The Motley Fool®

13 Steps to Investing Foolishly

A MOTLEY FOOL INVESTMENT PRIMER

Welcome

It all started with chocolate pudding.

As boys, brothers David and Tom Gardner learned about the business of stock investing at the supermarket. Their dad, a lawyer and economist, told them, “Y’know the pudding you just piled into the cart? Well, we own a part of that company, and every time someone buys pudding, it’s good for our company.”

Ah, the ole’ “buy what you know” trick. The lesson stuck — and the pudding made kind of a mess, too. From that day forward, the brothers began to develop the beliefs that would soon become the foundation of Foolishness:

1. Investing isn’t rocket science.
2. You are the best person to manage your own money.
3. Investing and personal finance can actually be fun.

Whether you’re new to investing or a market whiz, The Motley Fool’s goal is to make managing your money easier. We’ll show you how to do it yourself, and we stand (along with a community of over 30 million other Fools) ready to offer our assistance along the way.

Those 30 million Fools are a looonnnggg way from the dozen or so friends and relatives who first subscribed to the humble Motley Fool newsletter in 1993. Since then, The Motley Fool has grown into a multimedia financial education company featuring a website, radio show, newspaper column, and best-selling books. Recently, *The Motley Fool Money-Making Life-Changing Special* debuted on PBS television.

These 13 Steps are a great place to begin your journey to financial independence. Welcome to Foolishness.

Fool on!

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Introduction

Your Ticket to Financial Independence

You may not yet realize it, but right now you're staring at a ticket to financial independence. That's right — this small primer might make a big difference in your life, enabling you to retire in your 50s (or 40s, even), send your grandchildren to college, buy that summer place on Lake Watchamacallit, or fly around the world in a zeppelin emblazoned with your high school nickname.

(Hey, "hot lips." Can you hear the violins playing as you float over a herd of wildebeest charging across Ngorongoro Crater?)

You've probably heard of The Motley Fool. But you may not yet know what we're all about and what we can offer you.

Chief Fools David Gardner, Tom Gardner, and Erik Rydholm came up with a mission and cranked out the first issue of The Motley Fool printed newsletter in July 1993. The Motley Fool debuted online a year later, on August 4, 1994. (That mission was, has been, and will always be to help you to invest for yourself and gain control of your personal finances. We want to help you make the smart decisions about your money. We strive to educate, amuse, and enrich — all at the same time.) We know that most people have never been taught much about finance or investing, and that a glance through *The Wall Street Journal* or a mutual fund prospectus sometimes can be rather intimidating or confusing. That's how they like it. But you know better (or at least you're going to in just a moment).

Tending to your finances isn't as mysterious and complex as you've probably imagined. The professional Wise men on Wall Street, however, would like you to keep thinking it's too difficult for you to do yourself. That way you'll entrust your hard-earned dollars to them, so that they can generate fat commissions for themselves. Yes, there are some good brokers out there worth the money they charge. But know that most financial advisors aren't paid by how well they manage your investments, but by how often they get you to trade in and out of stocks. And what do you get in return? Sub-par performance and lower returns.

Give us a little time and we'll show you how you can beat Wall Street at its own game. You read that right. Your portfolio shouldn't have much trouble trouncing 75% to 90% of professionally managed mutual funds over time.

And now for a hot stock tip.

Just kidding! We think the person who most has your financial best interests at heart is you. That's right — you're the one who should be making the decisions affecting your monetary future. And you don't need an MBA or a pair of suspenders or a pricey summer home in the Hamptons. You don't even need a stranger's hot stock tip. (FYI: Most of those were cold long before they got to you.) Believe it or not, some fifth-grade math is pretty much all you need to get better returns than most professional money managers. Once you've got a little painless learning under your belt, we suspect you'll find that managing your own money can actually be fun.

Enter this modest booklet. In it we lay out a systematic approach to investing that should benefit novice and seasoned investors alike. We first focus on getting your financial house in order, then move into a discussion of various investment options, and later address more advanced investing topics.

No material presented here should frighten or intimidate you (unless you happen to be frightened by semicolons or puns involving llamas). You don't need any fancy credentials in order to understand anything in here, but that doesn't mean you should jump immediately into the stock market whole hog. Ease into investing. Take it one step at a time. For example, you might want to first move your mutual fund money into an S&P 500 index fund (we'll explain why shortly) and then take a breather while you read and learn more. Don't take any action until you're comfortable with what you're doing.

So without further ado, let's part the curtains and unveil the Foolish approach to investing.

Creak, creak, creak.

(The sound of curtains being drawn open)

(Oohs and ahhs from the audience)

(Someone in row 17 coughs.)

(Someone in row 12 shushes the lady in row 15 unwrapping her butterscotch.)

Step One

"The Wise would have you believe that 'A fool and his money are soon parted.' But in a world where three-quarters of all professional money managers lose to the market averages, year in and year out, how Wise should one aspire to be?"

David and Tom Gardner,
The Motley Fool Investment Guide

What Is Foolishness?

Let's start out with what you may be most confused about right now. As a newcomer, you might be wondering just what the heck all this "Fool" stuff is, and why you should spend any time here. You were looking for investment or personal finance information (right?), and now you're suddenly staring a court jester directly in the eye.

Who are these guys?

What is this?

To make a long story short, The Motley Fool name comes directly from the beginning of Act II, scene vii of Shakespeare's *As You Like It*. In the days when Shakespeare was writing about kings, Fools were the happy fellows who were paid to entertain the king and queen with self-effacing humor that instructed as it amused. Fools were, in fact, the only members of their societies who could tell the truth to the king or queen without having their heads rather unpleasantly removed from their shoulders. In Fooldom, you the readers are the king, and it's our job to tell you the truth about investing and show you how you can manage your own money better than the pros on Wall Street.

The Motley Fool was formed in mid-1993, appeared on America Online a year later, and launched its full site on the World Wide Web in 1997. (Its goal was, is, and will always be to educate, to amuse, and to enrich.) We're here to help you help yourself with all aspects of personal finance and investing. We don't manage anyone's money but our own, and we're not investment advisors. Again, our interest is solely in educating, amusing, and enriching. (We do have an interest in winning awards for producing the best financial website in the whole dang world, but that's pretty much a pride thing; there sure isn't any prize money that comes with any of these awards.)

Now, when you're plying your trade in the investment world, you normally wouldn't want to be caught dead being called a "Fool," right? We think quite the opposite, of course. We look around at the supposed Wisdom in the world today, the Conventional Wisdom, and wish to put an end to it, to reform it. In fact we're on a mission here — a mission from Shakespeare.

So what is some of the Conventional Wisdom so contrary to the Foolish point of view? We'll preview just a few slivers of it now — suffice it to say that the subsequent 12 steps contain a touch more, and the rest of our website goes into Foolishness in much greater detail.

CONVENTIONAL WISDOM #1
You should just let "experts" invest your money for you by putting your money in managed mutual funds.

FOOLISH RESPONSE
Yikes! Did you know that well over three-quarters of all managed mutual funds underperform the stock market's average return? In other words, most of the Wise "professionals" out there are losing to the market's average return in most years — and they are paying themselves very, very well in the process! Mutual fund managers will try to persuade you they have some special Wisdom or crystal ball. Unfortunately, their impressive-sounding jargon is hogwash when compared to the actual performance of the market averages. If you're ever going to be invested in mutual funds, look only as far as an index fund, which tracks the market's returns at a very low cost. (For more information, check out The Truth About Mutual Funds at www.funds.Fool.com.)

CONVENTIONAL WISDOM #2
Financial gurus do a good job of predicting the direction of the stock market.

FOOLISH RESPONSE
Nope. No one has ever proven the ability to predict the stock market's future consistently and accurately. We are amazed and amused by all the people who still try to do it, and all the journalists who daily (or hourly!) quote them on the matter. Buy and hold good stocks, and don't sweat where anyone's telling you the market's going.

CONVENTIONAL WISDOM #3
Wall Street brokerage firms and professionals are a great asset to our society, and they're worthy of our trust.

FOOLISH RESPONSE
Well, they spend hundreds of millions a year on TV commercials insisting so, but... ummmm... not even close. First off, it's not in Wall Street's best interests to teach you (go to **www.Fool.com/school.htm** to find out more). So long as you're in the dark about investing, you'll have to give your money over to Wall Street to manage it for you. That way, Wall Street professionals can charge you (hidden) fees to manage your money. The entire Wall Street industry is built on your not figuring out how to manage your money. And that, on the other hand, is exactly what your fellow Fools are here to help you do — for FREE.

Further, most brokers are well trained in the subtle art of salesmanship and are paid based on how often you trade, not how well you do. That has created a massive conflict of interest, because the best way to invest is to buy and hold, not buy and sell and buy and sell again.

The Wise have prevailed in the money world for far too long. Now it's finally time that some Fools showed up and leveled the playing field. By "Fools," of course, we don't just mean ourselves — we also mean the millions of Foolish readers who come every month looking to answer each other's Foolish questions on our discussion boards.

All that we humbly ask is that you use whatever you may learn here for the benefit of good rather than evil, and that if you chance across some other Fool's question that you can help out with on one of our discussion boards, that you give a thought to doing so.

We believe that when you take control of your financial life, you're taking control of your destiny, and that you'll be rewarded by making the decision to do so. By the time you're done with our 13 Steps, you'll be well on your way to a lifetime of successful do-it-yourself investing and extreme Foolishness.

But before we get into all that investing stuff, first a word about your credit card sponsor...

Step Two

"A lot of savings tips are depressing. You follow the fashionable advice in the paperback bestsellers and find that you haven't bathed in a week, you aren't washing your clothes very often, and you've been alternating between ramen noodles and oatmeal all winter. We don't think you want to live that way (if Foolishness doesn't make saving money uplifting, it ain't worth it). Bring to your savings plans the good humor that pulled Scrooge out of hell. Your enjoyment isn't merely crucial to the process. It is the process."

David and Tom Gardner, *You Have More Than You Think*

Settle Your Personal Finances

You have a few bucks set aside, you've just canceled your subscription to *WiseMoney*, you've stopped watching the "Cable News Wisdom Channel," and you're thinking of starting to get a little bit Foolish with your dough. Maybe you've registered (for FREE!) at The Motley Fool website (at **www.register.Fool.com**), and you've been coming back regularly to some of our Foolish discussion boards. In fact, you've even peeked ahead a few steps to read about choosing a broker to make your first purchase of stock...

Hey! Whoa there!

Not so fast, buddy — what's your rush? We know you're on the information superhighway and all, but believe us, when it comes to investing money you've worked hard to earn, you want to obey all the speed limits. Your personal finances need to be in squeaky clean order before you ever think of placing that exciting first stock trade. As you'll find Fools imploring again and again all over this site, do not ever rush. This second step is here to tell you to settle your personal finances.

Only invest money that is free of obligation.

ERASE CREDIT CARD DEBT

First stop... how thick is your billfold these days? Is it full of cash or credit cards? One of the critical keys to investing is only to use money that is free of other obligations. Thus, if you are carrying a revolving balance on your credit cards, it ain't free! (Neither are you, unfortunately.) Here's why: Many credit cards have an annual interest rate of 16%-21%.

Let's say you have $5,000 to invest, but you also have $5,000 in credit card debt with an average annual interest rate of 18%. If you invest the $5,000 instead of using it to pay off the credit card, you will have to get an 18% return on your investment after taxes (or about 24% before taxes) just to break even.

Credit card debt remains probably the single best answer we know to the question, "Why can't I ever seem to get ahead?" As of this writing, there are more than a billion credit cards in circulation in the United States... that's almost four cards for every American man, woman, and child. And nearly 70% of all credit card holders in the U.S. today carry a revolving card balance each month (i.e., they are paying the minimum amount due). Yikes! Most unFoolish, dear reader. With an annual interest rate of 18%, making minimum payments (2% of the balance or $10, whichever is greater) on just a $1,000 balance is going to take you a little over 19 years to pay off — during which time you will pay close to $1,900 in interest on that $1,000! It's enough to want to get into the credit card issuing business, isn't it?

As you now chart your path to becoming a more Foolish investor, we simply will not let you pass on to Step Three until you stop letting the credit card companies feed on you. Find out the details on how to pay down your debt (we offer one tactic below), or discuss your credit card questions with other Fools at **www.Fool.com/credit**.

Renegotiate Debt

Did you know that you can renegotiate much of your debt? If your credit card interest rate is around 18% a year, call the company and inform them that you plan to transfer to a lower-rate card if they won't bring your rate down to something less like highway robbery (try for 10%-12%). They'll likely comply, as they'd still be making good money off you. If not, transfer to a new card as you dig out of debt.

A PLAN FOR REGULAR SAVING

Next stop... how well are you regularly paying yourself? In other words, are you routinely setting aside an adequate established percentage of your paycheck every payday? Or do you only set aside money when there is something left over? Or worse, are you finding there is nothing left to pay yourself with?

If you answered yes to either of the last two questions, you're simply not ready to pass Go yet. It's time to examine why you aren't paying — or can't pay — yourself. A Fool does not go investing with her lunch money, or next month's rent, or with money that should go toward paying off a credit card. We invest money that we have worked for (or received as a gift — that counts, too) and have Foolishly saved. As stated above, only invest money that is free of other obligations.

Fools try to save around 10% of their annual income. For some, it'll be closer to 5%. Others might manage to put away 15%... for instance, those who are soaring in the National Basketball Association. The important thing is to establish a regular "rhythm" of savings and stick to it, even if that means living below your means. You should also have around three to six months worth of living expenses in an account that is liquid (like a money market account) for those rainy-day emergencies.

Now, if you already are routinely saving, are you exploiting all the possibilities you have to make that money grow tax-deferred — i.e., through an IRA, or SEP, or Keogh, or 401(k), or 403(b) plan? Money in tax-deferred retirement plans can grow exponentially compared to money in a regular investment account, because you don't pay taxes on the money deposited or the earnings until you begin to withdraw it. Further, a number of employers now offer to match your 401(k) plan savings with additional monies kicked in to benefit you (read: free money!). Make certain you are plowing as much of your savings as possible into these highly Foolish vehicles. Remember: Pay yourself first, and you'll thank yourself later.

LEARN MORE ABOUT THE REST OF YOUR PERSONAL FINANCES

Before you leap headlong into that dramatic first investment, you should at least give some additional thought to other aspects of your financial life, such as any investing for your kids, insurance, housing, future employment, your bank, and your wheels, all topics we cover at **www.Fool.com/pf.htm**.

Come on over to the various "Managing Your Finances" discussion boards and meet thousands of other readers who are there to share their experiences and answer one another's questions.

Step Three

"Fools don't while away many hours wondering whether Wall Street is right when it tells us that we ought have our money broadly diversified in mutual funds, bonds, gold, and T-bills. Fools already know that all of these have underperformed the S&P 500 year after year after year. Seventy-five years of history is sufficiently convincing proof for bonds, gold, and T-bills, and the last 20 years have convinced us that mutual funds are an investment opportunity that isn't one."

David and Tom Gardner, *The Motley Fool Investment Guide*

Set Expectations and Track Results

Most people in the U.S. know what place their local sports teams are in. They know what film won the last Academy Award. They know what Teletubbies, Beanie Babies, and Furbies are, for goodness sake, and perhaps they even are aware of controversies surrounding such toys. We live in a society that pays a lot of attention to some pretty weird stuff, but one thing we don't seem to pay much attention to is how our investments are doing compared to the market's averages. Why is that?

Very simply, because nobody ever taught us how and because no one who is selling investment advice has had it in their best interest to show us how to account for our investment performance. If you think most money managers, mutual fund managers, and brokers want you to know how your investments are doing in relationship to the market, we've got a "limited edition" Tinky Winky doll we'd like to sell you for, oh, a couple thousand bucks.

Professional investors just don't want you to pay much attention to how they're doing. It gives them a lot of room for error.

Coming down the digital road now are more than 2 million Fools proposing that unless you're going to take the time to measure your results, you shouldn't put investment dollars into anything but an index fund — a mutual fund that tracks the market, step for step. Don't buy stocks, bonds, gold bullion (yikes!), or managed mutual funds. If you can afford to put money away for five years, but don't have the time to keep tabs on how you're doing, buy an index fund and leave it at that. To help you with just what an index is, we've developed an Index Center that explains and compares the various indices and shows how each is doing, year-to-date.

We suspect, though, that most of you have more than an hour a year to devote to this and wouldn't mind aiming to be better than average if it were possible. You should know that accounting for your savings, just like a business would, doesn't take much. Nor is it beyond your abilities to beat the stock market over time. One of today's great travesties is that most people don't consider their personal finances a business and don't think the market can be deciphered, let alone beaten.

That's because not enough people have gotten Foolish yet.

Let's start with some basic expectations... and again, this is for the money that you can afford to put away for five years (ideally more).

Would it surprise you to hear that more than three-quarters of the equity mutual funds that are thrown at us from brokerage houses, banks, and insurance agencies perform worse than average each year? (Actually, it could only surprise you if you skipped Step One, as we've mentioned this already.)

At first, it's shocking to think that the achievements of paid professionals are so significantly shy of mediocre. But on second consideration, those numbers shouldn't come as any surprise at all. Managed mutual funds charge their investors average annual fees of 1.5%, mostly to "fund" their active and national marketing plans. That's 1.5% of the total assets in your account, not just the "earnings" (if there are any). And most fund managers have enough to do — golf, tennis, socializing, and foxhunting immediately come to mind — without having to spend time pondering growth stocks, allocation models, and their consistent, predictable, and enduring market underperformance.

Track Your Portfolio Online

Wouldn't it be great if you could log on to your computer anytime during the day and see at a glance how your portfolio is faring? Well, you can.

In the Portfolio area on The Motley Fool website (**www.Fool.com**), you can create multiple portfolios and fill them with your actual holdings. (If you're just starting out, you can create mock portfolios to track stocks you might want to buy. This is a great way to learn how good you're getting at investing.) After you've entered your holdings, you can begin tracking your portfolio performance online — without doing any math yourself!

Portfolio tools allow you to see not only how your stocks have performed since you bought them, but also how that performance compares with the S&P 500 (a good benchmark) in the same period. You can also enter the cost of the commissions you paid, and let those expenses be incorporated in your returns. And did we mention that you don't have to do any math?

Any money that you have to invest for five years or longer should not underperform the market over that five-year period.

If that sounds harsh — absolutely, it's meant to be. Bad and overpriced mutual funds deserve much poking, and since they don't provide much in the way of results, they should at least be recognized for their vast capacity to amuse. But we're here to do much more than that, we hope. Finding problems in the financial "services" industry isn't much of a challenge. It's tacking on useful solutions that makes things difficult.

Here's our solution to baseline accountability: Any money that you have to invest for five years or longer should not underperform the market over that five-year period. If it does, you've blundered, because you can get average market performance out of an index fund without doing any research and without taking on significant risk. The Motley Fool's online portfolio tracking feature lets you enter all of your investments and check their returns against the major market indices (as well as our own real-money portfolios) to find out how each has done since the day you purchased it. (This is a free service — all you have to do is register, which is also free.)

Stick close to those expectations, prepare and aim to beat them, and know why you have or haven't. Set up your own My Fool page, which can include your personal portfolio, links to your favorite Fool features and discussion boards, and free Fool newsletter subscriptions. Laugh at the business pages of our national newspapers and magazines, which devote plenty of room to "professional" predictions but don't typically allow even a day each year for reviews of bottom-line performance — including the deduction of all trading costs.

But we've gotten ahead of ourselves. Here we've been yapping away about index funds without even explaining what they are. So, without further ado...

Step Four

"Because the index fund makes for a brainless and respectable choice, it's really our first-stop recommendation to investors of all kinds, novice and experienced. Factor in convenience, performance, low expense, and simplicity, and these things beat the pants off the two traditional options — brokers and mutual fund managers."

David and Tom Gardner, *You Have More Than You Think*

Start With an Index Fund

Let's stop for a second and do some reconnaissance:

1st Step: You have a general idea of what it means to be a Foolish investor.

2nd Step: You've gotten your personal finances in order — paying down all credit card debt and working to set aside funds for investment over the next five years.

3rd Step: You've set reasonable expectations, and you're going to track your investments against the market.

What you have done thus far is prepare yourself emotionally, financially, and intellectually to be an investor. By so doing, you are already significantly ahead of the majority of all people participating in the stock market.

But how can that be, you ask? Simple. A huge number of investors, be they young, old, new to the market, or old hands, have never bothered to give themselves or their financial status a checkup before jumping into investing.

Still others did so, but then entrusted their money to professional management: mutual funds and full-service brokers. Chances are that these decisions will hinder their future financial standing.

But you, on the other hand, are ready to jump in. So, jump!

What, you're still here? You say you don't know where to put your money?

Good. Very good. You pass the test.

In this step, we are going to look at what, for many, is the beginning point for investing, and for many is the end point. A significant number of individual investors have chosen to invest their money in index funds, and will never have to think about investing again. They just send in their checks, and they participate in the future growth of the most dynamic portions of the economy, U.S. and worldwide.

Since The Motley Fool first began educating investors in 1993, index investing has changed dramatically. So, there are a few considerations that investors need to make. And yet, index funds remain the lowest-cost, lowest-maintenance form of investing for an individual. Indexing is free from punitive management fees, and it is free from the concern that even shareholders of the most dynamic, stable individual companies have about their investments from time to time.

Quite simply, there are as many reasons to invest in index funds as there are investors. Some investors lack the time, interest, or confidence in their own ability to pick and track individual stocks. This, in no way, makes these people inferior investors. If anything, that self-awareness makes them superior, more-Foolish investors to many who are actually out there chasing the next "big thing." (A hint: 99% of the chasers are still chasing and will continue to chase.) Index fund investing allows people to take part in the expansion of the economy — to participate in the stock market — in a low-involvement, lower-risk way. Those who get to this point and determine that their best choice is to index are to be saluted.

Indexing also serves as a backstop for people who do choose to invest in individual companies. One particularly Foolish strategy is the Index Plus a Few, in which the investor places the majority of his or her portfolio into an index fund, and then carefully selects a couple of stocks to augment overall performance.

In this part, we're going to talk about the myriad index products that exist, but let's start with the Granddaddy of them all.

THE S&P 500 INDEX FUND

Over the past 50 years, the S&P 500, an index of 500 of the largest and most profitable companies in the U.S., has risen an average of 13.6% annually (with dividends reinvested).

That means that, if you invested $10,000 into the S&P 500 50 years ago, today you'd be able to call your discount broker, sell your position for $5.78 million, patriotically pay down your taxes of $1.62 million, and end up with $4.16 million. Sounds great, huh? But most people who have invested in equity mutual funds haven't pocketed that market average (or anything close to it) — unless they have invested in an index fund.

According to Princeton University's Burton Malkiel, the average actively managed mutual fund has returned 1.8% per year less than the S&P 500. Interestingly, this 1.8% closely mirrors the average expense ratio of these actively managed funds. 1.8% per year may not seem like a great deal, but it is over time. That same $5.78 million that one would get by holding an index fund mimicking the S&P 500 would be worth less than half that given a return 1.8% lower per year.

Further, this does not account for the fact that actively managed funds generally have higher "turnover" (the amount traded in or out by the manager in a given year), the capital gains taxes of which are passed on to the fund's shareholders on an annual basis. The lower the turnover, the lower the annual tax bill. Index funds generally have turnover of less than 5% per annum. According to the Investment Company Institute, the turnover for actively managed funds is above 40%.

But, even if you are picking a mutual fund for your tax-deferred 401(k) or 403(b) plans, or for an IRA, if there is an index fund available in your list of choices, the Foolish thing to do would be to make it your only choice.

LEARN TO LOVE SPIDERS

The best-known index fund is the Vanguard S&P 500 Index Fund. But, there are also a myriad of choices for people who wish to purchase index-tracking products on a real-time basis. Standard & Poor's Depositary Receipts, or "SPDRs" (pronounced "Spiders") are the best-known, but this genre of products are known as Exchange-Traded Funds (ETFs). Spiders are purchased through a broker (we'll learn all about this in Step 6), just as if they were stocks. Spiders trade under the ticker symbol AMEX: SPY. Don't believe us?

Spiders, Man!

You may want to consider investing in a close cousin of the index fund — Standard & Poor's Depositary Receipts (SPDRs). Often called "Spiders," SPDRs are stock-like instruments designed to behave much like the S&P 500 Index and they have a few advantages over funds. They trade under the ticker symbol "SPY" on the American Stock Exchange and each share is valued at about one-tenth the value of the S&P 500 Index. Read more about them by heading to **www.Fool.com/foolfaq/foolfaq.htm** and clicking on "Spiders."

INDEXING BEYOND THE S&P 500

Are index funds just for the S&P 500? Oh, no. If you can name a measurement of the market, then somebody has probably slapped an index fund on top of it: the Russell 2000 (an index of 2,000 smaller-company stocks), the Wilshire 5000 (the entire stock market — in reality there are about 9,000 publicly traded companies, but the "Wilshire 8,934" just wouldn't sound too good), the Dow Jones Industrial Average (the 30 stocks that make up the Dow)... just to name a couple of the big ones that are featured in our Index Center.

The list of different indices that have mutual funds tracking them is getting longer all the time. You can purchase these through fund companies that offer index funds, or you can buy them as ETFs. Want to buy the companies in the Nasdaq 100? They trade under the symbol AMEX: QQQ. How about something that tracks the major index for Malaysia? It trades under AMEX: EWM. A resource covering many of the most prominent indices is available at The Motley Fool Index Center.

We like all of these products. Except for one thing...

The spiraling number of index-based funds and products has added complication to an area of investing that used to be simple. "Index fund," until not that long ago, meant the Vanguard S&P 500 product almost by default. We still believe that this individual fund, and its cousin, the Spider, are the best long-term products for index investors. But, to add some international exposure or some additional technology exposure, there are other options. The best place to get a current list of ETFs is the American Stock Exchange website.

But watch carefully what some companies are selling as "index funds." The real point of investing in index funds is not to try to pick the "hot" index or to pick the "cold" index before it gets hot. Putting your money into an index fund — any index fund — delivers great results to the long-term shareholder, because index funds keep costs so low. The Vanguard 500 Index Fund has annual costs of roughly 0.18%. Full-price brokerage Morgan Stanley, on the other hand, runs an S&P 500 index fund (buying the exact same stocks as Vanguard's fund) with annual costs of 1.5% — nearly eight times as much!

A Fool reminds you that the only reason to move beyond the Vanguard 500 Index Fund, or another low-cost index fund, is if you believe you can beat its performance after all of your investment costs have been deducted: research reports, fax newsletters, financial newspapers, business magazines, etc. If you can't beat the index, you'd better just join it... and keep adding savings to it each year. In the decades ahead, you (and your heirs) will be happy you did.

Some index funds will allow you to establish a regular account for an initial investment of as little as $500 if you set up an automatic investment plan, adding $50 a month thereafter. If you're looking to get started investing with an even lower amount, make sure to read Step 5: All About Drip Accounts.

What's the S&P 500?

The Standard & Poor's 500 is an index of 500 of the premier companies in America, such as Microsoft, Intel, Eli Lilly, Mattel, Procter & Gamble, Sara Lee, and Xerox. If the companies as a group rise in price, the S&P 500 index rises, as well. This is an excellent benchmark for investors, and it's what we like to compare our returns to.

Step Five

"Discipline, time, and compounding are the three main contributors to successful investing — not the amount of money that you have to invest. Drip investing provides you a disciplined framework and a structure that should lead to compounding wealth. You then just need to give it time.

Jeff Fischer, *Investing Without A Silver Spoon*

All About Drip Accounts

If you've read this far, you may be raring to invest in individual stocks you've picked yourself. You might be worried about one thing, though: whether you have enough money to start. This is a common concern, and sadly we suspect that it's one of the main reasons why many people never get around to investing in stocks. They figure that it's just for the rich, or at least for those with more money.

But we're here to set the record straight — you don't need very much money on hand to get started investing. If you have even $20 or $30 per month to invest in stocks, you can do so. You don't need to first accumulate $3,000 or anything like that. Starting with $200 will be more than enough.

There are many ways to plunk your dollars into stocks. The most common way is to buy all the shares you want to buy at one time. If you'd like to own 100 shares of Coca-Cola and it's selling for $65 per share, you cough up $6,500 and buy the shares, paying your discount broker a modest commission of $20 or less. Alternatively, you could enroll in Coke's "dividend reinvestment program" (often called a "Drip") and spend as little as $10 monthly on Coke shares, essentially buying fractions of shares at a time — without paying any brokerage commissions. "Drip" isn't a very appealing name, but it does get the point across. You're reinvesting dividends, but you're also "dripping" additional money into your holdings — every month, ideally.

Drip... drip... drip... That adds up over time.

These programs are a blessing for those
who don't have big bundles of money to invest at a time.

DIVIDEND REINVESTMENT PLANS (DRPS) AND DIRECT STOCK PURCHASE PLANS (DSPS)

These two special types of programs permit investors to bypass brokers (and broker commissions!) and buy stock directly from companies. These types of plans have been growing in popularity in recent years and more than 1,000 major corporations now offer them.

With dividend reinvestment plans, the company usually requires that you already own at least one share of its stock before you enroll. Furthermore, the share must be in your name. This means that if you're not already a shareholder, you'll have to buy at least one share through a broker or a Drip service.

If you use a broker, you'll need to pay a commission on this initial purchase. (More about choosing a broker in Step 6.) In addition, you'll have to specify that you want the share(s) registered in your name, not "street name." Brokerages routinely register shares in "street name," meaning that when you buy stock through them, it's registered in their name. This is normally not a problem. It means that they hold the certificates for you and that makes it easier for you to sell quickly, without having to mail in certificates.

Once you own a share or more in your own name, you can open a DRP account with the company and buy additional shares directly through the company (or its agent).

Direct stock purchase plans operate in much the same way, except they don't require you to own at least one share before enrolling. That's right — you can even buy your very first share through the program.

These DRPs and DSPs vary a little from one to another. Some charge you a few pennies per share when you buy, most others (the ones we like best) charge nothing. Some permit automatic regular purchases, taking money directly from your bank account if you'd like. While some of these plans represent a great bargain, others might not be worth it, depending on your circumstances. You need to examine the particulars of the plan(s) you're interested in before deciding to enroll.

ADVANTAGES

Clearly, these programs are a blessing for those who don't have big bundles of money to invest at a time.

They're also wonderful in that they will reinvest any dividends sent your way. This can be a really big deal. Many investors don't appreciate the power of reinvested dividends. Let's look at an example.

If you'd held shares of Coca-Cola for the 18 years between 1981 through 1998, they would have appreciated a total of 4,718%. That's an annualized gain of 24% per year. (Who said enormous global companies are slow growers?) But wait, there's more! Here's the "secret formula" for investing in Coke: If you'd reinvested all the dividends paid to you into more shares of Coke, your total gain would have been 56% higher, at 7,364%. Annualized, that's 27% per year.

A $5,000 investment in Coke in 1981 would have grown to about $240,000 without reinvested dividends. With dividends reinvested, it would have become roughly $373,000.

Another advantage to these plans is that they permit you to slowly build up positions in stocks over a long period of time. This might not seem like such a big deal, but imagine that you really want to invest in Wal-Mart, but it seems very overpriced right now. If you're a typical investor, not using DRPs or DSPs, you'll probably wait on the sidelines for the stock price to fall a bit. If it never falls, you're out of luck. But if you go with one of these programs and choose to invest small amounts of money in Wal-Mart each month, you establish a position in the company immediately and keep adding to it. If the stock price falls, your regularly invested amount will buy you more shares. (And you might even opt to send in more money than usual, to buy more shares.) If it keeps rising, the shares you already bought keep rising in value.

Finally, while these plans are best for those with limited incomes, they're also good for anyone who wants to invest regularly — and you can buy as much as $5,000, often much more — of stock at any time through a DRP or DSP. In fact, you can treat the plans as if you're buying each stock just once from a broker. The reason you might want to do this is to take advantage of the reinvested dividends. Be aware, though, that some brokerages now offer dividend reinvestment with no commissions. So for those with greater sums to invest, DRP and DSP plans are no longer as important as they were a few years ago.

DISADVANTAGES

Every silver lining has a cloud and these plans are no exception. A major drawback to them is the paperwork involved. If you invest small sums regularly in a handful of companies, you'll be receiving statements from each plan every time you invest. You'll need to keep everything very organized and record all your transactions for tax purposes. Taxes can get a little hairy when dealing with DRPs and DSPs if you haven't kept good records. Fortunately, there is good software on the market that can ease some of the record-keeping hassles.

Another disadvantage, although it's not a major one for most Fools, relates to timing. Let's say you're convinced of the value of a stock and are eager to buy. Using a broker, you simply make a phone call or execute the trade online. But with dividend reinvestment plans, you usually have to send in a form and a check. This will take some time. Also, many plans make all their purchases and sales only once a month, delaying things further. So you might not get into the stock exactly when you want and might end up paying a little more than you wanted for it. Similarly, when you want to sell a stock, it's not going to happen immediately. It might take a few weeks. For someone who's regularly sending in checks, perhaps every month, these delays don't matter. But be aware of them.

MORE INFORMATION

There's plenty more to learn about dividend reinvestment plans and direct stock purchase plans. Start with our Fool's School section on Drips, which explains direct investing from A to Z. Then check out the Drip Portfolio, where we explain in greater detail how the plans work through the use of our own real money. Our Drip Portfolio was launched with just $500 and we add $100 per month to it. The portfolio is meant to teach how someone with a limited budget can profitably invest in stocks. Its managers report on the portfolio's progress and discuss companies in the portfolio and companies under consideration to be added to the portfolio. (The first five companies in the portfolio were Campbell Soup, Intel, Johnson & Johnson, Mellon Bank, and Pepsi.)

Be sure to check out our book, *Investing Without a Silver Spoon*, where the Fool's Drip Port manager Jeff Fischer demystifies the world of direct investing by providing everything you need to know about getting started. The book also gives details and contact information for more than 1,000 direct investment plans (over 300 pages!) and a look at the industries and companies to strongly consider for direct investing.

A mother lode of information on DRPs and DSPs can be found at Netstockdirect.com. This site lists details on just about every one of the 1,600 DRP and DSP programs. At Netstock you can download plan enrollment information, and you can also begin to invest directly online in 300 companies (and growing). Now that's convenient!

The National Association of Investors Corp. (NAIC), the country's authority on investment clubs, offers a DRP enrollment service, the "The Low Cost Investment Plan." For just $7 plus the price of one share of stock in any of the participating companies, you'll be enrolled and can then add to your shares regularly at little or no additional charge. You do need to be an NAIC member, however, and the annual fee is $39.

OTHER RESOURCES

The Moneypaper website lists information on more than 1,100 companies that offer DRPs. The site also offers the Temper of Times DRP enrollment service, which will purchase initial shares and enroll investors in DRP plans for a nominal fee. Details are available at the website.

Direct Stock Purchase Plan Clearinghouse, at 800-774-4117, is a free service that allows investors to order up to five prospectuses from companies that offer DSPs. (This is for direct stock purchase companies only, not DRP-only companies.)

Now, on to our next stop on this Foolish journey...

Some (of Many) Companies Offering DRPs and DSPs

DRPs

– BankAmerica
– Clorox
– Coca-Cola
– Eastman Kodak
– General Motors
– Harley-Davidson
– Intel
– Kellogg
– Johnson & Johnson
– PepsiCo
– Sara Lee
– Wendy's
– Xerox

DSPs

– American Express
– Chevron
– Compaq
– Computer Associates
– ExxonMobile
– General Electric
– Gillette
– Merck
– Pier 1 Imports
– Puget Sound Energy
– Wal-Mart
– Walgreen
– Walt Disney

Step Six

"The use of full-service brokers must be considered, under most circumstances, quite UNFoolish. Consigning your money to the houses of Merrill, or Salomon, or Morgan is as much as to say, 'Do it for me yourself, Harry (or Janice, or Joey, or whatever your full-service broker's name might be). I think you can manage my money especially well, and I'm going to pay you extra to do it for me. In fact, I'm going to pay you a premium for every trade you make on my account, since you're going to be coming up with virtually all my investment ideas.'"

David and Tom Gardner, *The Motley Fool Investment Guide*

Open a Discount Brokerage Account

FULL-SERVICE BROKERS

Full-service broker is the name given to those expensively dressed souls who work for Merrill Lynch, Salomon Smith Barney, Morgan Stanley, etc. The phrase "full-service" indicates that they are there to attend to ALL the needs of their account holders. That includes generating investment ideas for you, giving you stock quotes whenever you request them, managing your account (in many cases), providing investment research materials, helping you with tax information — the works.

In return for these full services, the broker will charge you very high rates to trade stocks in your account. Whereas discount brokers (we'll get to them in a second) typically charge between $5 and $20 for an online trade, you'll probably pay around $150 for the average trade done through a typical full-service broker. Furthermore, full-service firms often charge annual "maintenance" fees through which they grant themselves a generous slice of your assets, say about $150 a year or more. In other words, they provide an expensive "service."

OK, TWO PROBLEMS HERE.

(Actually, dozens of problems, but we'll keep it to a brief two for now.)

The first is that most brokers (or, more snootily, "Financial Consultants") who give advice are just glorified salesmen, shopping around their brokerage house's stock picks or pricey mutual funds. While there are some knowledgeable brokers who do a knockout job for their clients, many aren't actually very good investors and lack impressive or even average performance histories.

The second problem is that full-service brokers usually receive commissions on each trade, so their compensation is closely tied with how often their clients' accounts are traded. The more trades you make, the more money they make. Highly distressing.

The full-service industry will save itself only when it bases its incentives on performance, not trading frequency. Your broker should be working to give you the best consistent long-term, market-beating return possible, and should receive bonuses based on a percentage of your long-term profits.

DISCOUNT BROKERS

Discount brokers provide a more affordable means for investors to execute their trades. Discount brokers are for do-it-yourself investors. The idea of paying exorbitant fees to some full-price broker for sub-par returns makes little sense. But just as you need to go out and select tools and materials before you can begin to fix things around your house, you need to learn a little before you go out and pick a brokerage.

There are lots of discount brokers. We've set up a Discount Brokerage Resource Center at www.broker.Fool.com to help you figure out how to select one. There we've included a comparison tool to allow you to compare our sponsor brokerages, side by side. And you'll find answers to commonly asked questions, such as:

- How do I open an account?
- What if I can only invest small amounts of money?
- Can I transfer my current account to a new firm?
- What's the difference between a cash account and a margin account?
- Can I buy mutual funds through a discount broker?
- Is online trading secure?

We also have a Discount Broker discussion board, which features the Foolish community providing the best answers anywhere on choosing the right discount broker for your needs.

Here are 10 things to think about as you begin your search:

1. Read the fine print. Keep in mind that there are virtually always going to be hidden costs, from account minimum balances to fees for late payments or bounced checks to transaction and postage and handling fees.

2. Commission schedules can vary considerably within the same brokerage, depending on the trade. If you most typically buy 1,000 shares of stock below $10 a share, use this trade as a test of your prospective brokers. See how much of a commission you'd pay for your typical trade with each prospective brokerage.

3. If you want to trade foreign stocks or options or penny stocks, none of which we generally counsel doing, make sure your discounter is set up to trade them.

Check Out Your Broker

The National Association of Securities Dealers (NASD) aims to protect investors and recently unveiled a new public disclosure program. It's designed to help investors gather information on brokers and brokerages in order to steer clear of the Snidely Whiplashes of the brokerage world. Information available includes employment history, criminal felony charges and convictions, bankruptcies, consumer complaints, formal investigations, terminations of employment, outstanding liens or judgments, and much more. The program isn't perfect though. At the moment, not all the information investors might want is available. For example, settlements valued at less than $10,000 are not included. Still, this is a big step toward protecting investors. Visit the program online at www.nasdr.com/2000.htm or call the Public Disclosure hot line at (800) 289-9999.

4. Check out the margin interest rate, if you ever plan on borrowing money from your broker for purchases. Margin rates vary substantially from broker to broker. If you're Foolish, you won't want to even think about using margin until you've been buying and selling your own stocks for a couple of years. (For more on margin, see Step 12, Advanced Investing Issues.)

5. The availability of checking accounts or bill paying may be very attractive to some. Discount brokers are expanding their banking services in an attempt to make the most from each customer. Do you really still need a checking account from a separate bank? A lot of Fools don't.

6. Mutual funds: You probably know already that we're not big fans of the world of underperforming mutual funds, but, heck, maybe you disagree with us. If so, and you're looking to buy mutual funds, learn which funds are offered from any prospective discount brokers.

7. Research and investing tools: We have plenty of free research and heaps of investing tools available at Fool.com, but one of the perks of a brokerage account is (or should be) getting access to additional screening tools, analyst research reports, stock charts, and more.

8. Money market sweeps: Does your prospective brokerage sweep any unused funds into a money market account at the end of the day? Check into it.

9. Touch-tone (phone) trading and/or a local office: If you want to place a trade the old-fashioned way — through automated touch-tone dialing or by phoning a human broker — see if that's offered. If you want a real bricks-and-mortar office, find out if there's one near you.

10. Free perks are free perks. Some are even worth having. Whether you're talking frequent flyer miles, free trades on your birthday, or even cold hard cash placed right into your account, there are some things out there that could tip the balance in favor of choosing one discounter over another.

Research Brokers Online

Online we offer information on how to choose the broker that's right for you and a guide to broker- and trading-related jargon. We also provide a direct link to our brokerage discussion board where Fools carry on discussions about various brokerages, sharing their experiences. The area also includes contact information for scores of discount brokerages.

To get there, visit our website at **www.Fool.com**. On the left-hand side of the screen there, click on "Choose A Broker" or, just type in **www.broker.Fool.com** and you're there!

Step Seven

"For most people, a 30-year career is quite enough, thank you very much. But is early retirement realistic for you, Fool? Sure it is! All it takes is planning, planning, planning. And a little bit of guidance, which we can offer you here."

From the Retirement Planning area on Fool.com

Planning for Retirement

You have your finances in order, maybe have a Drip or two, perhaps contribute to your 401(k). You may also have opened a discount brokerage account.

What is all this investing for, if not to be used and enjoyed at some point? Close your eyes and envision yourself sunbathing on the black-sand beaches of Wai'anapanapa on Maui, for instance. Or sipping cappuccino in Carrara, where Michelangelo went to choose the stone out of which he carved his David and his Pieta.

SCULPT THYSELF

Your retirement plans may now be a mass of shapeless stone weighing you down. What we propose to do here is to take out our modern-day hammers and chisels — our calculators, community, and strategies — to mold something precise from that stone. You'll find these tools in our Retirement Area. But before you pound the chisel for the first time (and hack off the femur within the formless block), you may be itching for a little guidance.

THE SIX STEPS

To ensure a successful retirement — whether you want to quit the workforce at 35 or 70 — you must:

- Think about what kind of lifestyle you want in retirement, and how much you're going to need per year to support it
- Figure out how much you'll need on the day of retirement in order to make sure you can draw the amount you need (see the "multiply by 25" rule below)
- Take an educated guess at how long you'll be retired
- Decide where you will live, and whether to rent or buy
- Ensure you have adequate health and medical insurance for the family
- Decide how to fill the hours in a day previously devoted to work

THE "MULTIPLY BY 25" RULE

There's a handy (though not entirely accurate) little formula, developed by mathematicians who are still stuck in a maze somewhere in Palo Alto, to help you figure out how much money you need to set aside now to meet a certain annual expense for a long time — for eternity, in fact. First you figure out what your real rate of return (that is, adjusted for inflation) on your savings. For example, assume your long-term overall annual rate of return on all investments will be 8%, and that at the same time inflation will run 4%. That gives you a real rate of return of 4% (8% minus 4%). You divide that 4% into 1.00, giving you 25. Multiply your annual expense in retirement by that number to arrive at the "lifetime expense" — that's a very rough estimate of how much you'll need to have on your retirement date to cover those costs in the future.

Another way of expressing it is to say that you need to put aside $25 to fund each $1 of annual spending in your budget. If your total annual spending in retirement will be $50,000, the "multiply by 25" rule indicates that you need to save $1.25 million before giving up the paycheck.

Though not perfect, this equation allows you to consider various scenarios. What if it were possible to cut your retirement spending to levels well below your current spending? If reducing your expenses allows you to get by on less income, you'll lower your tax burden as well. So taking the above assumption, if you were able to bring your annual spending in retirement down to $30,000, the "multiply by 25" rule indicates that you would need to put aside $750,000 before retirement, a considerably smaller sum. Of course, if you invest well, then you actually have to "put aside" much less and let investment returns make up the difference.

Keep in mind that this calculation does NOT incorporate Social Security, pension benefits, money you may earn from work after retirement, and so on. It assumes no other sources of income than your investments. This will (we hope) not be the case, but it's better to err on the conservative side — to assume that we'll have less. Then, of course, if we have more than we planned on, we can live the high life (whatever that is).

There's no time like the present to begin planning for retirement!

HOW LONG WILL YOU BE RETIRED?

This has two parts: When you will retire, and how long you will live.

You choose when you retire; there is no right answer. Select a date, or choose the age at which you want to retire. Whether it's 35 or 55 or 69 — it's your choice.

Then, to get a genetically informed guesstimate as to how long you may live, take a look at your parents and grandparents. Who lived the longest among them? Take that age, add 10 years to it (people now are living longer than ever), and use that number.

Subtract from that the age you'll be when you retire, and voila! You have a working number for how long you'll be retired.

WHERE YOU STAND

In order to arrive at a target amount on your date of retirement, you must determine your current financial status. If you use a software program such as Quicken or Microsoft Money, you'll find your work simplified. Essentially you need to tally up how much money is coming in right now, and also what you have in terms of assets. You're invested in the stock market, right? Since you know the date your retirement is to begin, our online calculators should help you project how much your portfolio will be worth at that time. You can then compare that with the amount you know you'll need on the Big Day, and see whether you need to invest more.

We should mention, of course, the magic of compound interest. The longer you have for your investments to grow, the larger the growth will be. That's why there's no time like the present to begin!

ACT!

Among the important weapons that are potentially in your arsenal, you should check into the following:

- Employer-provided pensions, otherwise known as defined benefit plans. These plans are dying off as employers switch to 401(k) plans or hybrid vehicles such as cash balance plans.

- 401(k)s or 403(b)s. Your employer may match the contributions that you make to this plan, up to a certain amount — and that means that you're getting free money. "Free money." Hmm... we like the sound of that. Couple the free money with tax-deferred compounding, and you've got a great tool for amassing a sizable stash by the time you retire.

- IRAs. If you're eligible, there's really no good reason why you shouldn't have one — whether you choose a Roth IRA or a traditional IRA. Each of these provide great tax advantages, and the flexibility to be invested in the stock market all the while. The Roth IRA is appealing because if you follow the rules, you can withdraw money you've contributed to it, as well as any earnings on the money, completely tax-free. You can contribute up to $2,000 per year to a regular or a Roth IRA.

Periodically, you must evaluate your progress toward meeting your retirement needs (we recommend at least once a year), and then make revisions where required. After all, things change: rates of return, unexpected expenses, and so forth. So be sure to stay on top of that changing scene by reviewing your retirement savings goals and investments annually.

THE EARLY BIRD AND THE CAN OF WORMS

Achieving a successful early retirement is another matter. Planning for an early retirement is much more difficult than planning for a "normal" retirement. That's because some unusual hurdles will crop up. For example, health and medical insurance present a special problem. Medicare isn't available until age 65, many employers will not allow group plans to be carried into retirement beyond the 18 months required by law, and individual health policies may cost in the hundreds of dollars per month. For the early retiree, then, obtaining adequate health and medical coverage can put a huge dent in the family's income.

Insurance is often the greatest deterrent to retirement prior to age 65. For more information, check out our Retirement Area at **www.Fool.com/retirement**.

INVEST WELL

It should be clear by now that investing well is key to having the resources you'll need on the day you retire. The greater your returns over time, the more money you're going to have.

So how do you evaluate companies in which to invest? One important move is discussed in the next step: Read financial info.

Step Eight

"Looking for great individual stocks to research and invest in is no more difficult than studying the companies that provide great products or services in your life. Wall Street professionals trapped 40 stories up in Manhattan may get overpaid to do just this, using a variety of tools, but then in contests against a chimpanzee armed with a finger (and some stock symbols to point at), the pros often lose. *The Wall Street Journal* runs a regular contest that demonstrates this, pitting expert stock pickers against stocks chosen randomly via the dart and a board, and the dartboard often wins. Nor will these experts at big investment firms win in competition with you, Fool."

David and Tom Gardner, *The Motley Fool Investment Workbook*

Get Information on Great Companies

Selecting stocks on your own, without the safety net of an index fund, can be scary. But it can also be fun and very, very rewarding. You'll need to learn what kinds of companies to seek out, and then you'll have to evaluate them, to make sure they're moving in the right direction and are worthy of your trust.

GATHER INFORMATION

No right-minded Fool (and what other kind is there, really?) would think of investing in a company based merely on cocktail-party chatter, a broker's recommendation, or even a discussion board overflowing with exuberance. Even if the company is one you've discovered on your own, you shouldn't just run out and buy shares of its stock. First, get your hands on the company's financial information, and get to know the situation thoroughly.

To start, call the company you're interested in, ask for the "Investor Relations" department, and request an "investor information packet." A full packet contains the following, all of which you want and should ask for:

- The Annual Report (most recent)
- The 10-K (most recent)
- The 10-Q (most recent)
- Press releases (all recent ones)
- Analysts' reports (any available up-to-date ones)

By the way — are you wondering what all this is going to cost you? Nothing more than a holiday bottle of wine for your postal carrier who'll be delivering all the packets you order. These packets are free!

But hey, let's face it — you're online. Nowadays, the Internet is really the place to do the best research. You can get a substantial amount of this information online. You can acquire all recent SEC filings, including company 10-Ks and 10-Qs, without ever leaving your keyboard. All you need to know is a company's ticker symbol to acquire news, financial snapshots, and estimates of future earnings. Whoops, maybe we're getting ahead of ourselves with that kind of talk. Sorry. Keep reading and we'll explain.

LEARN ABOUT THE COMPANY

You've got the company's information packet. Let's have a look. The first thing you'll want to do is scan everything in order to get a sense of the company's mission, its products, its attitude, and its prospects. There are three main financial statements included:

- The Income Statement (or Statement of Operations)
- Balance Sheet
- The Statement of Cash Flows

The easiest of the three is the income statement, which shows how much money the company made over the last year and its profit margin. Next up is the balance sheet, revealing how much cash, inventories, and debt the company has. The third and most complex piece is the statement of cash flows, revealing how much money the company is really making as it works through operations, makes investments, and borrows money.

When studying a company's financial statements, you should be able to determine how quickly sales are growing, how the company is financing its growth, whether it has taken on too much debt, how efficiently it's collecting its accounts receivable, how much profit it's making on its products and services, and all kinds of fascinating things like that.

You should also be paying attention to trends, to see if the firm's financial health is improving or declining. And finally, it's best to compare companies with their industry peers to see how they stack up.

These financial statements will also appear in the 10-Q and 10-K reports. The 10-K is issued once a year, along with the annual report, while 10-Qs are issued three times a year, at the end of the intervening quarters.

The 10-Q summarizes the company's quarterly performance. The 10-K is dedicated to a company's financials, not its story, and thus includes information you simply won't find in most annual reports, like insider stock holdings and brief biographies of the management team. The latter is of extreme interest to a Fool. We love to read about how the company chairman filed for personal bankruptcy in 1989, or graduated from our college.

Press releases are an even more frequent source of information on your company, and should be read and followed by hands-on investors. Those who prefer to keep up less frequently with their stocks can usually safely ignore press releases, and just catch the quarterly reports. Of course, this works much better with safer, bigger companies. If you own volatile small-cap growth stocks that move radically based on every new piece of information, it behooves you to plug into these things. Do keep in mind, of course, that press releases in general tend to put a positive spin on news, since they're issued by the company itself.

Buy What Everyone Knows

The Motley Fool has a modification to famed investor Peter Lynch's "buy what you know" credo. We suggest that you consider buying what everyone knows. There's a simple reason for this. What you know well could prove to be a very lousy investment. You're much better at zeroing in on what everyone knows to be great, products that everyone uses, from soft drinks and potato chips to blue jeans and baseball mitts to amusement parks and bookstores.

ANALYST REPORTS

Most companies have been examined and analyzed by one or more financial analysts. These professionals, most often employees of brokerage houses, will write reports that include the analyst's opinion of the stock, as well as estimates of future earnings and other prognostications. This information is public. Assuming the company whose financial packet you've received has an analyst following it, one of these reports might be included in the packet.
(If not, the company will provide you with analyst names and phone numbers, so you can call and make your own request.) Reading analyst reports can be a truly useful exercise.

For a Fool, some of the most valuable information in the report is the estimated earnings per share figures. (The better reports print estimates quarter-by-quarter.) By matching the analyst's quarterly estimates against the quarterly earnings announcements as they come out, investors can determine whether a business and its profits per share are meeting, exceeding, or underperforming analysts' expectations.

We at The Motley Fool love getting our hands on analyst reports, recognizing that analysts know a fair amount about how to evaluate a particular company's prospects for growth. Hey, it's their full-time job. And, while we don't accept every assertion made by any analyst, we think that confronting their analyses is a key ingredient to sharpening our understanding of the story of our companies.

That's the good side to analysts' opinions. (Red Alert. Red Alert. Fool attack coming. All Wise men of Wall Street prepare to be fired upon.)

We do NOT advise you to pay attention to the analysts' ratings on securities, whether "Strong Buy," "Buy," "Accumulate," "Attractive," "Speculative Hold," or whatever. These subjective judgments are very much slanted according to a blatant and unapologetic conflict of interest that exists in the brokerage industry. The same firms whose analysis you're reading also have built their businesses on financing the companies they're analyzing. Thus, you won't be surprised to hear that the first buy recommendation issued on a company that just came public virtually always comes from the very same firm or firms that underwrote the initial public offering. (Hmmmm...)

Further, and more important, if the brokerage firm analyst were ever to put an outright "Sell" recommendation on a given company's stock, that company would probably never do any financing business with the analyst's firm. Thus, you'll almost never see a "Sell" recommendation from Wall Street. Less than 1% of all analyst reports contain "Sell" ratings. Wall Street analysts will virtually never be the first ones to identify a serious problem with a company — hey, it really isn't their job to do that. Their job is to get you to buy stocks and trade in and out of them, not lead you to long-term wealth.

MISINFORMATION

We'd be remiss if we didn't mention one thing you may encounter in your quest for financial information — and that is the "hot tip." The hot tip has many guises. It can appear as investment "information" or a "can't-miss opportunity" or "the chance to invest in a company that will revolutionize the industry." The pitch can take place on the Internet, in print, on the phone, or at a party. It may even take form on a discussion board.

We have one rule of thumb for such so-called "information": do your own research and make your own independent investment decisions. Never make an investment decision based on one of these hot tips.

Once you've gathered the information that you truly need, we'll show you what to do with it.

Step Nine

"Baptisms by fire are common on the stock market. Poll the populace and we feel quite sure you'll discover that most people had little to no understanding of what they first invested in."

David and Tom Gardner, *You Have More Than You Think*

Evaluating Businesses

Notice that the title of this step is "Evaluating Businesses," not "Evaluating Stocks." Though evaluating a stock is most often the way that investment research is phrased, Fools know that when you buy a share of stock you are really buying a share in a business.

To figure out how much the stock is worth, therefore, you first need to determine how much the whole business is worth. You can begin this process by assessing the company's financials in terms of per-share values to calculate how much the proportional share of the business is worth.

If you own one share of Wal-Mart stock, you, along with members of founder Sam Walton's family, own the company. True, the Walton family owns more of it than you do. A lot more. But your share still counts. When important decisions are to be made, the company will send you a ballot and solicit your vote. And, every time a shopper buys a snorkel, a stereo, or a set of towels at Wal-Mart, a tiny fraction of the profit that purchase generates is yours. A very, very tiny fraction. But, don't let that get you down — there are a lot of Wal-Mart shoppers.

The fate of each share of stock is tied inextricably to the fortune of the underlying business, and the market's perception of the future prospects for that business.

IT ALL BOILS DOWN TO PRICE AND QUALITY

As you learn more about how to study companies, you'll run across many different measures and tools that investors use in their evaluation. These tools might include P/E ratios, return on equity, cash-flow valuations, and so on. At first, all the valuation tools in your mind might end up in a big clutter. You'd do well to try and sort them into two categories eventually, though: price and quality. Here's why...

Bearing in mind that there are really only three kinds of people in the world — those who can count and those who can't — there are three main questions you need to answer before you decide whether to invest in a company:

1. Is this a strong and growing high-quality company?

2. Is the company's stock priced attractively right now?

(We stole the above joke from Warren Buffett's 1998 annual letter to the Berkshire Hathaway shareholders. At some point, if you really want an education in evaluating businesses, just read Mr. Buffett's collection of annual letters.)

If you don't make a point of addressing these questions (however many there were), you might end up buying grossly overvalued shares of a wonderful company, or you might snap up shares of a business that's about to be cut in half at what seems like a bargain price.

QUALITY

There are a number of ways that you can zero in on a company's quality. Is it debt-free or up to its ears in interest payments? Does the firm have a lot of cash? Is it generating a lot of cash and spending that money efficiently? Are sales and earnings growing at an admirable clip? Are gross, operating, and net profit margins growing, as well? Is the management smart and executing well? Is the company well-positioned to beat out competitors? Does the company have a brand name that is widely known and admired?

These are just some of the many measures you can take when evaluating a company's quality.

PRICE

When evaluating a company's price, you shouldn't be interested in how many dollars one share costs — you need to measure the per-share cost of a stock against something. Investors typically take a number of measures and compare them to the firm's earnings. The price-to-earnings (P/E) ratio, for example, compares a company's stock price to its earnings per share. Some companies aren't properly valued based on their earnings, though (because there may not be any), and often the price-to-sales ratio is used. Another earnings-based ratio is the PEG, which compares the P/E ratio to the company's earnings growth rate.

You can also evaluate price by estimating the company's earnings for all the years ahead and then discounting them to their present value. A company's stock price is essentially a reflection of all its expected future earnings, discounted at an appropriate rate. If your calculations suggest the total discounted earnings of a company will result in a valuation of $80 per share, and the stock is currently trading for $60 per share, you're possibly looking at a real bargain.

VALUE

Once you have a handle on a company's quality and its price, you can begin to make a judgment on what the intrinsic value of the company should be. Before we go any further, know that there are many different investing styles, and many different ways to value stocks. Some investors focus primarily on finding undervalued companies, paying close attention to a stock's price. Others consider price, but focus more on the quality of the business. Both of these are Foolish approaches.

What is un-Foolish is simply to look for rapidly growing companies, regardless of price or quality, or to only examine charts of a stock's price movements and its trading volume.

LEARNING MORE

Success in analyzing individual businesses and ultimately investing in them is about buying what you understand the best and constantly refining and adding to your knowledge about companies.

HERE ARE SOME STEPS YOU CAN TAKE TO BROADEN YOUR RANGE OF UNDERSTANDING:

- Try out the company's product(s) or service(s). Be familiar with how it is improving and what the demand for it is.
- Read up on the company. Find books and magazine and newspaper articles on it.
- Check out our discussion boards for any company you're interested in. Online, you can and should ask questions of fellow Fools. In particular, check out the Frequently Asked Questions (FAQ) post that is linked near the top of many individual company message board posts.
- Figure out what the company's business model is. How is it making money? How is it organized? How might the model change in the years ahead? On what assumptions is the model based?
- Examine the company's competitive environment. What are its competitors up to? Is the company likely to fend off attacks? What advantages does the company have over the competition? Is it at any disadvantage? How is the industry changing and what challenges does it face?
- Think about the company's risks. In SEC filings, the company's management will have explained some risks that they see.

Thinking About Prices

A stock's price is meaningful when you compare it to earnings and other measures like that. It's pretty much meaningless, though, when examined in a vacuum. People often mistakenly think that a $10 stock is more attractive than a $150 stock. Wrongo. Buzzy's Broccoli Beer might be way overvalued at $10 per share, while shares of the Velvet Elvis Co. might be a great bargain at $150 each.

People often think that they have to buy "round lots" of 100 shares. Not true. You can buy as many shares as you want. If the company you're interested in trades at $75 per share and you only have $2,000, you can buy 27 shares.

Another common misconception is that penny stocks, those trading for less than about $5 per share, are great buys. People think that a $1.50 stock is likely to double quickly. Well, penny stocks are usually trading that low for a reason. They're more likely to zoom to zero than to double. Don't think that just because you can afford to buy 10,000 shares of a stock, you're bound to make a bundle.

- Crunch a bunch of numbers. See just how quickly sales are growing. See what the firm's debt-to-equity ratio is. Determine its gross margin.
- Talk to people in the business, such as company employees, suppliers, people in stores that sell the company's products, customers of the company, people familiar with competitor companies, and so on. See how they perceive the industry and where it's headed. See what they think of the company you're studying and its future prospects.
- That may seem like a lot to put together — but remember, that's what this forum is all about, helping Fools understand and put it all together. To see a portfolio that is put together by closely studying and evaluating businesses before it invests in them, move on to Step 10: Understanding Rule Maker Investing.

Step Ten

"The Rule Maker strategy buys stalwart businesses and relies only on simple numerics, common-sense logic, and your patience. It's an investment model that is as convenient as a mutual fund, but which offers above-average performance and lower expenses."

David and Tom Gardner, *The Motley Fool's Rule Breakers, Rule Makers*

Understanding Rule Maker Investing

The Rule Maker investing philosophy begins with the same premise that all Foolish investment philosophies do:

You are the best manager for your money. The Wall Street Wise telling you that you don't have the time or the skills to manage your money profitably are dead wrong.

If you go about making your selections properly, in short order you can acquire a portfolio of roughly 10 giant companies that make the rules in our economy. After buying these Rule Makers, you don't have to spend dozens of hours a year latched to a computer screen tracking your portfolio. With curiosity, discipline, and a little elbow grease, you have a good shot at generating strong returns over the long haul.

LEADING BRAND

The criteria for identifying Rule Makers begin with looking for the No. 1 brand name in an industry. And not just the No. 1 brand here in America — we're talking king of the world brands. What companies come to mind when you think of soda, razor blades, diamond rings, and microprocessors? We suspect that most people will name Coca-Cola, Gillette, Tiffany, and Intel.

When searching for Rule Makers, you need to crunch a few numbers — nothing horrific, just a few basic measures of financial performance.

MASS MARKET, REPEAT PURCHASE

Repeat mass-market purchases also characterize Rule Maker companies. People who aren't NBA stars don't buy many automobiles in a year, so General Motors is out. (Unless, of course, the NBA expands to include 6,000 or 7,000 teams. And, even then, we're not sure General Motors is the brand that'll see multiple purchases each year.) Think instead of things you routinely use, either because you like to or you have to: soda, casual clothing, blood-pressure pills, shampoo. Think Coca-Cola, Gap, Pfizer, and Procter & Gamble.

STRONG HISTORICAL PERFORMANCE

When searching for Rule Makers, you need to crunch a few numbers — nothing horrific, just a few basic measures of financial performance. Start with strong historical performance from the company. If you're making a 10-year commitment to buy and hold a handful of businesses, you have to be certain they're the kind of companies that richly reward their owners. Check out the 10-year record of your companies to make sure they're worthy of attention. Take a look at the 10-year price graphs of Intel, Coca-Cola, and Cisco Systems.

PROFITABLE AND GROWING BUSINESS

Rule Makers sport gross margins (gross profits divided by revenues) above 50%, net margins (net income divided by revenues) of at least 10%, and sales growing faster than 10% per year. Some companies that pass muster on these counts include drug maker Schering-Plough (gross margins of roughly 80%), Internet infrastructure builder Cisco Systems (net margins around 16%), and Intel (sales growth topping 12%). The preceding terms are covered in more detail in our Rule Maker Criteria at Fool.com.

CASH IS KING

These are companies that have been around for a while and have been making loads of dough for years. By now they should have a nice big vault of it, with which they can expand their operations in the future, not having to borrow money from anybody else. You can find how fat a company's coffers are by reading the balance sheet. Looking for a low Foolish Flow Ratio is a special metric of Rule Maker investing. The Flow Ratio reveals whether a company is managing cash flow effectively by demanding payment from its customers quickly (an indication of strength), and paying its obligations slowly.

You can find how fat a company's coffers are
by reading the balance sheet.

STRONG FINANCIAL DIRECTION

Even more important than past performance, however, is the future. What direction is the company heading? Since a stock's price will always be tied to the current value of future cash flows — and how the market views this scenario — you want the present to look better than the past. Hunt for rising margins, a company that's generating boatloads of free cash flow, and low debt. Think about software king Microsoft, armed with almost $25 billion in cash and cash equivalents as of this writing. Compared with industry peers, the Rule Maker candidate should sit at the head of the class.

LONG-TERM BUY AND HOLD

Rule Maker investments are meant to be long-term. Once you identify and invest in these powerful companies, you should, for the most part, be able to leave your money invested for a decade or longer. This means you won't be making many buy- and-sell decisions, and won't be forking over capital gains taxes to Uncle Sam.

With deep-discount brokers offering trades for less than $10, a Fool could buy 10 Rule Maker stocks for less than $100, starting with an initial investment between $5,000 and $10,000. This would meet the Foolish aim of keeping commission costs below 2% ($100/$5000 = 2%).

There's a lot more involved in identifying and investing in Rule Makers (hey, there's half a book devoted to it), but these are some of the core principles. This tip-of-the-iceberg treatment ought to give you an idea whether the strategy might be one to which you want to devote a little more time. Our Rule Maker Portfolio's goal is to beat the market by a few percentage points annually. It isn't guaranteed, mind you. Beating the market over a 10-year period isn't easy, but picking quality companies with lots of cash, powerful brand names, and proven management is a good place to start.

You can learn more about the specifics of this approach in our Rule Maker area at Fool.com. Plus, Fools from around the globe discuss the Rule Maker strategy 24 hours a day on the Rule Maker Strategy discussion board. To read about companies you think might be Rule Makers, go to the Rule Maker Companies board, and try asking your first questions on the Rule Maker Beginners board.

While the Rule Maker strategy hunts for dominating giants, more advanced, risk-averse investors should check out Step 11, where we introduce Rule Breaker investing.

Step Eleven

"Rule Breakers can provide investors with the most dynamically high returns achievable on the public markets — period. Rule Breakers provide inspiration and guidance to all business people, be they managers, planners, or executors. Rule Breaking is capitalism's special sauce, its tastiest and most necessary condiment."

David and Tom Gardner, *The Motley Fool's Rule Breakers, Rule Makers*

Consider Rule Breakers and Small–Caps

Warning: Rule Breakers are for the most bold and daring of investors. Those who are brand new to all this investing stuff should understand the risks involved.

Rule Breaker stocks should make up only a part of any portfolio — and investors should be prepared to lose the money they invest in these companies. High risk can bring high reward, though. In its history (August 1994 to December 2000), our real-money Rule Breaker Portfolio is up over 650%, beating the S&P 500's 188% gain and the Nasdaq's 243% rise.

We don't expect these heady returns to repeat forever. We think, however, we can offer some useful tips on how to find outstanding investments from the field of small-company stocks. Here are the six main characteristics of Rule Breaker companies:

1. The company should be a top dog and a first-mover in an important, emerging field. Being top dog in the left-handed scissors industry isn't enough. The left-handed scissors industry is pretty mature — and it ain't going anywhere in the near or distant future. As an example, in the emergence of electronic commerce Amazon.com is the top dog and first-mover.

2. The company needs to demonstrate sustainable advantage gained through business momentum, patent protection, visionary leadership, or inept competitors. Examples include Wal-Mart (with net income gains of 25% during much of the 1980s), Amgen (with patent protection of its drug formulas), and Microsoft (with visionary leadership that benefited from Apple Computer's regrettable decision not to license its technology).

3. The market should have rewarded a Rule Breaker's promise with strong price appreciation, measured by a relative strength rating of 90 or above. (Relative strength ratings appear in Investor's Business Daily.)

4. Look for good management and strong backing. The steel company (yes, steel!) Nucor, led by Ken Iverson, became a world-class powerhouse by revolutionizing steel production processes. Also consider the "backing," or supporters of a company. eBay was backed by executives from Starbucks and Sun Microsystems.

5. Rule Breakers should have a strong consumer brand. Again, consider Starbucks. Its name recognition is much stronger than competitors such as um, like... (Get the point?)

6. It's a good sign when the financial media calls a company overvalued. (Perhaps the greatest single contrary indicator is Barron's lead editorialist. When *Barron*'s is asking about America Online: "Short on Value?" — good. When *Barron*'s leads with "Sell now!" — excellent.)

A completely nutritious Foolish mix might include a bunch of Rule Maker stocks, with a few Rule Breakers thrown in to spice things up.

The best place to analyze whether a company that you're interested in qualifies as a Rule Breaker is on the Rule Breaker Strategies discussion board, where Fools gather 24 hours a day to trade ideas. To learn more and get more comfortable with Rule Breakers, read the first chapter of *The Motley Fool's Rule Breakers, Rule Makers*, and the online portfolio reports. Another good place to search for ideas is in our Internet Report. Rule Breakers aren't limited to Internet stocks, of course, but these companies are often known for breaking the rules — and some may present terrific investment opportunities for Rule Breaker investors.

Some investors should consider making Rule Breakers just a part of your overall investment strategy. A completely nutritious Foolish mix might include a bunch of Rule Maker stocks, with a few Rule Breakers thrown in to spice things up.

THE BEAUTY OF SMALL-CAP INVESTING

You should consider including a number of small-cap (small-size) growth companies in your portfolio, Rule Breakers or otherwise. Small-caps give the individual investor a chance to beat the Wise to the punch.

Perhaps the best reason to buy small-cap growth companies is because they grow — sometimes rather quickly.

The size and structure of most mutual funds and a pesky SEC regulation make it hard for funds to establish meaningful positions in small-caps. In order to buy a position large enough to make a difference to their fund's performance, they would have to buy 10% or 20% of a small-cap company (which their own guidelines frequently restrict them from doing). Before they can do that, though, they have to file with the SEC. By that time, they've already tipped their hand to the market and inflated the previously attractive price by buying 5% of the company. Individual investors who have the ability to spot promising companies can get in before the institutions do. When institutions do get in, they'll do so in a big way, buying many shares and pushing up the share price.

Another reason to buy small-cap companies is that they can grow quickly. Small companies are in a much better position than their larger brethren to expand their businesses. Rapidly multiplying earnings often translate into higher share prices.

THE DOWNSIDE OF SMALL-CAPS

Small-caps are for experienced investors. Novices should steer clear. You wouldn't go up in a lunar orbiter without prior training, nor should you try small-cap investing until you've cut your teeth on some large- and mid-cap issues.

You should also stay away from small-caps (all stocks, really) if you're ponying up your mortgage payment (or any other much-needed funds) to make the purchase. The money you invest in small-caps should be money you can afford to lose.

Time — or the lack thereof — is another dissuading factor. Finding good small-caps is a lot of work before and after you've made your purchase. If you don't have the time, energy, or inclination to keep up with the news on your portfolio, you're better off in an index fund.

Finally, if you have a natural aversion to risk, stay away from volatile small-cap growth stocks. If the mere thought of a 5% drop in one day gives you an ulcer, you're better off saving your stomach. Index funds will give you respectable returns without the acid-blockers.

HOW TO FIND SMALL-CAP STOCKS: THE FOOLISH 8

One method for locating solid small-cap companies is through "The Foolish 8." The Foolish 8 refers to eight qualities that we look for in growth stocks, as laid out by David and Tom Gardner in the *The Motley Fool Investment Guide*.

OUR LIST OF FOOLISH 8 PRINCIPLES:

1. Relative strength of 90 or more
2. Minimum price of $7 per share
3. Daily dollar volume between $1 million and $25 million
4. Sales and earnings growth of 25% or greater
5. $500 million or less in sales
6. Net profit margin above 7%
7. Insider holdings of 10% or more
8. Positive cash flow from operations

The Foolish 8 isolates small, profitable, growing companies. The list itself does not comprise our final selections, but we often pick our purchases from the list. Every month, we publish a Foolish 8 spreadsheet that identifies companies with these desirable qualities so that you can spend your time on researching these various investment opportunities in hopes of finding small-cap winners. Also check out our new weekly Foolish 8 article online.

Now that you've got small-caps under your belt, proceed to Step 12, where even more advanced investing issues are confronted.

Step Twelve

"Perish all thoughts of accountability. When you spend this much money and energy on making your picks every day, you can't afford to look backward. In fact, you can't afford to do anything else, period. Forethought is too dear a luxury; tallying, valuing, and accounting are out of the question."

David and Tom Gardner, *The Motley Fool Investment Guide*

Advanced Investing Issues

Derivatives, shorting against the box, ascending trend channels, 50-day moving averages, Bollinger bands... ohmigosh! Yes, there are a heck of a lot of high-level, complicated topics in investing. Fortunately for you, they are basically nonsense.

You can let out a big sigh of relief, because in this step we won't be covering or going into excruciating detail about many of these "advanced" topics. Instead, we'll highlight a few market complexities, some that are worth running away from (day trading), others that provide a useful chuckle (technical analysis), and a couple that you might consider learning more about and perhaps employing (margin and shorting).

DAY TRADING

We think the best way to accumulate wealth is to buy stock in great businesses and hold on for decades. But this is easier said than done. When the stock market is surging or plunging, or when you learn of one exciting company after another, it can be hard to refrain from actively buying or selling.

The buy-and-hold message is further challenged by the likes of "day traders," who believe they can wring extra profit by following the stock market by the hour. You've probably seen segments on day traders on your nightly news. It's become a fad, as more and more people forego regular 9-to-5 jobs and instead spend that time with their eyes glued to computer monitors (and we all know how painful that can be), buying thousands of dollars of stock at a time, holding it for a few hours (or minutes!), and then selling. Sheesh.

Investing with margin isn't an automatic no-no, in our opinion. It should just be used with extreme moderation and caution.

People "investing" like this aren't really investing. They're gambling. They're not holding on to pieces of strong companies, accumulating wealth as the companies grow. They're making bets that they can out-think others. They aren't participating in the growth of the American economy — they're betting that they're better guessers than the next guy. They aren't.

TECHNICAL ANALYSIS

Technical analysis dwells on charts of stock price movements and trading volume. Fundamental analysis, on the other hand, focuses on the value of companies, studying such things as a firm's business, earnings, and competition. While investors from the fundamental school (Fools!) want to understand a business from the inside out, technicians mostly remain on the outside, observing how the stock behaves in the market.

Investors who use technical analysis focus on the psychology of the market, scrutinizing investor behavior. They try to determine where the big institutional money is going so they can put their cash in the same places. It's amazing to us to think that anyone might study a stock chart, see a particular pattern, determine that the stock is "breaking resistance," and then commit actual money to that proposition. Simply put, leave technical analysis alone.

MARGIN

Buying on margin means you're borrowing money from your brokerage firm and using it to buy stocks. It's attractive because you can turn a profit using money that you don't even have. For that privilege, you're paying interest to the brokerage, just as with any other loan. (Actually, it's a lot easier to open a margin account than to apply for a bank loan.) If the market turns against you, you either sell for a loss — plus interest costs — or hold on until the market picks up, paying interest all the while.

Investing with margin isn't an automatic no-no, in our opinion. It should just be used with extreme moderation and caution. Some people, however, will max out on margin, borrowing 50% of the value of their portfolio. We think that's far too risky, and something any investor should avoid.

If you already have been investing for a few years and decide to use margin, we suggest you limit yourself to borrowing no more than 20% of your portfolio's value. If you do so and you have $20,000 in your portfolio, you'll be borrowing $4,000 and putting $24,000 to work for you. That's called leverage. A little of it can be a useful and not-too-risky thing.

Think very carefully before you use margin, though. If you're borrowing on margin and paying 9% interest, you should be pretty sure your stocks will appreciate more than 9%. If your margined securities fall below a certain level, you'll receive a "margin call," requiring an infusion of additional cash.

Only experienced investors should use margin. Indeed, many experienced investors steer clear of it. As of this writing, none of our real-money online portfolios have used margin, and they're all doing just fine.

However, there is one reason why, even if you're not interested in buying stocks on borrowed money, you still might want to open a margin account...

SHORTING

If you've ever swaggered up to a craps table, cleared away the necessary elbow room, and slapped down a few candy-colored chips on the Pass Line, you were doing what most of the people at a craps table do. You were betting with the crowd.

Adjacent to the Pass Line, however, is a cheaper strip of real estate (usually a vacant lot) known as the "Don't Pass." It's virtually the opposite bet; you win when the Pass Line crowd loses, and lose when it wins. Because you're betting against the roller and most of the rest of the table, betting Don't Pass is considered bad form. The craps jargon for you is "wrong bettor." Many other bettors will actually dislike you for doing it, a feeling that will be reinforced whenever you smile at dice rolls that make them frown. If you read our discussion boards for very long, you'll notice that short-sellers aren't generally the most beloved of contributors to this forum.

When you short a stock, you are banking on that stock's price going down. You initiate the process of shorting a stock by first borrowing shares from a current shareholder. This may sound difficult, but it isn't. Your discount broker does this for you automatically. You then sell these borrowed shares at the current market price. Then you sit and wait, rooting for the stock to spiral downward. While you wait, you have to pay dividends to the person who actually owns the stock you borrowed (if the stock pays a dividend) and, in some cases, you can also be subject to paying margin interest to the brokerage, just as if you had borrowed money.

When you're ready to cash out of your investment, whether for profit or for loss, you close out the position by buying the stock back at the market price so you can return your borrowed shares to the lender — another thing your broker does for you automatically. That's it.

Shorting can offer a couple of potential benefits for your portfolio. First, shorting stock is a "hedge" — you're taking compensatory measures to counterbalance a potentially plummeting stock market. Outside of its status as a hedge, however, selling stocks short is also a great way to make money. Indeed, if you make the right choices, you can make money both ways — as the stocks you own rise AND as the stocks you have shorted wither. It's tremendous fun! In fact, before we turned Foolish enough to short stocks, we didn't know just how much fun we were missing.

Second, and more important, the shorting of stocks is vastly underpracticed by the investment community at large. From a purely Foolish point of view, this makes shorting stock even more compelling. That's because Fools relish a good swim against the tide. When most investors are trying to figure out how many more half-point gains they can squeeze out of their equities, we're looking the other way. We're regarding these same securities from the top down, assessing how far each might fall. The seldom-taken contrary view can be lucrative.

A final note: Once in a blue moon, your broker may be forced to return your shorted shares to the anonymous lender, usually because he wants to sell them. Forced into doing so, you'll have to buy back the shares prematurely — whether you've made money or not. This happens only with very small companies that have few shares outstanding, and is usually just a minor nuisance. Put the money somewhere else.

When calculating returns, keep in mind that all the normal steps of buying and selling a stock are still present, just reversed. Both transactions still have a cost basis and a sales price. But, for stocks sold short, the chronological order has been reversed.

Shorting stock is one approach that separates the sophisticated investor from the novice. Believing that selling shares short is difficult and highly dangerous, some people pay oodles of money to enter "hedge funds," mutual fund partnerships whose managers short stock and go on margin. Having read this far, you already know most of what these "pros" know, and can do it yourself.

Finally, remember that when your "Pass Line" friends find out you're shorting stocks, they may start to regard you as Darth Vader. So, wear dark clothes, a low visor, breathe loud, and milk it.

You're almost home-free, Fool. Now, on to the last step to investing Foolishly.

Step Thirteen

"Now, imagine your small town investors' club writ large. Instead of a dozen members sitting around a table in Ethel's parlor, you have thousands of investors working together in concert across the nation and around the world. Here you can share insights, alert one another to trends, pass on information and late-breaking news, and argue the finer points of investing technique, twenty-four hours a day, every day of the year. It's happening right now, online."

David and Tom Gardner, *The Motley Fool Investment Workbook*

Get Fully Foolish

Sure, you can read *You Have More Than You Think*, *The Motley Fool Investment Guide*, and *Rule Makers, Rule Breakers* and be more prepared to invest in today's hurly-burly markets than nine out of ten people. But how can you become better able to handle the twists and turns of individual stocks than 99 out of 100 investors? We've got six words for you, friend, and they ain't "Call market predictor Elaine Garzarelli now." They are "Check out The Motley Fool online." Online you will find hundreds of additional educational and interactive features, online discussions, and much, much, more.

So where do you begin?

GET YOUR FINANCIAL HOUSE IN ORDER

Your first goal should be to get your personal finances in tip-top shape before embarking on any Foolish investing. In our Personal Finance area (**www.Fool.com/pf.htm**), you'll find in-depth coverage on such matters as getting a broker, paying for college, banking, taxes, investing for kids, and buying insurance, homes, and cars.

LEARN THE BASICS OF INVESTING

You can then move over to the Fool's School (**www.Fool.com/school.htm**) for an explanation of different investment vehicles, a tutorial on starting an investment club, the lowdown on mutual funds, an area that tracks all the major market indexes (including our own FOOL 50 Index), and an explanation of dividend reinvestment plans.

You can also home in on How to Value Stocks, featuring articles on how to value companies using earnings, cash flows, revenues, and all sorts of stuff found on the balance sheet.

HELP IS ON THE WAY

We also provide a Help Desk (**www.Fool.com/help.htm**), with everything from Foolishly Answered Questions (FAQs) about anything imaginable to direct links to our non-stop Ask a Foolish Question discussion board. We'll answer your questions right there online. If you see any problems or anything you'd like done more or done better, simply drop a note at our Improve the Fool discussion board.

WE WALK THE WALK

Plenty of investment advisors are happy to tell you what they think you should do. Very few are willing to put their money where their mouth is and explain exactly how to manage a portfolio using a specified investment approach — warts and all. Even fewer do so as they aim to whup the market.

We are not investment advisors. But our real-money portfolios, which you'll find in our Strategies area (**www.Fool.com/strategies.htm**) — including the Rule Breaker Portfolio, Rule Maker Portfolio, and Drip Portfolio — illustrate the process of imperfectly managing your own money while bettering the indexes over the long haul. The results reflect all commissions and spreads that an individual investor would be charged — and we do aim to beat the S&P 500 handily over the long term.

These portfolios are designed to answer that burning question: "How do successful investors weigh the news and rumors that surround their individual stocks?" Tune in whenever you're in the mood to find out.

GENERATE INVESTMENT IDEAS

Our Strategies area as well as our Fool News & Commentary (**www.Fool.com/news.htm**) will plug you into the news coming out of companies you already own while identifying other potential investment opportunities — all with a Foolish touch of analysis. Day in and day out, you'll be exposed to issues and lessons important to individual investors.

A Word on Risk

Many people steer clear of stocks because they think they're dangerous. Many people cling to bonds, rationalizing that they're "safe." You owe it to yourself to explore what the risks really are, though. Yes, the stock market is risky if you're just investing for six months or two years. But if you're Foolishly planning to keep your money in the market for one or more decades, much of the risk melts away. You'll be able to ride out any downturns and crashes.

Over the long haul, the stock market has grown an average of about 11% per year in the 20th century. Over that same long haul, bonds have pretty consistently and significantly underperformed stocks. Don't sell your future short and avoid stocks without at least learning more about them.

For those who cannot tune in on a daily basis, we offer an archive of everything we publish on our Today's Features (**www.Fool.com/foolwatch**) page. Bookmark it and you'll never miss your favorite features again.

Our Quotes & Data (**http://quote.Fool.com**) area offers a number of research resources, including earnings estimates, press release databases, financial information, and historical price charts for every stock out there. In addition, you can plug into Securities and Exchange Commission (SEC) filings and dig for all the cool facts and numbers that will help you evaluate your investments.

In other corners of our forum, we bring you stock screens set to various Foolish criteria and Duels featuring the pros and cons of a popular stock in a Foolish debate. We also offer information on conference calls and help locating those hard-to-find replay numbers. When you're ready to start investing, we can even help you open a discount brokerage account (**www.broker.Fool.com**).

TALK WITH OTHERS

On our thousands of discussion boards, you can debate the value of publicly traded stocks, talk over the merits of a new approach to investing, get money-saving tips, or just ask whatever question happens to pop into your head. Try reading the Post of the Day or the Fribble, examples of some of the best material submitted by our readership.

YOUR FOOL

When you register, you'll set up your own, customized Fool page. "My Fool" allows you to quickly view your favorite discussion boards, portfolios, and Fool features all on one page. You can also change your Fool preferences such as your email address, your password, and your personal profile. Finally, My Fool lists all of the perks we offer you as a member of The Motley Fool. Check My Fool often to see the new offerings.

BRINGING IT ALL TOGETHER

Investing is not just something you do once — it is an ongoing process that requires time and attention. A solid, well-diversified portfolio that moves beyond simply buying an index fund requires work... work that you can do at The Motley Fool online, sharing with other Fools as you go along. Whether it is in our educational areas or out on the discussion boards, you can hang out with Fools and beat the pants off Wall Street.

Welcome, and Fool on!

Help Us Help You

We think that the Fool has a lot to offer every kind of person, from kids to retirees, from novice to veteran investors. But that doesn't mean that we can't do even more to make your experience better. Fooldom is a two-way street (if not a million-way one). Please take the time to ask us when you have questions. Head to our Info/Help area (**www.Fool.com/help.htm**), where you can get all kinds of answers. And pop in on our "Improve the Fool" discussion board, too, if you have ideas for how we can improve the Foolish experience.

What Makes Us Different

The last thing we'd want is to be mistaken for Wall Street professionals or, worse yet, some of those shady get-rich-quick operators. (We do believe in getting rich, but we do it slowly.) So here's a quick rundown of what The Motley Fool is and is not:

We don't tell you to buy this or sell that. And we don't want to manage your money, either. We're about teaching, not advising.

Our model portfolios are real-money portfolios. All our portfolios are funded with our own greenbacks. They're meant to be teaching portfolios that reflect Foolish investing, and we report on their progress online every weeknight.

We're fun. At the very least we try to deliver a dollop of lightheartedness in what is too often a heavy, dry-as-chalk topic. Our aim is to make investing easy to understand, with clear writing and (occasionally) clever jokes.

We're accountable. When we plan to buy or sell a stock in our portfolios, we announce it beforehand. The returns we report for our portfolios account for commissions and spreads — something rarely seen in traditional financial statements.

We're not just about stocks. We cover just about any money-related issue, from mutual funds to paying for college to getting a pet.

We're not just online. Look for our nationally syndicated newspaper column and radio show, best-selling books, and occasional TV appearances and magazine coverage.

Fool.com Cheat Sheet

Some relevant links to interesting stuff:

Step 1: What Is Foolishness?

Fool's School: **www.Fool.com/school**

Step 2: Settle Your Personal Finances

Personal Finances (How to Pay Down Debt, How to Buy a Car, Home Buying, Paying for College) **www.Fool.com/pf.htm**

Step 3: Set Expectations and Track Your Results

Fool Portfolio Tracking: **http://quote.Fool.com/portfolios**

Step 4: Start With an Index Fund

Index Center: **www.Fool.com/school/indices/introduction.htm**

American Stock Exchange website: **http://www.amex.com/indexshares/index_shares_over.stm**

Step 5: All About Drip Accounts

Drip Portfolio: **www.drip.Fool.com**

Investing Without a Silver Spoon: **http://shop.Fool.com**

Step 6: Open a Discount Brokerage Account

Discount Brokerage Resource Center: **www.Broker.Fool.com**

Step 7: Planning for Retirement

Retirement Area: **www.Fool.com/Retirement**

Retirement Savings Calculator: **www.Fool.com/calcs/calculators.htm#saving**

Step 8: Get Financial Information

News, financial snapshots, and estimates of future earnings: **http://quote.Fool.com/**

How to Read a Balance Sheet: **www.Fool.com/school/valuation/howtoreadabalancesheet.htm**

Foolish Research Products: **www.Fool.com/research**

For some advice on spotting investment scams, we've put together a primer called "Securities Fraud: How to Avoid the Cons" at **www.Fool.com/specials/2000/sp000223fraud.htm**

Step 9: Evaluating Businesses

Introduction to Valuation: **www.Fool.com/school/introductiontovaluation.htm**

Security Analysis: **www.Fool.com/school/securityanalysis.htm**

Step 10: Understanding Rule Maker Investing

Rule Maker Portfolio: **www.rulemaker.Fool.com**

Foolish Flow Ratio: **www.Fool.com/portfolios/rulemaker/rulemakerstep6.htm#10**

Rule Breakers, Rule Makers book: **http://shop.Fool.com**

Step 11: Consider Rule Breakers and Small-Caps

Rule Breaker Portfolio: **www.rulebreaker.Fool.com**

First chapter of *The Motley Fool's Rule Breakers, Rule Makers*: **www.Fool.com/about/books/rbrm/chapter1.htm**

Internet Report: **http://shop.Fool.com**

The Motley Fool Investment Guide: **http://shop.Fool.com**

Foolish 8 Spreadsheet: **http://shop.Fool.com**

Step 12: Advanced Investing Issues

Shorting Stocks discussion board: **http://boards.Fool.com/registered/messages.asp?id=1030023000000000**

Step 13: Get Fully Foolish

Personal Finance Area: **www.Fool.com/pf.htm**
Fool's School: **www.Fool.com/school**
Help Desk: **www.Fool.com/help/help.htm**
Strategies area: **www.Fool.com/strategies.htm**
Fool News & Commentary: **www.Fool.com/news**

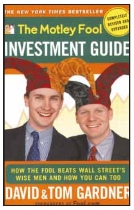
Acknowledgments

The original 13 Steps was a group effort written in 1996 by a bunch of stalwart Fools huddled in our first office (really, a single room) fueled by Twinkies, Cheetos, and a dusty crate of New Coke.

The updated version you read here is the collaborative work of Selena Maranjian, Bill Barker, Bob Bobala, Brian Bauer, David Wolpe, David Braze, Dayana Yochim, Richard McCaffrey, Jeff Fischer, Bill Mann, Robert Brokamp, Julia Wilson, Robyn Gearey, David Ostroff, and others whose fingerprints you can probably find on these pages. Also thanks to Allie Shaw for the design and layout of this document, and for graciously handling the 472 tweaks we asked her to make.

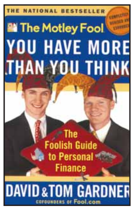
Motley Fool Products

BOOKS



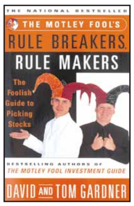
The Motley Fool Investment Guide

David and Tom Gardner, the co-founders of The Motley Fool, help investors learn the basics of investing, the truth about mutual funds, how to invest in 401(k)s, and much more. This book has been completely revised and expanded for 2001.



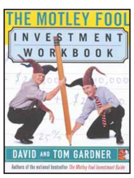
The Motley Fool You Have More Than You Think

Learn how to get out of debt and take control of your personal finances. This book provides beginning investors with the tools they need to gain financial security. Also completely revised and expanded for 2001.



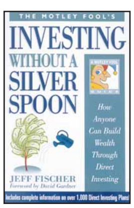
The Motley Fool Rule Breakers, Rule Makers

David and Tom Gardner explain their personal investing strategies that are the basis for their real-money portfolios used to teach advanced investing principles on Fool.com.



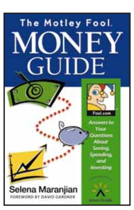
The Motley Fool Investment Workbook

This step-by-step guide helps you build a budget, decide how much to invest, choose an investment strategy, and discover the best source of stock market information.



The Motley Fool Investing Without a Silver Spoon

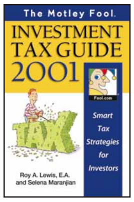
You don't need a broker to become an investor. Dividend reinvestment is a great way to start and build your wealth over a lifetime. This book will show you how to get started and lists hundreds of companies which offer dividend reinvestment plans.



The Motley Fool Money Guide — NEW

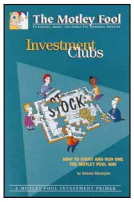
In this friendly and helpful guide, you'll find clear answers to frequently asked questions about personal finance and investing. We cover all the basics: budgeting, buying a home or car, insurance, paying for college, investing in mutual funds and stocks, and managing your investment portfolio.

Available at http://shop.Fool.com



The Motley Fool Investment Tax Guide 2001

Our annual guide will help you prepare for the tax season and show you how a little planning and strategizing throughout the year can save you a lot of money.



Investment Clubs: How To Start and Run One The Motley Fool Way

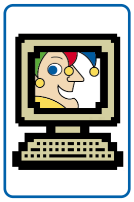
This primer covers all of the basics of forming and running an investment club, and includes information on drafting formal agreements, club accounting, performance evaluation, and more!

THE MOTLEY FOOL SELECT – NEW

The Motley Fool SELECT

Get our top investing ideas sent directly to your inbox each month. This exclusive service gives you the information you need to make confident investment decisions and generate new opportunities for growth.

THE MOTLEY FOOL ONLINE SEMINARS



Covering topics ranging from retirement planning to advanced investing strategies, these courses help you tackle your big financial questions. Lessons are sent via email, and help is always available from the instructors and community via our discussion boards. Visit **http://seminars**.Fool.com for our current offerings.

Available at http://shop.Fool.com