, make sure your investment plan is based entirely around meeting that goal. Investing is not about getting the high score – it's about helping you reach your goals.

Investors with no clear understanding of why they're investing often chase one hot investment trend after another and end up back where they started. They have nothing to keep them grounded and focused.

Financial markets are a powerful set of tools for you to use, but you need to know how to use them. They bounce all over the place. It can be hard to maintain your discipline and keep your eyes on your goal. In the end, the long term trend of the market is incredibly positive – but you have to stick with it.

The Capital Markets Have Rewarded Long-Term Investors

Monthly growth of wealth ($1), 1926-2014



In US dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. US Small Cap Index is the CRSP 6–10 Index; US Large Cap Index is the S&P 500 Index; Long-Term Government Bonds Index is 20-year US government bonds; Treasury Bills are One-Month US Treasury bills; Inflation is the Consumer Price Index. CRSP data provided by the Center for Research in Security Prices, The S&P data are provided by Standard & Poor's Index Services Group. University of Chicago. Bonds, T-bills, and inflation data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield).

Investing toward a goal helps you tune out the day-to-day noise of the markets and stay focused on long-term returns. They are there for you to harvest, you just need to know how.

And that brings us to the basics.

Step Two: Understanding the Basics

Just like any industry, the world of finance has developed its own vocabulary to describe the various parts of itself. And, like any industry, the list of acronyms and terms is a little ridiculous, to the point that an outsider might not be able to carry on a conversation about finance with someone "in the know."

Here are 14 basic financial terms you need to understand.

What is the Stock Market?

Like most financial terms, this is both simple and complicated.

The simple answer — the answer that suits our purposes — is that the stock market is a place where you can buy and sell stocks.

It becomes complicated when you start talking about where that place is. There is no stock market like there is a grocery market. It can be a physical place, like the New York Stock Exchange, or it can be on a computer, like NASDAQ. It exists wherever people are trading stocks.

But the simple answer will suffice for us, because pretty much all stock trading happens on a computer now. Even if the exchange exists at a physical location, the trade is likely performed via a computer.

What is a Stock?

A stock is a very small ownership stake in a company. When you own stock in a company, you become a shareholder.

You can receive investment returns from stocks in two ways: dividends and capital gains.

What is a Dividend?

You often hear about a company "paying dividends." A dividend is cash returned to a shareholder by the company. Some companies – generally older, larger and more stable ones – pay dividends on a set schedule. Some pay when profits allow. Others don't pay dividends at all, typically using the money to continue growing the business.

Dividends are one source of a stock's investment return.

What is a Capital Gain?

The other source of a stock's investment return occurs when its price rises. A capital gain is the difference between the price you paid for a stock and the current value of the stock (a capital loss occurs if the current price is lower than what you originally paid for it).

You are taxed on this gain when you sell the stock. If you've held the stock for more than one year, you are typically taxed at a lower rate than if you quickly trade in and out of a stock.

What is an Investment?

An investment is a process in which you use money to make purchases within the stock market in hopes of turning a profit.

How you invest is up to you. You can buy and sell individual stocks or bonds (generally not a great idea), or you can pool your money with other people and pay someone to invest for you. You can do this any number of ways, but for our purposes, we only care about mutual funds and ETFs.

What are Mutual Funds?

Mutual funds are investment vehicles that allow large numbers of investors to pool their money to invest on a larger scale. They are run by fund companies, which hire a fund manager to decide on strategy and handle the fund's day-to-day operations.

A fund manager can charge a fee in two ways (one good, one bad).

The first – the good one – is an ongoing fee, typically called an "expense ratio." It will be charged as a percentage of the money you have in the fund.

Say you put $10,000 in a mutual fund and the fund charged 1% per year (a steep fee in the real world, but we'll use it for the sake of simplicity in our example), you would pay about $100 throughout the year.

If you pay a front-end load, you can't put all of your money to work for you. If you pay a back-end load, you're a hostage of the fund, even if it's not right for you.

The other type of fee is charged to enter (front-end) or leave (back-end) the fund. These fees are referred to as "loads," and they are no good.

You don't want to pay a load. If you pay a front-end load, you can't put all of your money to work. If you pay a back-end load, you're a hostage of the fund, even if it's not right for you.

Funds that charge loads have never been proven to do better than funds that do not. Avoid loads.

What Are ETFs?

Whereas a mutual fund pools money to invest wherever the fund manager sees fit, ETFs (exchange traded funds) are invested in a specific group of stocks, which is published by a third party called an "index" (see "What Are Indices?"). Mutual funds can do that as well. The big difference between mutual funds and ETFs is that an ETF index trades throughout the day. There are other differences between mutual funds and ETFs relating to taxes and fund operations, but the differences are often overstated.

A lot of debate exists over whether ETFs are better than mutual funds and vice versa, but both have their pros and cons and both can work. In the big picture, the structure matters considerably less than what the funds are investing in.

What is a Bond?

A bond is a loan given to an organization – generally a company or government – with the promise of repayment on certain terms. Bonds tend to be more secure than stocks. Whereas stocks never promise that you'll make money or even get all your money back, a defaulting bond is rare.

Just like stocks, bonds have two sources of returns: capital gains and interest. Capital gains for bonds work the same way they do for stocks, but the capital gains of bonds are usually not that significant.

Interest is the more substantial source of income for bonds. By holding onto the bond, you receive scheduled interest payments for as long as it takes to repay the loan. The company or government has to pay you back at a regular rate.

What are Indices?

Indices (the plural form of the word index) are used to track the performance of specific sections of the market. ETFs and some mutual funds are built around indices. An index is like a mirror for a specific portion of the market.

Indices try to describe some section of the market. For instance, the Russell 2000 Index – a common index for stocks of American small companies – is made up of the smallest 2,000 companies, of the largest 3,000 publically traded US companies. They can be broad and cover the entire market, or they can be hyper-specific – such as the Index of the Power Utility Companies of the Republick Srpska, or the Dow Jones 2008 Summer Games Index.

Just by investing in a certain area, you should get roughly the returns of the index, assuming you look roughly like the portion of the market described by that index. Tracking your portfolio against one or more indices can give you a good idea of how well your portfolio is doing.

What is Diversification?

Diversification is the financial realization of the old cliché "Don't put all your eggs in one basket." The market is constantly in flux. While Index A is doing poorly, Index B could be skyrocketing. If you've invested everything in Index A, you're going to take a pretty big hit.

However, if you invest some in Index A and some in Index B, you will take a much smaller hit or no hit at all. Diversification smooths out the bumps so you can more effectively capture the returns you are looking for.

What is Asset Allocation?

Asset allocation is what you decide to invest in – you allocate a certain amount of your assets to one investment type and a certain amount to another. To a large degree, this is your plan for investing, and the most important decision you will make regarding your portfolio.

What is an IRA?

An IRA (individual retirement account) is a tax-advantaged account set up to save for retirement. There are two basic types: a traditional IRA and a Roth IRA.

A traditional IRA allows you to take a tax deduction for money you save up to an annual limit. You will be taxed when you take money out of the account in retirement.

A Roth IRA is the inverse. There's no tax deduction when you save, but you are not taxed when you take money out of the account in retirement

If you're trying to decide between a traditional IRA and a Roth IRA, think about if you are likely to have a higher tax rate in retirement than you do now. For young people, a Roth IRA often makes the most sense. For those closer to retirement, this might not be the case. While there are restrictions on your money when you use an IRA, the advantages almost always outweigh the downsides.

What is a 401(k)?

A 401(k) plan is like an IRA, but it is accessed through work. Many of the rules are similar to IRAs. A traditional 401(k) allows for tax deductions on savings and taxation upon withdrawal. The contribution limits to a 401k are higher than IRAs. In many cases, there are also limited investment options in a 401(k).

Roth 401(k)s exist, and work just like a Roth IRA, but are only now beginning to gain popularity.

Now that you have the basic terms and a fundamental framework for investing in the market, it's important to understand how financial markets work.

Step Three: How the Financial Markets Work

Financial markets are noisy and chaotic. The closer you get to them, the more noisy and chaotic they seem. But there is an underlying internal logic to what is going on.

Financial markets exist to allocate capital. Think of them as massive (and massively complex) loan departments at a bank. They allow companies to raise money so they can grow.

As a result, the financial markets are a network of price discovery machines. As everyone scrambles to determine how risky each company is, the market absorbs all available information, combines it, and then spits out a price.

Now, the market is not "perfect." Not every price is exactly right. In fact, every price is probably wrong. The thing is, we don't know which way – too high or too low. As the market continues to adjust the price, it could go up or down. Until your crystal ball starts working, you won't be able to predict which direction the market will go.

You can't beat the market. It's basically impossible to guess which company is going to be the next Apple or Google, or even which way the market will go. So don't try.

All that guessing and trading – called "active management" – just adds noise and costs you money through investment expenses and lost returns. Remember: Ignore the noise and focus on accomplishing your financial goals by harvesting long-term market returns.

Step Four: Building Your Portfolio

As we said in the beginning, investing is actually pretty straightforward. Most people overthink investing, and it's easy to understand why. This is your life savings. This is your retirement. This is your financial legacy. You want to make sure you're doing the right thing.

If you build an intelligent portfolio, then you can rest a little easier. To do that, focus on these three things when building your portfolio:

- Investment Expenses
- Diversification
- Your Risk Tolerance

Investment Expenses

Investing carries a multitude of unknowns. The whole field of finance is devoted to figuring out how to chip away at those unknowns. With so many variables, we need to pay very close attention to the things we know and can control, which includes your investment costs.

Price is often a fairly decent gauge of quality. The $100 pair of pants is probably going to last longer than the $10 pair of pants. But that's not the case with investments.

The mutual fund that charges more isn't any better than the fund that charges less. In fact, the fund that charges more is probably going to be worse than the cheaper fund because those extra fees are coming directly out of your returns.

Diversification

You don't know how any particular company, industry, or market is going to do, so spread your money around to reduce risk and smooth out the ups and downs of the market in your portfolio.

Focusing on capturing broad market returns keeps you from making bets on tiny sections of the market. Harvesting total market returns from around the world will help you reach your goals. Diversifying your portfolio helps you capture those market returns.

The most important decision you will make about your portfolio actually has nothing to do with your specific investments.

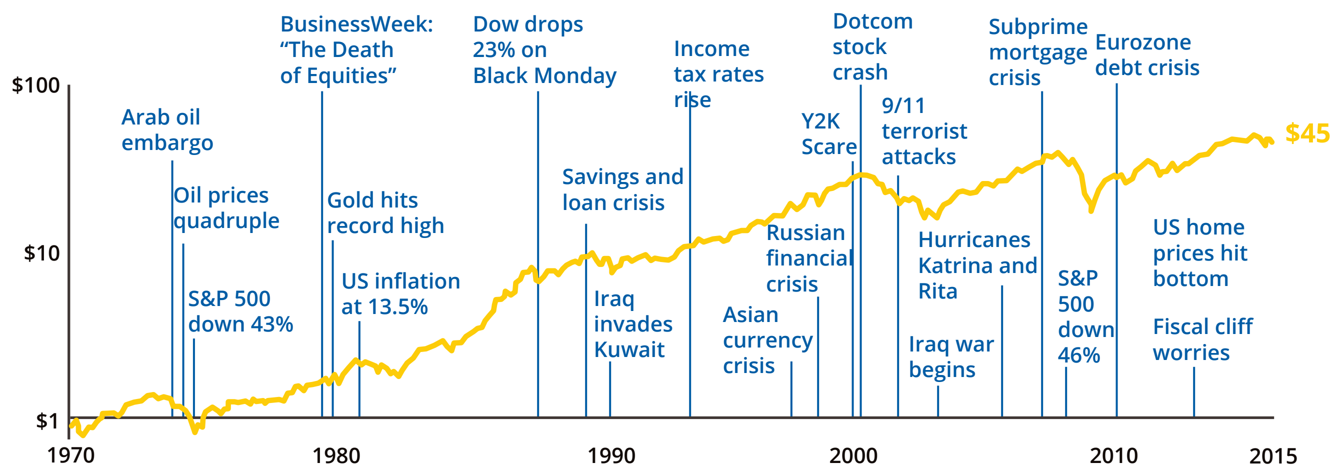
Your Risk Tolerance

The most important decision you will make about your portfolio actually has nothing to do with your specific investments. It is your risk tolerance. How much financial risk can you take and still sleep at night? The answer to this will drive every aspect of building your portfolio.

There is always a reason to expect the worst. Bad things happen around the world every day. Through it all, the markets clearly trend upward. Since 1926, the S&P 500 Index has been up on an annual basis 73% of the time. Long-term returns consistently show up for those who wait. This is why you need to stay disciplined.

Markets Have Rewarded Discipline

Growth of a dollar - MSCI World INdec (net dividends), 1970-2015



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Correctly identifying your risk tolerance helps you build a portfolio that will keep you disciplined and improve your investment experience.

Now you have a basic understanding of the markets and a framework for making the market work for you. It always helps to bounce your ideas off a financial professional when you're first getting started. Feel free to contact us with any questions.

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As McLean's Director of Investment Analysis, Bob helps keep the team at McLean on the forefront of market developments.

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