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INVESTING WITHOUT

The Five Essentials of Financial Freedom

Contents

A wise man should have money in his head, but not in his heart.

—Jonathan Swift

Investing without Wall Street

THE FIVE ESSENTIALS OF FINANCIAL FREEDOM

Sheldon Jacobs

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To my wife, Betté, who has enriched my journey with love.

Also by Sheldon Jacobs

Put Money in Your Pocket: The Art of Selecting No-Load Mutual Funds for Maximum Gain

The Handbook for No-Load Fund Investors (20 annual editions)

Sheldon Jacobs' Guide to Successful No-Load Fund Investing (2 editions)

How to Pick the Best No-Load Mutual Funds for Solid Growth and Safety

Preface

With some books the Preface is unimportant. That's not the case with this book. This preface provides an overview of what investors really need to know to prosper in today's markets, which are so very different from the ones we loved in the 1980s and 1990s. But first, I need to quickly touch on two money-making basics.

1. Do-it-yourself is the real key to lifetime profits.

First of all, you need to appreciate the huge difference between doing-it-yourself and hiring professional guidance. Although there is value in a book explaining the best ways to work with a broker or professional investment advisor, the real benefit comes from a book that teaches you, simply and clearly, how to do it yourself.

The wealth difference is overwhelming. *Over a 40-year investing lifetime, an average earner can make $252,000 more doing it him or herself than a person who has to share his or her profits with professionals.* That's a lot of money going to advisors, not you. That's why this book is titled *Investing without Wall Street*! (See Chapter 4 for the computations.)

Achieving this wealth increment is within everybody's ability and takes very little time. In addition, by doing it yourself, you will know your self-interest has always been put first. That's no small thing in an era where crooks like Bernard Madoff stalk uninformed investors. *Investing without Wall Street* gives you control of your finances.

2. Savings are crucial.

All the advice offered in this book is academic if you have no money to invest. Money is accumulated by saving. Savings are not just a good idea; they are crucial.

There is no need for this book to discuss the mechanics of saving. You simply spend less than you earn. If you don't already have savings, *start saving*. Start as early as you can, the earlier the better. If you have some savings, *save more*.

A 12-Year-Old's Commentary on Saving

The top reasons why I think it is important to save are:

1. To help me tell the difference between my needs and wants
2. To gain interest on my money
3. To save for larger things such as a bicycle
4. Currently I am working to raise money to go to camp next summer.

Sarah, Shepherdstown, WV. Reported by Michelle Singletary, WashingtonPost.com.

As Bill Donoghue, the money-market maven, once said, "If you can't live on your income now, you can't live on 10 percent less. So save 10 percent."

Here's a summary of the book's investing advice and philosophy.

Today's Times Call for More Conservative Strategies

In the 1980s and 1990s, the buy-and-hold investing strategy superseded all others. You didn't have to be a brilliant stock- or fund-picker; all you had to do was buy-and-hold stocks, and you could have earned 18 to 19 percent a year.

The market is unlikely to achieve gains of this magnitude again in my lifetime, and possibly yours. That's because secular bull markets, the long-lived megatrends that last 5 to 20 years, usually occur only when there are dynamic new, giant growth industries such as computers, information technology, the Internet, and in earlier eras, canals, railroads, electricity and automobiles. They provide the basic foundation. All these advances had myriad applications over a broad range of industries. I don't see anything comparable on the horizon. Technological advances since the computer and the Internet became mainstream have been more evolutionary than revolutionary. The new social media are evolutionary, even though they have produced several billionaires.

For many years to come, I believe stock markets will be in a secular bear market. They will move up and down, not basically up as in the 1990s. I expect average gains over the next decade or more will be in the neighborhood of 6 to 7 percent annually. That's because I don't see any reason for the price/earnings (P/E) ratios of stocks to expand significantly in the coming years, and they may possibly contract. (In the 1980s and 1990s, 43 percent of all gains came from P/E expansion, as investors paid more and more for a dollar of corporate earnings.) I believe stocks, over the next decade or more, will at best gain pretty much in line with their earnings increases (which will depend to a greater extent on the economy than has previously been the case).

The good news is that this means stocks can still deliver returns superior to bonds or cash, albeit with greater risk (which I'll show you how to control). The best news is that since stocks declined 38.5 percent in 2008, they could easily have double-digit gains over the next five to six years, and return to that estimated long-term average.

A study by Capital Guardian funds found that when the S&P 500 Index had an annual return of 2 percent or less over a decade, stocks gained between 10 percent and 17 percent annually in the ensuing decade. The annualized return for the 10 years ending 2008 was −0.93, and the S&P 500 gained 23.5 percent in 2009 and 12.8 percent in 2010.

Regardless of the volatility, equities must continue to have a place in your financial planning, particularly if you are young.

Sheldon Jacobs' Statement of Purpose

Investing books are commonly written to enhance authors' careers. However, that was not my motivation. I've had two successful careers, each a quarter-century long, and I have no desire for a third go-to-the-office job. I didn't write this book to sell newsletters or obtain managed account clients. I sold both my money management business and newsletter a few years ago, but I continue to work as a contributing editor of the *Investor* newsletter. In addition, I am on the Finance Committee of the Westchester Community College Foundation, in New York, where I help to manage a multi-million dollar institutional portfolio. And lastly I manage my personal investment portfolio.

The purpose of this book is to share with others the important lessons I have learned over a lifetime. I have always written about what interests me. And right now, what interests me is making my investing as simple as possible. *Investing without Wall Street* is a guided tour based on personal experiences. Most of the strategies that I offer in this book, I have tried myself. *I know they work*.

I am not a genius. I have always looked for ways to make money without being a Goldman Sachs-level expert, and I promise you that any ordinary person will be able to implement the profit-making recommendations in this book.

There are two reasons for this. First of all, investing literature commonly attempts to tailor advice by investor demographics (age, wealth, time horizon) and risk preferences. *Investing without Wall Street* does this too, but in addition, it offers advice by degree of desired investor involvement. It speaks to investors who are willing to spend time to obtain the best results, but mostly to the more numerous investors who are simply seeking a comfortable nest egg while getting on with their daily lives.

Secondly, the specific advice offered takes into account what I think investors will actually do on their own, since no matter how wise the advice, it’s not productive if investors don’t follow it.

Finally, you’ll quickly see that I don’t always agree with the conventional wisdom, and as you discover how much about investing there is to learn, you also may find you have even more to *unlearn*.

In November 2010, the *Bottom Line Personal* publication observed, “Among financial experts who are able to think with a small investor’s perspective, no one is more level-headed than Sheldon Jacobs.”

My Approach to Financial Profits

Between 1974 and 2004, I wrote 24 books as well as *The No-Load Fund Investor,* a top-ranked monthly, mutual-fund newsletter that I founded to provide specific investing advice, recommendations, and model portfolios. The books and newsletter basically offered advice within the framework of a secular bull market. Because investor interest was concentrated almost exclusively on profit seeking in those bull market years, like virtually every investing publication in those decades, I placed greater emphasis on profits than on risks. Even though my recommendations in those years were conservative compared to most of my colleagues, long-term bearishness would not have served my readers.

But times have changed, and so has my advice.

In *Investing without Wall Street* I have expanded on the tried and true wealth creation programs to take into account the challenges of the new market climate. *Investing without Wall Street* emphasizes both risk control and profits by zeroing in on five "essentials."

The Five Essentials

The book is divided into three parts. Part One (Chapters 1–5) discusses five principles that are the essence of the knowledge you need to be a successful equity investor. Master these five "essentials" and you'll have the wherewithal to be a successful investor without the need of professional assistance. They are your priorities.

1. Determine the right asset allocation.

2. Properly diversify within asset classes.

3. Understand and control risk.

4. Keep your costs low.

5. Choose the right financial media to follow.

I suspect that at this point some of you are thinking, "I've heard most of these principles for ages." And probably you have, but I will bet that a good number of you have never really understood their importance, or how best to apply them.

You will also notice that security selection (choosing specific stocks or funds)—most advisors' favorite recommendations—is not one of the five "essentials." Notwithstanding its ubiquitous coverage by the media, it's a myth that you need a lot of knowledge in this area.

Security selection can be simplified to the point where you can make good selections effortlessly. Equally important, if you follow the five essentials, security selection won't be a make-or-break factor in your investing efforts. The purpose of this book is to make you a better investor, not to load you up with tips about specific investments.

In the 1980s and 1990s, investors achieved success by mostly just being in the market. Over the next decade, I believe *the key to success will be you*—how you approach investing, how clear-headed is your understanding of the market's underlying realities, and whether your skills and attitudes are right for the times.

Part Two (Chapters 6–12) refines and provides specific ways to implement the five "essentials." Included are my "takes" on surviving bear markets, the latest advance in index fund investing, and model portfolios that put into practice the "essentials." In Chapter 10, I make the case for market timing.

Part Three (Chapters 13–19) discusses important and timeless lessons that I have learned over the years as an investor, investment advisor, money manager, editor, entrepreneur, and observer of human nature. These chapters show how you can profitably expand your general money knowledge. They will give you an overview of personal money management situations seldom, if ever, covered in other personal finance books or periodicals.

Here are some of the topics covered:

Acknowledging that investing is a science dealing with uncertainty, Chapter 13, titled "For Clearer Thinking," shows that it's just as important to learn *how* to think, as it is to learn *what* to think. It offers lessons in clear and critical thinking. Similarly, Chapter 14 discusses behavioral finance, now an important frontier in investing knowledge. With a few exceptions, my take on the subject ignores the academic approach, concentrating instead on practical applications.

The purpose of these two chapters is to help you acquire the skepticism and creative thinking that are important to financial success. Again, "The key will be you" is not just an empty phrase. This adage is just as important as the fundamentals.

Chapter 16 aims to help women achieve their investing goals, and in Chapter 17, I briefly discuss owning collectibles for profit. Another chapter tells you how to invest in a Broadway musical with a relatively small outlay. Few readers are likely to make such a high-risk investment, but my experience as a backer of *Hairspray* was fascinating and brought me so much enjoyment I had to share it with you.

Integrity is so important when you are giving your hard-earned dollars to impersonal businesses or total strangers that I have devoted an entire chapter to it.

Because almost everybody makes far more money in the workplace than they make from investing, I offer advice in Chapter 19 to both employers and employees, based on my personal experiences as the owner of a small business, and as an employee of two large corporations.

Although there is a chapter titled "The No-Work Way to a Comfortable Retirement—Maybe," don't be misled. *Investing without Wall Street* is not a "lazy man's" guide, or even a "permanent" portfolio strategy. Quite the contrary, it's for people who want maximum results for the time and effort they spend investing. It's for young investors who want to learn it right the first time.

Investing without Wall Street also shares stories of interest. As Adam Smith said in the Preface to the *Money Game*, the classic tale of Wall Street in the 1960s, "Enjoy the stories, they always teach more than the rules." That's what Wall Street does to sell stocks to investors. That's what I have done in *Investing without Wall Street:* recounted stories that will "sell" you investment strategies that are profitable for you, not for Wall Street's promoters.

Although I favor funds, the insights I offer are relevant whether your preference is mutual funds, exchange traded funds (ETFs), stocks, or anything else. And for those of you who are wealthy enough to have personal money management, *Investing without Wall Street* provides a valuable guide for riding herd on these advisors, something that every managed account client should do.

Finally, this book contains many of the usual investing and Wall Street terms. If you don’t know a particular term, there is a glossary at the back of the book that will make you an expert on this jargon.

Introduction

Take a Journey with Me

You might think that there is only one investing world, but there are many, and their differences go far beyond investing strategies or financial products. There are the separate realms for hedge fund operators, stockbrokers, commodity traders, gold bugs, and day traders. There are perma bulls and perma bears. There are also the worlds of investors who rely on advisors, the do-it-yourselfers, the stock-pickers, asset allocators, market-timers, trendsetters and trend-followers, the involved and the uninvolved.

My foray into a different world explains these distinctions. Back in the 1990s, I was invited to make a speech to the subscribers of an Internet stock market trading system. I knew that investors who traded on the Internet were not the audience for my style of moderate risk, diversified investing. But the invitation had come through a friend who had recommended me, and the sponsor offered me a substantial fee, so I accepted.

Before I was called to the podium, the president of the Internet trading company jumped up and said he wanted to poll the audience, about 100 strong, to ascertain their risk preferences.

Using a scale of one to ten, with ten being the most aggressive investing and one being the most conservative, he asked, “How many people are tens?” About five people raised their hands. “How many are nines?” About 25 people raised their hands. “Eights?” At least 50 responded.

I thought to myself, “Good grief, I’m a *four*, and this audience wants advice that will make them a killing in the market *tomorrow.*" Well, I delivered my usual speech and only one person walked out. Although I considered it a moral victory, I tried hard never to repeat that experience again. And, thankfully, I never did. Time is precious and I hate to waste investors' time with advice they are unlikely to accept.

This book is for investors with risk tolerances ranging from about three to seven. It's not for eights, nines, or tens. If you're an eight or higher, and are perusing this book in a bookstore or library, put it back on the shelf. This book is not for you and I don't want to waste your time. By my standards, you are not really an investor. You should be in a casino playing the slots.

On the other hand, if you are a one or two, stick with your bank CDs, savings accounts, or e-bonds, unless you want to learn how to increase your wealth with only a moderate increase in risk.

My world is primarily the world of diversified, low-cost, no-load mutual funds that you invest in for the long-term. I first ventured into no-load funds because I figured that any financial product that is always on sale had to be the right world for me.

A four is right for me, and some other number may be right for you. That's okay—people are different.

In this book I would like to take you on a journey through my world of investing. It will be fun, and you'll find it worth your time. But before we get down to the main business of this book—improving your investing skills—I want to briefly tell you about the town I grew up in, since it has a strong bearing on who I am and how I came by the advice I will be dispensing.

How My Journey Began

I grew up in Deadwood, in the Black Hills of South Dakota. If you drove through Deadwood back in those days, you might have thought it was an ordinary small town. But Deadwood was unlike any other small town in the United States, and everyone living there knew it. Deadwood had been the scene of one of the country's most notable gold rushes, and the town never lost its frontier spirit.

In the forties, when I grew up there, the town had a population of 4,000. There are many small towns where people live because they can't make it in the big city. But that wasn't true of Deadwood. Some of the sharpest people I have ever met lived there. They could have made it anywhere, but they preferred Deadwood because of the breathtaking beauty of the Black Hills, its heritage, its sense of small town intimacy, and its proximity to Mount Rushmore. There was great hunting, fishing, skiing, camping, and mountain climbing, all within an easy drive. For climbing, there was Devil's Tower, which later on gained fame in the Steven Spielberg movie, *Close Encounters of the Third Kind*, and Harney Peak, which at 7,242 feet is the highest peak between the Rocky Mountains and the French Pyrenees.

The town had a strong Libertarian bent. Its Main Street, filled with prosperous stores, was the shopping center for 40 miles around. It was home to seven churches and seven bars, and each bar had a room in back for gambling, usually slots, blackjack, and crap tables. There had always been gambling in Deadwood, ever since the gold rush days. Technically, it wasn't legal, but the state never bothered to enforce the law.

In those days (the 1930s and 1940s) Deadwood also had three houses of prostitution. All were on Main Street on second floors, above the bars. And they all had neon signs at street level advertising their presence. The signs read: Ma's Nifty, the Cozy, and the Shasta.

Everybody in town favored these businesses, including the clergy, because they brought in tourists, which were one of the two lifeblood industries of the town. “Everybody” certainly included my dad, who was born and raised in Deadwood, and was totally accustomed to this environment. He approved of anything that brought in business. The “girls,” as everybody called them, did a lot of shopping in my dad’s ladies ready-to-wear store.

The other lifeblood was gold mining. The fabled Homestake Mine, once owned by George Hearst (William Randolph Hearst’s father) at the time the largest gold mine in the Americas, was located in Deadwood and in nearby Lead, South Dakota. The mine was listed on the New York Stock Exchange (NYSE) in 1879 and continued producing gold for more than 120 years. Homestake became the longest-listed stock in the history of the NYSE and brought millions of dollars of revenue into town.

Deadwood’s liquor laws were loose, to put it mildly. Of course, South Dakota had laws regulating drinking, and I guess they applied to Deadwood, too. But the reality was that liquor was regulated in Deadwood not so much by age as by height. If you were tall enough to stand at the bar and pound it with your fist, it was likely you would be served. You could even drink 3.2 beer legally at age 15.

Another convenient thing about Deadwood, and actually the entire state of South Dakota, was that you didn’t need a driver’s license to drive a car in those days. The sole requirement was to be 15 years old. Consequently, when we all got to be about 14 and a half, we badgered our fathers to teach us how to drive so we could drive on our own as soon as we reached 15.

During my lifetime, things changed radically in Deadwood. In 1947 the state of South Dakota finally decided to enforce the gambling laws, and that had a crippling impact on commerce. The brothels were closed in the late 1970s in an action that drew national coverage. Then one day right after the last brothel closed, hundreds of people paraded down Main Street holding up banners reading BRING BACK OUR GIRLS!

In 1989, Deadwood got a new lease on life when the state of South Dakota made the town an exception to its gambling laws, just as New Jersey did for Atlantic City.

Main Street, which used to have regular stores catering to families, is now wall-to-wall gambling casinos its entire length—139 in all if you count the stores with slots. The ladies ready-to-wear store, once owned by my dad, is now a casino called the Midnight Star, owned by the actor Kevin Costner and his brother.

The new gambling money has spruced up the town. The streets have been repaved, and almost all of the storefronts are new. There are several new hotels and restaurants.

And it was just in time. Two years later, the Homestake Mine, its gold finally exhausted, closed for good. If it hadn't been for the gambling dispensation granted by the state, Deadwood would have become a ghost town. Even with the gambling, the town's population has dwindled to 1,270 according to U.S. 2010 Census. Deadwood will be around for a long time, but it's not the same town now that it was for my generation.

In 1964, Deadwood became the only city in the United States to be named a National Historic Landmark. In 2004, it received a new measure of fame when HBO launched a western TV series, *Deadwood*, set there. In 2009, ForbesTraveler.com selected Deadwood as one of the twenty prettiest towns in America.

And now you need a license to drive in the state of South Dakota, including Deadwood.

When gambling closed in Deadwood, many of the town's gamblers moved to Las Vegas. So the first time I went to Las

Vegas I looked up two of them, Virgil Rakestraw (Rakie) and Eli Gasson.

I found Rakie, a big hulk of a man, dealing at a roulette wheel at the Stardust casino. When he took a coffee break, we discussed gambling. “Never gamble in Vegas,” he admonished. “It’s different than Deadwood.”

I knew what he meant. In Deadwood, if the casino saw a local man gambling away the rent and food money, they made him stop for the sake of his and his family’s well being. That didn’t happen in impersonal Las Vegas.

I found Eli working as a pit boss at a small casino. Over coffee, he also warned me not to gamble in Vegas, though he made an exception for poker. I politely accepted his advice, but it was meaningless to me.

I knew Eli was a world-class poker player. According to legend (probably Eli’s), he was the champion poker player of the Pacific fleet during World War II. How he came by this title I never understood, although I believe there was some legitimacy to the claim. If he were around today, I’m pretty sure he would be earning big bucks on TV.

Poker is a game of immense skill, not luck, although in the short run, luck can temporarily overcome skill, just as it can in economic life. I am sorely lacking in the skills needed to win at poker. (I know, because I learned how to play the game at Boy Scout camp—and never won.) In addition, poker, too, is a zero-sum game, and finally, in poker if you lose there is no TARP to bail you out.

For many years I went to Vegas once a year to speak at the Money Show (see Chapter 5). I always heeded Rakie’s and Eli’s advice, although the real reason I don’t gamble is that gambling is a zero-sum game less the house edge, meaning for every winner there’s a loser. Stocks, on the other hand, are a positive-sum game. By that I mean it’s quite possible, and often likely, for all the players to win, since they can participate in earnings growth over time. I