The Basics for Investing in Stocks

Although they are unpredictable over the short term, stocks have delivered superior returns over the long haul.

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By the Editors of
Kiplinger's Personal Finance

CONTENTS

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Kiplinger's PERSONAL FINANCE MONEY SMART LIVING

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Stocks deserve a place in long-term plans

Over the long run, stocks have beaten the performance of any other major asset class by a wide margin. Since 1926, stocks have returned nearly 10% per year, on average. Note that this nine-decade span includes numerous wars, recessions and the Great Depression. It also includes the severe decline in stock prices from late 2007 to early 2009, a period that overlaps what some call the Great Recession.

Stocks have proved their worth and deserve a prominent place in any long-term investment plan, such as a retirement account. But because stocks are volatile—which means that by their nature, their value rises and falls—invest in them with caution. Ideally, stocks should be held to meet medium- and long-term goals. In other words, money invested in stocks should not be money that you might need in three to five years. Stocks tend to deliver handsome returns over the long run, but volatile markets may not cooperate with your short-term cash needs.

Common stocks represent a share of ownership in the company that issues the shares (for a description of preferred stocks, see the box on page 5). Stock prices move according to how a company performs, how investors perceive the company's future and the movement of the overall stock market. The following is a guide to understanding stocks and how to invest in them.

Different Flavors of Stocks

Growth stocks are shares of companies with the potential to consistently generate above-average revenues and profit growth. These companies tend to reinvest most or all of their earnings in their businesses and pay out little or none of their profits to shareholders in the form of dividends. Growth companies expand faster than the overall economy, yet you can sometimes find these companies in mature industries. Note that even fast-growing companies are not necessarily good investments if their shares are overvalued.

Cyclical stocks are shares of companies whose sales and earnings are highly sensitive to the ups and downs of the economy. When the economy is performing well, cyclical companies tend to shine. A contracting economy typically hammers the sales and

Stocks that pay large dividends are less volatile

profits of these companies and hurts their stocks. Cyclical industries include manufacturers of steel, automobiles and chemicals, airlines and homebuilders.

Defensive stocks describe shares of companies whose sales of goods and services tend to hold up well even during economic downturns. Examples of industries that are substantially insulated from the business cycle are utilities, government contractors and producers of basic consumer products, such as food, beverages and pharmaceuticals.

Income stocks pay out a relatively high ratio of their earnings in the form of dividends. The companies that issue them tend to be mature and have limited opportunities for reinvesting their profits into more-attractive opportunities. Example: many utilities. Stocks that pay large dividends are usually less volatile because investors regularly receive cash dividends, regardless of market gyrations.

Value stocks describe stocks that are cheap in relation to fundamental measures, such as profits, sales, cash flow or the value of a company's assets.

Small-company stocks have generated better returns over time than stocks of large companies. Young, small companies tend to grow faster than their larger brethren. But there's a trade-off: Small-company stocks are much more volatile than shares of big companies. There are a number of ways of defining what constitutes a small company. By one common definition, a small company is one with a stock-market capitalization of $1 billion or less (market capitalization is a company's stock price multiplied by the number of shares outstanding).

Foreign stocks add valuable diversification to a purely domestic stock portfolio. That's because U.S. and foreign stock markets don't always move in tandem. Foreign stocks provide exposure to overseas currencies, economies and business cycles. Overseas stocks are divided into two subsets: developed markets (such as Western Europe, Japan and Canada)

HOW TO PLACE AN ORDER

You place orders to buy or sell stocks through a broker. If you work with a full-service broker, you may just call your account executive and tell him or her what you want to do. If you work with an online broker, you can place the order yourself through the brokerage's website. If you place a market order, you're committing to buying or selling a stock at the best current price. With a limit order, you specify the price at which you are willing to buy or sell a stock. When and if the market price reaches the limit-order price, the order is executed. Stock investors pay commissions to brokers on both stock purchases and sales.

and faster-growing emerging markets (China, India and Brazil, to name a few).

The Importance of Diversification

Diversification means spreading your money among many investments to lessen risk. The idea is to avoid a situation in which your investments are concentrated in so few holdings that big declines in the value of just one or two of them wreck your portfolio. If you buy individual stocks, you probably need a minimum of 20 to 30 companies from a variety of industries to provide sufficient diversification. (If you choose to invest in a diversified stock mutual fund, the fund will achieve this diversification for you; more on stock funds later.)

For instance, you might strive for a mix of stocks that tend to fare well in different economic environments, such as strong, stagnant and inflationary economies. Perhaps you want to blend growth and income stocks in the portfolio and add a dash of small-company and emerging-markets stocks. The appropriate blend of stocks depends on personal circumstances, including your time horizon (when you'll need to spend the money) and your tolerance for risk and volatility (your ability to sleep at night when stock prices fall).

How to Pick Stocks

Broadly speaking, there are two basic approaches to stock picking: one based on an assessment of economic and market factors (known as a top-down approach) and one based exclusively on analysis of individual stocks (a bottom-up approach). Investors—including professionals such as mutual fund managers—sometimes combine both approaches in selecting stocks.

Top-down approach. The investor begins with an analysis of the economy, markets and industries. Trends in the economy, such as employment and interest rates, substantially influence company earnings. Because many companies operate all over the world, the analysis must often be global in scope.

Stocks tend to perform differently at various points in an economic cycle. For instance, financial companies and homebuilders often do well early in an economic recovery, or even in anticipation of a recovery. Commodities-related companies, such as chemical and aluminum manufacturers, often

There are numerous ways to pick stocks

perform well in the late stages of an economic cycle, when inflation tends to heat up and they can command higher prices for their products.

Bottom-up analysis. There are numerous ways to pick individual stocks, some of them quite complex. In general, though, investors prefer companies that deliver solid earnings growth or those whose share prices are cheap relative to the perceived value of the company. Finding the best of both worlds—a rapidly growing company whose share price is cheap—is an even better formula for successful stock picking. Of course, that is much easier said than done.

It's crucial to understand how stocks are valued. By itself, a stock's price tells you nothing about its value. A stock that trades for a nickel a share can be expensive, while a stock that trades for $500 per share can be cheap. As mentioned earlier, what matters is how much the share price compares with a fundamental measure, such as a company's profits or sales.

Key Measures of Value

Price-earnings ratio. The P/E ratio is perhaps the best-known and most widely used yardstick to assess the value of a stock. The numerator, ***P***, is the current market price of a stock. The denominator, ***E***, is the company's earnings per share, which is calculated by dividing after-tax profits by the average number of outstanding shares of common stock. For example: A company that earns $400 million in a year and has 100 million shares outstanding has earnings of $4 per share. If its stock sells for $40, the P/E ratio is $40 divided by $4, or 10.

The P/E ratio tells you how much investors are willing to pay for each dollar a company earns. You can use that number in a variety of ways to spot value. For example, you might look for P/E ratios that are low on an absolute basis—in the single digits, for example. Or you might look for stocks with P/E ratios lower than the P/E ratio of the overall market. Or you might

ALL ABOUT TECHNICAL ANALYSIS

This is actually a third school of stock picking. Technical analysts make decisions based on observations of historical market and stock trends and current data. They study patterns of price movements and trading volume of the market and individual stocks, looking at such things as moving averages and relative strength. Practitioners of technical analysis pay little or no attention to fundamentals—they may not even care what business a company is in. Many academics scoff at technical analysis, but the technique has many passionate advocates.

ALL ABOUT PREFERRED STOCKS

Preferred stocks have elements of both stocks and bonds. As with common stock, companies issue preferred shares. Preferred stock ranks higher than common stock in the company's capital structure, which means that preferred shareholders are paid dividends first and have a better chance than common shareholders of being paid off if the company goes into bankruptcy. Bond investors, however, have a higher claim on a company's assets than holders of preferred stock.

Preferred shares resemble bonds in that dividend payments are typically high but fixed. As such, preferred shareholders cannot benefit in the growth of the company, but neither are they hurt if the company stumbles a bit. In fact, preferred-share prices tend to behave like bond prices, rising as interest rates fall and sinking as interest rates rise. But unlike bonds, most preferred stocks do not have maturity dates, and the issuers of the shares (unlike borrowers paying interest to bondholders) are under no legal obligation to pay dividends to investors.

search for stocks of companies whose P/E ratios are lower than the average P/E of the industry in which they operate. Warning: Because an entire stock market or industry can be overvalued (think Internet stocks in the late 1990s) purchasing a stock purely because it's relatively cheap can be dangerous.

To make matters trickier, stock investors generally base their decisions on expectations of a company's future earnings. So they are usually willing to pay up—that is, accept a high P/E ratio—if they think a company will grow rapidly in the future. Because of this focus on the future, many investors calculate P/E ratios on the basis of estimated profits—typically what a company is expected to earn over the coming 12 months. You can find earnings estimates on many websites, including Yahoo! Finance (http://finance.yahoo.com) and Zacks (www.zacks.com).

> Stock investors generally base their decisions on a company's *future* earnings and are willing to pay if they think the company will grow.

Price-to-book-value ratio. This method of valuing a stock is useful in certain cases and not so useful

Dividend yield is akin to interest on savings

in many others. Book value, also known as shareholder equity, is essentially a company's assets minus liabilities. Divide that number by the average number of shares outstanding to arrive at book value per share, then divide the share price by book value per share to arrive at a stock's price-to-book-value ratio (P/B). Compare a stock's P/B to that of similar companies to get a sense of relative value.

One instance in which price to book value is often used to evaluate a stock is when the P/E ratio doesn't make sense. This may be the case if a company has no earnings (you can't divide ***P*** by zero), negative earnings (that is, the company loses money), or its earnings are temporarily distorted in either direction. This is often the case with cyclical companies, whose earnings tend to be highly volatile.

Price-to-sales ratio. Price-to-sales ratio may be even more useful than price-to-book-value ratio in valuing a company whose earnings are negative or erratic. That's because sales are more stable than earnings and because it's more difficult for a company to use accounting techniques to manipulate revenues than it is to use them to manipulate earnings figures.

Price-to-cash-flow ratio. Use of this ratio to value companies is growing in popularity. Cash flows are more stable than earnings and, as with sales, are much less prone to distortions from different accounting methods. There are several ways of measuring cash flow. One common definition is that cash flow equals earnings from operations, plus depreciation and other noncash charges against earnings.

Dividend yield. Akin to interest on a savings account, this number is the amount of the dividend a company pays to shareholders expressed as a percentage of the stock's price. So, for example, if a company pays out $2 a year (dividends are usually paid quarterly; in this case, the dividend would be 50 cents per quarter for every share you own) and the stock sells for $50 a share, the yield is 4% ($2 divided by $50). Stocks with high dividend yields are sometimes seen as

better values than stocks that pay relatively small dividends or none at all.

Financial strength. Although not technically a measure of value, you should have a sense of how much debt a company is carrying. Debt isn't necessarily bad. Used judiciously, it can help a company boost profits.

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But too much debt can be dangerous, particularly when the economy weakens. If sales and profits slump, a highly indebted company may have trouble meeting its obligations to lenders. Two common measures of a company's financial leverage are the ratio of debt to equity and the ratio of debt to capital (equity representing what stockholders have put into the company and capital representing equity plus outstanding debt). To get a sense of how leveraged a company is, it's best to compare these debt ratios to those of other companies in the same industry.

Finding Growth

Most of the discussion until now has focused on how to value a stock. Of course, the other side of the investing question is discovering growing companies.

There are many ways to find great growth stocks. Perhaps the simplest is through your own observations. You may dine at a restaurant chain with an interesting new concept that seems to be opening a new facility every week. Your teenage kids may tip you off to a new store that all their friends are patronizing. Or it could be a technology company that turns

BEWARE PENNY STOCKS

Take extra care with stocks that sell for extraordinarily low prices. Just because a price is low doesn't mean the stock is cheap, according to traditional ways of determining value. "Penny stocks," defined by the Securities and Exchange Commission as stocks that sell for less than $5 per share, often deserve to be low-priced. The company might be in deep trouble. Plus, penny stocks are subject to manipulation, particularly schemes to inflate their share price temporarily. It's crucial to do your homework before investing in a penny stock. Many penny-stock companies don't file regular financial reports. If a company you're interested in doesn't, stay away.

Refusal to sell is the undoing of many investors

DIVIDEND REINVESTMENT PLANS

A dividend reinvestment plan is a low-cost way of reinvesting the dividends you receive from a company whose shares you own. When you purchase shares of a company with a so-called DRIP, you can direct the company (when it holds your shares) to reinvest your quarterly dividends for little or no charge. DRIPs are particularly helpful to small investors because the plans allow investors to buy fractional shares. DRIPs also allow you to make additional investments in a company's stock, either on a regular or occasional basis. Not all companies have DRIPs; to find out whether a company offers one, go to its website or contact its investor-relations department.

In general, you have to own at least one share of a company's stock before you can sign up for its DRIP. However, several hundred companies let you buy your first share directly from the company at little or no additional charge. If you have a brokerage account, you can also direct your broker to reinvest dividends automatically, typically for no additional charge.

out one blockbuster product after another. As a rule, you should invest only in companies that you can understand.

You can find past growth rates and estimated future growth rates for earnings and sales in brokerage reports and on the Internet. If you can find a company that can generate earnings growth of 15% a year, its profits will double in five years. If you haven't overpaid for the stock, chances are good that your investment will double over that time frame, too.

When to Sell

The decision of when to unload a stock is as important as deciding which stocks to buy in the first place. But the decision to sell is often harder than the decision to buy. That's because once you own a stock, emotional factors come into play. If you own a stock that falls in value, you may want to hold on to it—whether you should or not—because by selling and locking in the loss you confirm that you made a bad decision. If you own a stock that performs exceedingly well, you may want to hold on because it has treated you so well, even if the stock has become overvalued.

The refusal to sell—whether due to unrealistic expectations, stubbornness, lack of interest or mere inattention—is the undoing of many investors. As a long-term investor, you don't want to cash in every time your stock moves up a few dollars. Commissions

and perhaps taxes would cut into your gain, and you'd have to decide where to put the proceeds. By the same token, you don't want to bail out in a panic in the aftermath of a steep market decline.

Here are some clues that will tell you when it is time to consider selling a stock, no matter if you have made a profit on it or not.

■ **The fundamentals change.** Whether you own shares in a large, well-known company or a company most people have never heard of, you need to follow the corporation's prospects, its earnings progression, and its business success as reflected in such things as its products and services, market share, and profit margins. Annual reports, news stories, research reports from brokerage houses and independent analysts, and investment newsletters are fertile sources of such information, along with the references listed on page 10.

If a company's basic, fundamental measures start to weaken, it's time to reconsider your investment. An example might be a fast-expanding retail chain whose sales per store suddenly decline after rising for years. Or here's a more obvious case: Suppose you bought a stock because you had high expectations for a new product. If the product turns out to be a dud, sell.

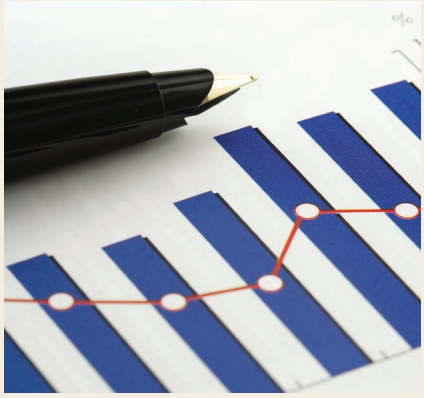
■ **The dividend is cut.** The progression and security of the dividend are important to any stock's prospects. A dividend cut or signs that the dividend is "in trouble"—meaning that analysts or money managers are quoted as saying that they don't think the company can maintain its payout to shareholders—can undermine the stock price. Beware, incidentally, of stocks that sport unusually high yields relative to their history or to their industries. The yield may be high because the share price has dropped a lot. This often indicates that investors believe a company will cut its dividend.

■ **You reach your target price.** Many investors set specific price targets, both up and down, when they buy a stock; when the stock reaches the target, they sell. A good target might be to look for a 50% gain within two years or to limit your patience with a stock to a loss of 20%. Such guidelines can prompt you to take your gains in a timely fashion and to dump losers before the damage gets too painful. Take the simple step of setting a "mental protective stop." Keep track of the

FACT FINDING: SOURCES AND WHAT YOU'LL FIND INSIDE

The Web has made it easier than ever to conduct your own research on stocks. Below is a basic guide to locating the key facts on companies.

Company websites. Spend some time on the investor-relations section of the company's website. You will find a wealth of information, such as stock-price and dividend history, investor presentations, and important financial documents, such as the annual report. The annual report contains audited financial statements from the most recent year, along with data from previous years. You can download the report from the website, obtain a hard copy from the company's investor-relations department, or request a copy through your broker.



Form 10-K. This document, which must be filed annually with the Securities and Exchange Commission, includes audited financial statements and voluminous information on the company. You can obtain 10-K filings through company websites or through the SEC's EDGAR database (www.sec.gov/edgar/searchedgar/company search.html).

Analysts' reports. Brokerage firms' research departments publish reports on companies that they follow. These reports contain financial numbers, analysis and analysts' stock recommendations, such as buy, hold or sell. You can obtain reports such as these from your broker. Some online brokers offer research produced by full-service brokerages, as well as independent research from the likes of CFRA and Argus Research.

Morningstar. This independent outfit made its name in mutual fund research, but it also conducts fine research on stocks. You can obtain basic stock and stock-fund information free of charge at www.morningstar.com. For greater detail and analysis of stocks and funds, Morningstar offers a premium membership service for $199 a year.

Value Line Investment Survey. Value Line offers a vast collection of data, including prices, earnings and dividends, stretching back years, along with its analysis. Among the unique features is a "timeliness" rating for each of about 1,700 stocks as well as analyst commentaries. Various packages are available at libraries or from Value Line (800-825-8354; www.valueline.com).

You can set your sell level anywhere

stock's price and sell any stock that hits your mental stop point. You can set your sell level anywhere, be it above the current share price or below the current share price. Once you've reached your objective, take the money. If the goals you set are very conservative, you might miss some gains from time to time, but that's better than holding on too long and falling victim to the Wall Street maxim that says: "Bulls make money. Bears make money. Pigs get slaughtered."

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■ **What's your return?** With any investment, you should judge performance by total return—essentially, the change in price plus any dividends you receive while holding the stock. For example, if you buy a stock for $40, sell it a year later for $50 and receive a $2 dividend payout during the year, your total return is roughly 30% (a 25% capital gain plus a dividend yield of 5%).

Consider Mutual Funds

There are a number of benefits to investing in stocks through mutual funds. Instead of researching individual stocks yourself, you are effectively hiring an investment professional to analyze companies and stocks. The manager will decide when is an opportune time to purchase and sell stocks.

Funds are convenient. While you may need to purchase 20 to 30 stocks for adequate diversification, a diversified mutual fund provides a one-stop approach to spreading risk. For example, researching small-company or foreign stocks can be especially daunting. But you can fill gaps such as these in your portfolio by buying small-company or foreign funds. In fact, you can find funds that address almost any investment strategy, broadly or narrowly defined.

Stock mutual funds, which you buy through an intermediary (such as a broker) or directly from a fund sponsor, come in several varieties. Index funds are passively managed funds that seek to mimic a benchmark, such as Standard & Poor's 500-stock index.

Actively managed funds are funds run by a manager who selects stocks according to his or her own assessment of their attractiveness. Exchange-traded funds, or ETFs, typically are a version of index funds. ETFs trade like stocks on a stock exchange, and you buy and sell them through a broker as you would an individual stock. In all cases, it pays to be sensitive to fund fees, which subtract from your returns.

Mutual funds are particularly amenable to a technique known as dollar-cost averaging. With this

Consider delegating stock picking to funds

STATE SECURITIES REGULATORS

State securities regulators have protected investors from fraud for more than 100 years. Securities markets are global, but securities are sold locally by professionals who are licensed in every state where they conduct business. State securities regulators work within your state government to protect investors and help maintain the integrity of the securities industry.

Your state securities regulator can:

- Verify that a broker-dealer or investment adviser is properly licensed;
- Provide information about prior run-ins with regulators that led to disciplinary or enforcement actions; serious complaints that may have been lodged against them; their educational background and previous work history;
- Provide a website, telephone number or address where you can file a complaint; and
- Provide noncommercial investor education and protection materials.

For contact information for your state securities regulator, visit the North American Securities Administrators Association (NASAA) website at www.nasaa.org and click on "Contact Your Regulator."

strategy, you invest a fixed amount of money on a regular basis. For example, if you have $10,000 you want to invest in a stock fund, instead of plunking it down all at once, you might choose to invest $2,500 now and $2,500 three, six and nine months from the time of the first purchase. Of course, anyone who invests every payday through a 401(k) or similar plan is effectively dollar-cost averaging.

Dollar-cost averaging offers important psychological benefits. It prevents you from investing all of your money near what could be a stock-market top, seeing the value of your investment drop, then having to sell at a loss with a vow that you'll never invest in stocks again. And if you adhere to the program religiously, it forces you to keep buying stock funds as prices go down—something many people would not do if left to their own devices.

Wrap up. Stocks merit a substantial place in your portfolio. Because stocks are volatile assets, they belong only in portfolios invested for medium- or long-term goals. Be sure you have a diversified blend of stocks that includes a helping of foreign shares. Do your homework to ensure that you aren't overpaying for the stocks. If you don't have the time, ability or inclination to buy and sell individual stocks yourself, consider delegating this important responsibility to some well-chosen stock mutual funds. ■

GLOSSARY

Bear market. A period when a market declines.

Book value. Also known as shareholder equity, this is the difference between a company's assets and its liabilities.

Bull market. A period when a market increases.

Bond. An interest-bearing security that obligates the issuer to pay a specified amount of interest for a specified time (usually several years) and then repay the bondholder the face amount of the bond.

Capital gain (or loss). The difference between the price at which you buy an investment and the price at which you sell it.

Central Registration Depository (CRD). A computerized database that contains information about most brokers, their representatives and the firms they work for.

Compound interest. This is really interest paid on interest. When interest is earned on an investment and added to the original amount of the investment, future interest payments are calculated on the new, higher balance.

Diversification. The method of balancing risk by investing in a variety of securities.

Dividends. The portion of a company's earnings paid out to stockholders.

Dollar-cost averaging. A program of investing a set amount on a regular schedule regardless of the price of the shares at the time.

DRIP. Short for dividend reinvestment plan, it's a program under which a company automatically reinvests a shareholder's cash dividends in additional shares of stock.

Earnings. A company's after-tax profits. Commonly expressed as earnings per share, or total earnings divided by shares outstanding.

Exchange-traded funds (ETFs). Mutual funds that trade like stocks on the exchanges. Their portfolios generally track an index that represents a particular market or a slice of a market.

Mutual fund. A professionally managed portfolio of stocks, bonds or other investments divided up into shares.

North American Securities Administrators Association (NASAA). Membership organization for state securities regulators, who work to protect investors' interests (www.nasaa.org).

Portfolio. The collection of all of your investments.

Prospectus. The document that describes a securities offering or the operations of a mutual fund, a limited partnership or other investment.

Risk tolerance. Risk tolerance is the degree to which you are willing to risk losing some (or all) of your original investment in exchange for a chance to earn a higher rate of return. In general, the greater the potential gain from an investment, the greater the risk that you might lose money.

State securities regulators. Agencies that work within state governments to protect investors and help maintain the integrity of the securities industry.

Stock. A share of stock represents ownership in the company that issues it. The price of the stock goes up and down, depending on how the company performs and how investors think the company will perform in the future.

Street name. The term used to describe securities that are held in the name of your brokerage firm but that still belong to you.

Total return. An investment-performance measure that combines two components: any change in the price of the shares and any dividends or other distributions paid to shareholders over the period being measured. With mutual funds, total-return figures assume that dividends and capital-gains distributions are reinvested in the fund.

Volatility. The degree to which a security varies in price. In general, the more volatile a mutual fund or stock, the more risk is involved.

WHERE TO FIND MORE FREE INFORMATION ABOUT INVESTING

The following booklets from the Editors of *Kiplinger's Personal Finance* magazine and the Investor Protection Trust are available at your library and offices of state securities regulators.

Five Keys to Investing Success
Make investing a habit
Set exciting goals
Don't take unnecessary risks
Keep time on your side
Diversify

The Basics for Investing in Stocks
Different flavors of stocks
The importance of diversification
How to pick and purchase stocks
Key measures of value and finding growth
When to sell
What's your return?
Consider mutual funds

A Primer for Investing in Bonds
How do bonds work, anyway?
How much does a bond really pay?
How to reduce the risks in bonds
Going the mutual fund route

Mutual Funds and ETFs: Maybe All You'll Ever Need
Mutual funds: The best investment
The different types of funds
How to choose funds and assemble a portfolio
Sources of mutual fund information
Where to buy funds

Getting Help With Your Investments
Do you need a financial adviser?
Who's who among financial advisers
How to choose an adviser
5 questions to ask before you hire an adviser
How to open an account
What can go wrong
How to complain

Maximize Your Retirement Investments
Three key rules
Creating the right investment mix
Guidelines for saving at every life stage
Investing on target
Best places to save
Getting the money out
Creating an income stream
Protect your money: Check out a broker or adviser

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Other tax-favored ways to save
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