

Straight Talk from a Financial Planner About Choosing Investments

Sooner or later if we work together, we're going to get around to the topic of what investments to use. When we get to that point, I start by describing the most savvy investment approach you can take. It's the path with:

- Lowest risk from several perspectives
- The lowest cost
- Has historically provided returns that are in the top 1/3 of all professional money managers.
- Is simple so you can focus on what's important in your life.

This approach is called "indexing" and I am a big believer, as are some of the savviest investors around (but we're in the minority). First, what is indexing?

Many books have been written about indexing and I'll happily recommend several to you (the best one is the **Coffehouse Investor** by Bill Schultheis). However, for our purposes, indexing is simply buying a representative sample of stocks or bonds that mimic one of the financial market's averages. The most common stock averages are the Dow Jones Industrial average and the Standard & Poors 500 average, but there are many indexes. When you buy a mutual fund that tracks one of these averages, you're buying small amounts of the stocks that make up these averages. If a stock joins or leaves one of these averages, the manager buys or sells that stock, otherwise there's no trading.

There are many advantages to indexing your investments. Here are my five favorite reasons to index.

1 Avoids many of the risks you take when you invest.

By indexing, you avoid:

- Stock and industry risk since a general index owns many different stocks in many different industries.
- Mutual fund manager risk since an index does not rely on a manager to pick the future winners.
- Broker risk since you're doing it yourself.
- Mutual fund company risk by either choosing indexes from only the top four mutual fund companies or by buying an index-like vehicle from the market itself.

I don't know about you, but I don't like to take risks I can avoid. That doesn't mean I won't invest. It just means that I want to avoid the risks I can and reduce the ones I can't avoid.

2 Most return for the amount of risk. Simply put, over a reasonable length of time (5 years or more), an index fund beats more than 70% of all mutual funds. "But wait," you respond. "Why can't I be in the 30% that beats the index fund?" You can, but the secret is that you can't **choose** to be in the top 30%, you have to be **lucky**. That's right, lucky. No combination of intellect, superior technology or hard work will ever let you be in the top 30% over time. I know that in any period of time, 30% or more of mutual funds will provide a better return than an index approach, it's just

that I don't know which ones in advance. That's one of the secrets on Wall Street. The future is un-knowable, but the brokers, analysts and television commentators don't want you to know that they don't know what the future holds. And I don't know the future either. Maybe indexing investments won't continue to be better than 70% of all other investment approaches in the future. But since I have to take a risk if I'm going to invest, I like my chances with an approach that has over time been correct 100% of the time.

3 Best value. I'm from the Midwest and was raised in a good, solid middle class family. My parents believed in getting value for their money and I do too. I don't want to pay too much for anything. Another dirty little, hidden secret with buying individual stocks and especially with buying mutual funds is that it's expensive no matter what performance you get. This cost comes right out of your pocket. The average stock mutual fund costs you 1.5% a year; a good index fund costs about 1/10th of that.

4 Works consistently. Even if a mutual fund provides superior performance with equal risk for a short period of time, what do you do when it no longer provides a superior return? What do you do when that manager stumbles (or retires)? Do you sell right away or do you wait? This is my favorite question to ask people when they brag to me that they "know someone" who has beaten the indexes. It's my favorite question because the person never has an answer. If someone uses an active investment approach, they are forever locked into the "what do I do now?" wheel. Like a hamster on wheel, they have to keep running or go to cash. With indexing, I don't have to come up with the next big idea. It's worked before and it will likely work in the future.

5 Simple. When you index, you get on with your life. You want to coach your son's or daughter's soccer team, take photos of birds and sunsets, help your wife decorate, read good books, play golf, ride your bicycle with your family, throw the ball with your dog. You don't want to look at your investments every day, week or month. You don't want to read those confusing reports from mutual fund companies that are purposely vague, or fret about what a mutual fund manager is buying, selling or how much cash she/he holds when she's supposed to be investing your money for you. Indexing your investments lets you get on with your life — maybe the best reason of all.

My mission is helping people make sound financial decisions one hour at a time.

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