THE NEW PARENTS’ GUIDE TO FINANCIAL INDEPENDENCE
A SIMPLE, PROVEN FORMULA FOR INVESTING, SAVING FOR RETIREMENT, AND CREATING YOUR FINANCIAL FREEDOM

Advance Review Copy

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What This Guide Is All About

My mission is to empower you to use your money in a way that gives you the freedom to live a life you enjoy.

Isn’t that the ultimate goal of all your financial decisions? It’s never really about money. It’s about your life and how you want to live it. Money is simply one tool, of many, that can help make the life you want possible.

This guide will help you use your money as effectively as possible.

By following the advice in this guide, you could walk away with the following:

- A clear picture of the specific goals you’re working towards.
- A clear idea of how much you need to save to attain those goals.
- An investment plan you understand and that helps you reach your goals as soon as possible.

It doesn’t matter where you’re starting from or how much you know about investing. I’m going to make it as easy as possible to put you and your family on the right track.

Let’s get started!

[Signature]
“Everything around you that you call life was made up by people that were no smarter than you.”

– Steve Jobs
Introducing Financial Independence

What are you investing for?

Why are you working so hard to save money and put it into special accounts like 401(k)s and IRAs? Why should you divide that money between stocks, bonds and other “investments” you’ve never actually touched or even seen with your own eyes?

What are you really trying to do here? What’s your end game? Heck, why did you buy this guide?

The party line in our society is that you’re saving for retirement. You know, that thing you get to do in your 60s, after you’ve kept a stable job for 40+ years, and you finally have enough money to abruptly quit and enjoy your golden years.

But that’s an old school way of thinking!

The game is changing. There’s a whole new set of possibilities opening up for people who are willing to think a little bit differently.

Introducing "Financial Independence"

The big problem with the idea of “retirement” is the assumption that everybody lives their lives along the same linear path and that everyone must wait 30 or 40 years before having the freedom to make their own choices about how to live.

I don’t know about you, but I don’t want to wait. I want to start living my life on my own terms now.

When it comes to my personal financial plan, I don’t have a “retirement” goal. And when I work with clients, I try to take the focus off retirement as well.

Instead, I like to talk about financial independence.

Here’s what financial independence means to me:

“The freedom to make decisions based on what makes you happy instead of what makes you money.”

Let’s dive into some of the implications of this definition.

The Beauty of Financial Independence

From a purely financial standpoint, the idea of financial independence is not all that dissimilar from the idea of retirement. They both require you to have enough saved up so that you no longer have to work for money.
But from a psychological standpoint, there are some key differences that open up a world of possibility.

**There Are Degrees of Financial Independence**

Retirement is absolute. It’s an end point. You’re either still working or you’re not. Simple as that.

Financial independence has degrees, and those degrees give you the freedom to make some exciting life choices a whole lot sooner.

The end goal of financial independence is to eventually have enough money that you never *need* to work again. Not that you will definitely stop working (see below), but you have the option to stop if you so choose.

But financial independence can also simply mean having enough money to temporarily give up income in pursuit of something you care about.

Speaking from personal experience, it was that second type of financial independence that allowed me to start this business. The savings we had in place allowed me to take time to grow my business into something profitable and sustaining while still handling my family’s needs.

We were *independent enough* to allow me to build my business from scratch.

Those degrees of financial independence can open up a world of opportunities to you over the course of your lifetime.

**Find Your Life’s Work**

While financial independence frees you from a dependence on income, it doesn’t assume that you stop working. After all, work done in support of a mission you believe in is one of the most fulfilling ways you can spend your time.

While I’m not going to sit here and tell you that running my business is all rainbows and sunshine, I can very honestly say that I would still be doing it even if I won the lottery tomorrow and no longer needed the income. I love what I’m doing and have no desire to stop.

Financial independence supports your quest to find fulfilling work you believe in, rather than forcing you to wait for the day you get to quit a job you hate.

**You Get to Make the Rules**

When you stop working towards retirement and start working towards financial independence, all of a sudden the entire world opens up to you.

It’s no longer about reaching the same end point that everyone else reaches 30-40 years down the road; it is suddenly about dreaming up whatever kind of life you want and starting to work towards it.
I would encourage you to Google “financial independence retire early” and just start clicking. You’ll find all kinds of stories about people who have reached financial independence at all different ages and are doing all kinds of interesting things with their lives.

There’s Jim Collins, who has continually used his “F-you money” to chase varied interests, ensuring that his days are always spent doing something he enjoys.

There’s Brandon Sutherland, who figured out how to take advantage of pretty much every loophole in our tax code to quit his job and travel the world with his wife.

And then there’s the infamous Mr. Money Mustache, who reached financial independence at 30 and now spends his days writing, building houses, and teaching advanced math at his son’s school.

The point is this: you have OPTIONS. There are no rules. You get to decide what you want out of life.

The rest is simply a matter of using the financial opportunities available to you to make that life a reality.

In the next chapter, I’ll walk you, step-by-step, through a process that will help you define exactly what financial independence looks like to you.
"So many of us choose our path out of fear disguised as practicality... You can fail at what you don’t want, so you might as well take a chance on doing what you love.”

- Jim Carrey
What Does Financial Independence Look Like to You?

Financial independence allows you to think about what you want out of life now instead of having to wait 30-40 years; that’s why I love this idea so much! It allows you to prioritize the things that are important to you instead of following a predetermined path.

BUT there’s a big question here that still needs to be asked:

What do you want out of life?

This little question can be incredibly difficult to answer. It’s actually not a question we’re asked all that often and, without a little guidance, it can be tough to specify a goal that enables us to work towards something concrete.

Here is an 8-step process that takes this big vague question and turns it into specific steps you can follow one at a time to get your answer.

Step 1: Visualize a Happy Life

Take 15-30 minutes to sit by yourself, uninterrupted, and imagine that in the near future you’re living a happy life. Not 40 years down the road when you’re old and gray, but a few years from now, maybe just five years down the line.

- **Where are you?** In the city or in the country? In a house or an apartment? What does the surrounding neighborhood look like?
- **What does your family-life look like?** Are you married? Dating? Do you have children? Have you adopted? What do you do together for fun? What does a regular day in your house look like?
- **Who are your friends?** How often do you see them? What kinds of activities do you do together?
- **What are you doing for work?** What kinds of projects are you involved in? How is your work helping to make the world a better place? How much time do you spend working?
- **What are your hobbies?** How do you relax? What keeps you energized and excited? Could any of these side projects turn into a business venture?

Let your mind wander as you ask yourself these questions. Don’t set limits or label anything as “unrealistic”. Think only of what a happy life looks like to you.

Step 2: Visualize and Write Down

A couple of days later, after you’ve let those thoughts settle in and have gone back to your regular routine, repeat the exact same process again. This time, write things down as you think of them. Anything that’s part of the picture you form in your head should be put down on paper.

This is the list that will eventually turn into goals.
Step 3: Prioritize

Now it’s time to put this list into some kind of priority order. You need some way of determining which goals are most important and worth working towards first.

So number each item or group them as high, medium, and low priorities; whatever works best to help you get some sense of which parts of your vision are most important to you.

Step 4: Communicate with Your Spouse/Partner

Ideally, your spouse or partner has gone through the first three steps as well and now the two of you can come together and talk about it. If you’re a single parent with a budding or working teenager, you should consider bringing them in on this discussion.

This is a really fun process. After all, you’re talking about the life you want to build together and all the possibilities involved, and that’s exciting! If at any point this conversation starts to feel like a chore, drop it and come back another day whenever everyone is in the mood.

But it can also be a tough process. No matter how much you love each other, you’re still different people and it’s only natural for you to have at least slightly different ideas for what you want out of life. And those differences can cause some conflict.

So here’s how I would approach this, at least on your first go-around:

1. Focus first on anything you have in common. These will be great goals to prioritize first.
2. For any goal that your spouse or partner has and you don’t, just try to hear why it’s important to them and leave it at that. Listening and understanding is the first step.
3. You will be re-visiting this process again in the future, so if there are goals or plans you really disagree on I would simply leave it for now. Focus on the priorities you both think are important as a way to get started.

Step 5: Acknowledge What Isn’t on Your List

This is one of my favorite steps.

It’s obvious that it is important to set priorities, but it is just as helpful to determine the things that ARE NOT important to you. By acknowledging that something isn’t important, you can intentionally take time, money and energy away from it so that you have more of those resources to focus on things you DO care about.

For a personal example, about a year ago I finally admitted to myself that I no longer cared about sports as much as I used to (may sound silly, but this was a hard thing to admit). That meant that I no longer felt like I needed ESPN, which meant that I could cut cable without really missing anything I truly valued.

That freed up some money each month that we now put towards travel, making it easier to visit my family that lives 1,500 miles away. I never would have been able to do it if I hadn’t intentionally acknowledged that watching ESPN was no longer part of my life vision.
Shifting expenses away from things you DIDN’T envision as part of your ideal life will give you more money to put towards the things you DID envision.

**Step 6: Turn Priorities into SMART Goals**

SMART goals are goals with a clear path that makes it both easier and more likely to reach them. And SMART is really just an acronym that says that any good goal has the following characteristics:

- **Specific**
- **Measureable**
- **Actionable**
- **Realistic**
- **Timely**

Basically, it’s a way of taking a vague goal and turning it into a clear one so you can take real action to accomplish it.

For example, a vague goal might sound something like this: “I want to buy a house in a few years”.

That goal is just isn’t specific enough. There’s no way to know exactly how to get started and there’s no way to clearly measure your progress along the way.

But you could turn it into a SMART goal by re-wording it to something like this: “I want to have $30,000 in a savings account for a down-payment on a house in 5 years”.

Now you have a specific dollar amount as your target, a specific timeline, a specific purpose, and a specific place you’re going to save the money. You can work backwards from there to figure out exactly how much you need to be saving AND you can figure out exactly what kind of progress you’re making along the way.

So, take some of your biggest priorities and do your best to turn them into SMART goals. That will help you start to...

**Step 7: Take Action**

You can do all the planning in the world, but until you start taking action none of it will mean anything.

And the truth is that this is usually the scariest step. Taking action opens the possibility of making all kinds of embarrassing mistakes, and the fear of making those mistakes keeps people from taking action.
So let me spoil the surprise: you WILL make mistakes. We all do. I’ve made plenty of them and have learned from every one: sometimes not the first time either. That’s right, I have made the same mistake more than once. And believe me, the lesson will eventually stick.

So the best you can do is acknowledge that mistakes will happen, take action anyways, and when you do make a mistake simply do your best to learn from it and keep moving forward.

And here’s the good news for you: you’re not alone here. The rest of this guide is dedicated to helping you take these actions and make fewer mistakes.

**Step 8: Regularly Re-Evaluate**

This is not a one-time process. Your life will change. Your goals will change. And it’s important to acknowledge those changes so that you’re always working towards your current vision of your ideal life.

Once every year or every 6 months, re-visit this process and update your vision.

**So, What Does Financial Independence Look Like to You?**

You might be wondering what any of this has to do with investing. The truth is that the vision you come up with above is the key to your financial success.

A clear idea for what you want out of life will allow you to use your money purposefully in order to get it.

Once that vision is clear, all it takes is a solid plan.

So let’s talk about how to make that plan!
"In the long run, it’s not just how much money you make that will determine your future prosperity. It’s how much of that money you put to work by saving it and investing it."

– Peter Lynch
No matter when you plan on reaching it, financial independence is a long-term goal. Because even if you plan on being fully financially independent in a couple of years, you will still have to manage your money in a way that allows it to last for the rest of your life.

Long-term financial goals require investing, because investing is the most efficient way to grow your money over many years.

So that’s what the rest of this guide will primarily be devoted to: showing you how to create an investment plan that you understand and that helps you reach financial independence along the timeline you want.

And the truth is that while there are a million things you could worry about as you start investing, there’s only one thing that really matters. And the good news is that it’s the one thing you’re in complete control over:

*Your Savings Rate*

**The Power of Saving**

It’s hard to really appreciate just how powerful it is to save more money without a visual. So let’s make one!

We’re going to compare two people, Frank and Sarah. Both of them make $75,000 per year and are ready to start saving for financial independence, but they go about it in different ways.

Frank frees up enough room in his budget to save 5% of his income. He also spends a lot of time reading up on the finer points of investing, creates a smart investment strategy, and is lucky enough to live through one of the good periods for the stock market. All of that gets him a 10% annual return from his investments. (Note: This is VERY high. A 7-8% return from the stock market is likely a more reasonable expectation.)

Sarah takes NO time to learn anything about investing. In fact, she just puts all of her money into a savings account at the local big bank which earns her a big fat 0% return. Maybe not the best move in the world, BUT she also finds enough room in her budget to save 10% of her income.

So we have Frank, saving 5% of his income and earning 10% returns.

And we have Sarah, saving 10% of her income and earning 0% returns.

Who does better? Here’s the chart (next page):
### Savings Rate vs. Rate of Return

<table>
<thead>
<tr>
<th>Year</th>
<th>Frank</th>
<th>Sarah</th>
<th>Annual Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$3,750</td>
<td>$7,500</td>
<td>Frank &amp; Sarah $75,000</td>
</tr>
<tr>
<td>1</td>
<td>$7,875</td>
<td>$15,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>$12,413</td>
<td>$22,500</td>
<td>Frank</td>
</tr>
<tr>
<td>3</td>
<td>$17,404</td>
<td>$30,000</td>
<td>Savings Rate 5%</td>
</tr>
<tr>
<td>4</td>
<td>$22,894</td>
<td>$37,500</td>
<td>Rate of Return 10%</td>
</tr>
<tr>
<td>5</td>
<td>$28,934</td>
<td>$45,000</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>$35,577</td>
<td>$52,500</td>
<td>Sarah</td>
</tr>
<tr>
<td>7</td>
<td>$42,885</td>
<td>$60,000</td>
<td>Savings Rate 10%</td>
</tr>
<tr>
<td>8</td>
<td>$50,923</td>
<td>$67,500</td>
<td>Rate of Return 0%</td>
</tr>
<tr>
<td>9</td>
<td>$59,765</td>
<td>$75,000</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>$69,492</td>
<td>$82,500</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>$80,191</td>
<td>$90,000</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>$91,960</td>
<td>$97,500</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>$104,906</td>
<td>$105,000</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>$119,147</td>
<td>$112,500</td>
<td></td>
</tr>
</tbody>
</table>

Remember, Frank is earning 10% returns every single year. Sarah is earning nothing.

And it still takes **14 YEARS!!!!** before Frank’s incredible returns are able to overcome Sarah’s savings rate. Sarah ends each of the first 13 years with more money.

**THAT** is the power of saving.

### How Quickly Can You Reach Financial Independence?

One more chart for you.

This one assumes that you’re starting with $0 in your savings account and shows the number of years it takes to reach financial independence at different savings rates. It doesn’t matter what your income level is, the math works out.

Let’s take a look (chart on next page):
As you can see, even just a 5% increase in your savings rate can knock more than a decade off your working years.

It's pretty simple really:

The higher your savings rate, the quicker your path to financial independence.

The Moral of the Story

Eventually, the returns you earn start to matter a lot more. When I extended the Frank vs. Sarah chart from above, Frank’s balance starts growing significantly faster than Sarah’s after 14 years because he’s earning a much higher return.

Once you have a lot of money in your account, you need to pay much closer attention to your investment strategy in order to minimize mistakes and ensure that it’s aligned with your financial goals. And we’ll spend plenty of time in this guide talking about how to do just that.

But at the beginning, the returns you earn barely matter all. What matters is that you start saving enough now so that your account balance is eventually big enough for those returns to have an impact.
In other words:

You don’t have to put a lot of pressure on yourself to make the right investment decisions right from the beginning.

BUT you do need to do two things if you want to reach financial independence:

1. Start saving now with whatever amount you can handle, and
2. Put your energy, first and foremost, on increasing your savings rate to wherever it needs to be, not on creating the perfect investment plan.
”The best time to plant a tree was 20 years ago. The second best time is now.”

- Chinese Proverb
How Much Should You Be Saving?

Okay, so saving is important. Good to know. Now comes the million-dollar question:

How much should you be saving?

It’s a good question, and an important one. And by the end of this section you’re going to have your personal answer to it.

Now, I don’t want to mislead you into thinking that there are any guarantees here. There are simply too many variables in play to give you a definitive answer that will absolutely allow you to reach financial independence at a specific point in time.

But I CAN give you a monthly savings target that puts you on the right track. You will still have to re-evaluate your savings plan from time to time (and you can use this exact same process to do that), but this will give you as good a start as you can get.

So that’s exactly what we’re going to be figuring out in this section: the monthly amount you should be saving in order to get yourself on track to financial independence.

This section makes use of the Financial Independence Savings Calculator spreadsheet that you received along with this guide, so you’ll want to have that open as you work through this section.

If you need to grab another copy of that calculator, you can do so here: http://momanddadmoney.com/fi-calculator.

Here are a few quick notes on using the calculator:

- I will be using “FI” as a shortened version of “financial independence” throughout this section. Just wanted to give you a heads up to avoid any confusion!
- You will be doing all of your work in the FI Projection worksheet.
- The FI Assumptions & Notes worksheet explains some of the assumptions that go into the calculator. You are welcome to review these and even change them if you would like, though I would only change them if you are confident in what you are doing.
- The Example FI Projection worksheet gives you an example of what it will look like once you’ve filled it out completely, using made up numbers for a made up couple.

Step 1: Enter Your Current Age

Open up the Financial Independence Savings Calculator and enter either your current age or your spouse’s age if you are married and he or she is older. For example, if you are 32 and your spouse is 34, you would enter 34.
Step 2: Enter Your Current Financial Independence Savings

In the **Current FI Savings** section of the spreadsheet, there are spaces to enter your current balance in any dedicated retirement/financial independence accounts, as well as those for your spouse.

Once you enter your current balance for each account, the **Current FI Savings** field in the **Variables** section will automatically add them up to get your total current balance.

Step 3: Estimate the Age at Which You Would Like to Reach Financial Independence

You may not have a specific target age yet, but one of the fun parts of this calculator is that you can enter different ages here to see what your savings target would be in each scenario. And honestly, I would encourage you to do just that.

Play around with this field and note the savings target needed to reach financial independence at different ages. That can help put some definite numbers around this question that may help you set your eventual goal.

Step 4: Estimate Your Monthly Expenses at Financial Independence

Along with your estimated FI age, your **Estimated Monthly Expenses at FI** is the big unknown that will have a big impact on the savings needed to reach financial independence. Simply put, the lower your required expenses, the easier it will be to reach financial independence.

And this is another variable that’s hard to know ahead of time. So what I would do is start with your current monthly expenses, since that represents your current lifestyle. If your lifestyle remains consistent between now and when you reach financial independence, this estimate will be reasonably accurate.

If you don’t know how much you’re typically spending per month, I would simply make your best guess for now. But for a more accurate view, I would suggest using a tool like Mint.com to track your spending for a few months. That information will be helpful for this projection and your general financial health.

You can get a little more detailed by making some adjustments to your current spending based on things you expect to add or remove once you’ve reached financial independence. Here’s a quick list of things to consider if you want to do this:

**Include in Your Estimated Monthly Expenses**

- Any savings that’s really going towards expected irregular expenses like home repairs, car maintenance, etc.
- Health insurance premiums
- 1/12 of annual payments for things like car insurance
- Any spending you might like to add once you’re financially independent, like travel
Consider Removing

- Financial independence savings (you will already be there!)
- A mortgage payment, if you plan on having it paid off
- College savings (unless you plan on reaching financial independence before your kids are done with school)
- Life and disability insurance premiums (you may no longer need this coverage once you’re financially independent)

Step 5: Estimate the Social Security Income You Will Receive

There’s a lot of doom and gloom out there about Social Security, but the truth is that it’s in much better shape than many people think. In fact, according to the 2013 Trustees Report on Social Security, it should still be able to pay out about 70% of the current estimated benefits for the rest of the century even if no changes to the program are made.

So it makes sense to factor it into your plans. What I like to do is get the full estimation of benefits and then only count 50% of it in the calculation, just to be conservative. That’s exactly what we’ll do here.

There are two different ways to get your estimated Social Security income. Both are described below.

Just a heads up, the first three steps are the same no matter which method you are using.

If you have a spouse, you can both go through this exercise and add the two numbers together.

Method #1: For People Who Expect Their Income to Stay Relatively Steady and Have Enough Work Credits

I recommend you try this one first, just to get your statement and see where you stand.

Here’s how to get your Social Security benefit statement:

2. If you’ve done this before and have an account, you can click the “Sign In” button.
3. Otherwise, you can click the “Create an Account” button and go through the process of setting up your account.
4. Once you have an account, you can sign in and click the “Estimated Benefits” tab. This leads you to a page that shows your estimated benefits for a number of different Social Security programs, including retirement.
5. Under “Retirement”, you will have three different estimated benefit amounts depending on when you plan to start claiming benefits. You can choose whichever one is most relevant for you and then:
   a. Enter the monthly benefit into the Estimated Social Security Income field of your Financial Independence Savings Calculator.
b. Enter the age associated with that monthly benefit into the Estimated Social Security Start Age field.

If you haven’t accumulated enough work credits yet for it to display estimated benefits, or if you expect your income to change in the future, you can use this next method instead.

**Method #2: For People Who EITHER Don't Have Enough Work Credits or Expect a Significant Change in Income**

Here’s the step-by-step (same first 3 steps as Method #1):

2. If you’ve done this before and have an account, you can click the “Sign In” button.
3. Otherwise, you can click the “Create an Account” button and go through the process of setting up your account.
4. Sign in, and this time click on the “Earnings Record” tab. Keep this open. You will use it in a minute.
5. In a new browser window, go here: [http://www.ssa.gov/planners/retire/AnypiaApplet.html](http://www.ssa.gov/planners/retire/AnypiaApplet.html).
6. Fill out the information requested. Here are a few important notes:
   a. Unless you genuinely plan to stop working much earlier, and therefore stop earning an income, enter your “Age at retirement” as 67. Because even if you reach financial independence earlier, you may still be working (on something you love) and earning money that counts towards your Social Security benefit.
   b. Leave the “Today’s dollars or future dollars” box marked as “today’s dollars”.
   c. For the “Annual earnings” boxes, you can refer back to the “Earnings Record” you opened up in Step 2 to fill in your income from previous years.
   d. For “Earnings in 2015 and later”, enter your estimated annual income going forward. This will only significantly change the result if it’s significantly different from what you’ve been earning to this point.
   e. After filling out that information, your estimated monthly retirement income is in the box labeled “Your monthly retirement benefit” in the “Benefit estimates” section.
      i. Enter that amount into the Estimated Social Security Income field of your Financial Independence Savings Calculator.
      ii. Take the “Age at retirement” you entered above and put that into the Estimated Social Security Start Age field.

Whichever method you used, 50% of that estimated benefit will now be factored into your monthly savings need.
Step 6: Get Your Savings Target!

Once you have entered everything above, the Savings Target field at the bottom of the calculator will show both your monthly and annual savings goal. This is your answer for how much you should be saving in order to reach financial independence along the timeline you want.

Play with the variables a little bit to see what the monthly savings target looks like in different situations. In particular, play with the Estimated Age at FI and Estimated Monthly Expenses at FI fields, since those are the two that you have the most control over.

Playing with the numbers can give you a sense of what’s possible, and seeing that range of opportunities will make it a little bit easier to start setting a concrete goal.

What If You Can’t Save That Much?

You may not be able to hit that savings target right away. That doesn’t mean that you won’t ever be able to reach financial independence. It just means that you will have to do a little work to get yourself on track.

Here’s what I would do in that case.

First, start by saving what you can right now. Even if it’s not the full amount, saving something will put you in a much better position than waiting until you can save more to get started.

Then, work on increasing your savings rate in small increments. Here are some ideas for how to do that:

- Set a calendar reminder to increase your savings by 1% every 6 months.
- Every time you get a raise, put 50% of the increase towards your monthly financial independence savings.
- Negotiate a lower cable bill, switch to a lower-cost cell phone plan, or otherwise lower your monthly bills one at a time and start putting the savings towards financial independence.
- Any time you have found money — like a birthday gift, a bonus at work or cash from something you sold on Craigslist — put some portion of it towards financial independence.

The best part about those first three points is — each time you make the effort — you see the benefit for as long as you continue saving. If you can make enough of those small improvements, you’ll be on track before you know it.

Step 7: Re-Evaluate Regularly

While your savings target is a great start that will absolutely put you on the right track, this is still very much an imprecise exercise with many assumptions that may not play out exactly as expected.
Revisit this process on a regular basis to see where you stand and whether you want to adjust your savings target. Setting a calendar reminder to re-evaluate your savings plan each December is a good idea, so that you have time to make any necessary adjustments to your contributions for the new year.
"The safe way to double your money is to fold it over once and put it in your pocket."

- Kin Hubbard
Where Should You Be Saving?

Now that you have your monthly savings target, the next big question is: “Where should you be putting it? Specifically, what types of accounts will make it easiest for you to reach financial independence as soon as possible?

You have a number of options and in this section we’ll walk through the pros and cons of each one.

First Rule: Take Advantage of Tax Advantages

The government has created certain types of savings accounts with built-in tax advantages, and there are a few big reasons why you should generally take advantage of these accounts before looking elsewhere:

1. Some of them offer a tax deduction for contributing, which means that you will actually get money back at tax time just for saving.
2. Those that don’t offer a deduction DO allow you to eventually withdraw the money tax-free. So it’s either tax-free on the way in or tax-free on the way out.
3. They all allow your money to grow tax-free while it’s inside the account, which means it will grow faster than if it were subject to taxes every year.
4. Contributing to these accounts may qualify you for the saver’s credit, which can save single parents up to $1,000 and married couples up to $2,000 at tax time.

Basically, these accounts make it easier for you to reach financial independence sooner.

For the most part, what we’ll be talking about here are these different types of tax-advantaged accounts and how you can use them.

Option 1: 401(k) or 403(b) with an Employer Match

If your employer offers a 401(k) or 403(b) with a matching contribution, then that is the place to start no matter what.

An employer match works like this: for every contribution you make up to a certain amount, your employer will match that contribution. In other words, your employer will put extra money into your 401(k) or 403(b) on top of what you contribute yourself.

Here’s a typical example of what an employer match might look like:

1. Your employer matches 100% of your contribution, up to 3% of your salary. If you save 3% of your salary, your employer will put in another 3%. You’ve just doubled your money simply by contributing.
2. Your employer matches 50% of your contribution above that, up to 5% of your salary. Essentially, you can contribute another 2% of your salary and your employer will match half of that extra contribution.
3. You are allowed to contribute more than 5% of your salary, but any amounts above that would not be matched.

In other words, in this scenario every dollar you contribute up to 5% of your salary earns an **IMMEDIATE** and **GUARANTEED** 50%-100% return on investment.

That’s a far better deal than you will find anywhere else.

Now, all matching programs will look different, and some employers won’t offer any match. You can request your plan’s **Summary Plan Description** to find the details about your specific program.

But the moral of the story is this: If your employer offers a match, you’ll want to contribute enough to get that full match before you even think about using another type of account. It’s simply the best deal around.

**Quick note:** In some cases the employer match will be subject to something called **vesting**, in which case you would only receive the entire match if you stay with the company for a certain number of years. For example, your employer’s policy might be to increase your **vested amount** (the amount that’s fully yours) by 20% for each year of employment. In that case you would have to be with the company for 5 years before the entire employer match you have received will be yours.

**Option 2: 401(k), 403(b) or 457(b)**

If your employer doesn’t offer a match, or if you’re already contributing enough to get the full match and still want to save more, there are a few more variables to consider when it comes to your employer plan.

The 401(k), 403(b) and 457(b) are all different types of retirement plans your employer might offer, but they share a lot of similarities so I’m grouping them together. (**Note:** I didn’t mention the 457(b) in the previous section because they typically do not offer an employer match.)

One big advantage of these plans is that it should be relatively easy to get started. You can simply ask the **Human Resources** department about setting up your contribution and it will be taken right out of your paycheck. That’s about as low-hassle as it gets.

Some plans (the better ones) may also have access to lower-cost investment options than you can get on your own. If so, that might be a good reason to prioritize these accounts before others.

Finally, the annual contribution limit here is higher than in any account you can open on your own, so they allow you to save more money. For 2015, the annual contribution limit for these accounts is $18,000.

The big potential downside to look out for here is the cost involved. Some of these plans have lots of fees, and those fees will affect your bottom line. Fees might include the cost of paying an investment manager, the cost of the investment options themselves, and administrative costs — like record-keeping and accounting.
Minimizing the cost of your investments is one of the best ways to maximize return, which is something we’ll be talking about in more detail below. If your employer plan has a lot of fees, you may want to look elsewhere once you’ve secured your employer match.

Summary of Pros

- Easy to get started. Contributions are taken directly out of your paycheck.
- In general, your contributions are tax-deductible in the current year, meaning you will get an immediate tax break. Your eventual withdrawals will then be taxed.
- These accounts may also offer a Roth option, which would not give you a current deduction but *would* allow you to eventually withdraw the money tax-free.
- High annual contribution limit ($18,000 for 2015). If you are 50 or older, you can contribute an additional $6,000 per year.
- May offer high-quality, low-cost investment options you can’t find on your own.
- When you leave your job, you can take this money with you by either rolling it over into your new employer plan or into an IRA (we’ll talk about IRAs just below).

Summary of Cons

- Some plans have high fees, which will drag down your returns.
- Your investment options are limited to what your employer chooses to include in the plan. In some cases these options may not be great.
- Technically, your money is supposed to stay in the account until age 59.5, but there are some ways around that rule.

Moral of the Story

- Take full advantage of the employer match first, no matter what the plan looks like.
- If your plan offers low-cost investment options that fit your desired investment strategy, this is a good option for your additional savings above that match.
- If your plan has a lot of fees, or if the investment options don’t fit your desired strategy, you might want to contribute additional money elsewhere first.

Option 3: Traditional IRA and Roth IRA

If your employer doesn’t offer a retirement plan, or if you’re looking for a lower-cost option, an IRA is likely to be your best bet.

An IRA is a dedicated retirement account, just like a 401(k) or 403(b). But instead of getting it through your employer, *you* open it with an investment company of your choosing.

One of the big advantages of using an IRA is that you have a lot more control than you do with an employer plan. You get to decide which investment company you use, which investment options to choose, and which fees you’re willing to pay.
There are two types of IRAs: the **Traditional IRA** and the **Roth IRA**. There are several differences between them, but the main difference is in the tax benefit they offer:

- A Traditional IRA works a lot like a traditional 401(k). You get a tax deduction for your contribution, your money grows tax-free inside the account, and your eventual withdrawals will be taxed as regular income.
- A Roth IRA is exactly the opposite. There is no deduction for contributions, but your money grows tax-free inside the account and your contributions will eventually be tax-free.

Essentially, it’s a choice between a tax-deduction today or tax-free withdrawals later.

Both are fantastic options, and the truth is that there isn’t a simple answer as to which one will end up being best for your specific situation. But there are a few rules of thumb that may help you make your decision:

- The higher your current tax bracket, the more likely it is that a Traditional IRA will be most beneficial.
- If your decision is whether to contribute the same dollar amount to either a Roth or Traditional IRA, the Roth will win simply because that money will never be taxed. But keep in mind that you should be able to afford a bigger Traditional IRA contribution because that contribution will save you some tax money.
- Since it’s taxed differently, a Roth IRA can be a nice supplement to an employer 401(k).
- Generally, I tend to favor the Traditional IRA as long as you’re using the tax savings to make a bigger contribution. The exception to that is someone who is already paying very little in taxes.
- Since Traditional IRA contributions lower your taxable income, they can help you qualify for income-dependent tax breaks like the saver’s credit. It may be worth consulting with an accountant or financial planner to understand the specifics of your situation.
- If you’re really not sure which way to go, you could always open one of each and split your contribution 50/50. Best of both worlds.

And again, these are both great options and the truth is that it’s impossible to know for sure which one will end up being better. So, while it is worth putting some thought into the decision, it’s much more important to just pick one and get started.

**What Investment Company Should You Open Your IRA With?**

Choosing where to open your IRA can be a tough decision, and there are too many options to list them all here.

So I’ll simply say that while I can't possibly give you a personalized recommendation, and you should do your own research before making any decision here, my default answer would be to open your IRA with Vanguard. It’s the company I use for my personal investments, and the one I end up recommending to most of my clients.
Here are a few reasons why I like Vanguard:

- They basically invented **index investing**, which is at the core of my personal investment philosophy (we'll talk more about this later on).
- They are **investor-focused**. Since their founding, Vanguard's mission has been to provide high-quality investment options to people of all levels of wealth.
- They are dedicated to **keeping costs low** and have been from the beginning. Given that cost is one of the biggest factors determining your investment return, it's nice to know that they're on your side.

There are plenty of other companies that can meet your needs as well, so Vanguard isn't the only game in town. Schwab is a good one, and Fidelity can be good as well. You could even go with one of the automated investment platforms like Betterment or Wealthfront if you like their investment philosophy.

But for my money, Vanguard is the cream of the crop.

**Summary of IRA Pros and Cons**

**Summary of Pros**

- An IRA gives you more control than an employer plan.
- You have more investment options, meaning you can definitely implement your desired investment strategy.
- You can keep costs low.
- You have the option of using a Roth IRA, which may be beneficial depending on your situation.
- You have until April 15 of the next year to make your contributions for the current year. For example, you have until April 15, 2016 to make your 2015 contributions.

**Summary of Cons**

- As of 2015, your annual contribution is limited to $5,500. If you are 50 or older, you can contribute an additional $1,000 per year.

**Moral of the Story**

- An IRA is a great way to contribute additional money beyond your employer plan.
- It's also a great alternative if your employer plan is high-cost or doesn't offer investment options you like.
Both the Roth IRA and the Traditional IRA are fantastic options, and the right decision for you really depends on the specifics of your situation.

Option 4: Health Savings Account (HSA)

Many people don’t know about this option, but it can actually be the most powerful place to put your financial independence savings, *if* you know how to use it.

An **HSA** is a special type of account that is only available to people with a qualifying high-deductible health insurance plan. For 2015, that means a health insurance plan with a deductible of at least $2,600 for families or $1,300 for individuals.

The **HSA** is meant to help with the cost of medical expenses, and it provides a few tax breaks to do so:

- Contributions are tax-deductible, just like a 401(k) or Traditional IRA.
- The money grows tax-free while inside the account.
- The money can be withdrawn tax-free for eligible medical expenses.

That’s all pretty cool and can certainly make it easier to handle the cost of your medical bills.

But there are a few more characteristics that **ALSO** make it a pretty fantastic place to put your financial independence savings:

- The money is 100% yours and rolls over year-to-year, even if you haven’t used it. This is in contrast to a flex-plan you might have at work — which can also help pay for medical bills — where any unused money is forfeited at the end of the year.
- You can invest your HSA money just like you would inside of an IRA, if you choose the right provider.
- While there is typically a 10% penalty in addition to taxes on any withdrawals that aren’t used for medical expenses, that penalty goes away once you reach age 65.

What this means is that if you’re willing to pay your current medical expenses out-of-pocket, you can use an HSA just like a 401(k) or IRA and invest it for the long-term.

In fact, it can be even better than a 401(k) or IRA because it’s the ONLY account that offers a **triple tax break**:

- Deduction on the way in
- Tax-free growth inside the account, AND
- Tax-free withdrawals for medical expenses

Since we’re all going to have medical expenses when we get older, it’s a pretty safe bet that you will be able to withdraw this money tax-free at some point. And if not, the worst-case scenario is
simply waiting until age 65, when you can withdraw the money penalty-free for any reason (just like a 401(k) or Traditional IRA).

So if you have the option available to you, an HSA is a pretty useful place to put some of your financial independence savings.

**Where Should You Open Your HSA?**

One of the downsides of the HSA is that it can be a little confusing trying to figure out where to open one. It’s something you have to do on your own, even if you have health insurance through your employer, and many of the major banks and investment companies don’t offer them.

Luckily, I’ve already done some of the work for you.

When I do the research for clients, I keep coming back to [Health Savings Administrators](http://healthsavings.com/) as the best place to open an HSA if your goal is long-term investing.

While they do have a $45 annual fee (as of this writing), they offer a strong selection of high-quality, low-cost Vanguard mutual funds that is tough to find within another HSA.

If you’re not going to be contributing much, you’ll want to consider another option since that $45 annual fee will eat away at a small balance. But if you plan on making consistent contributions over a number of years, I generally think the fee is worth it.

Still, it’s a good idea to do your own research here and this search tool will help you find a health savings account that works for you: [http://www.hsasearch.com/](http://www.hsasearch.com/).

**Summary of HSA Pros and Cons**

**Summary of Pros**

- It’s the only account with a **triple tax-break** – Deduction on the way in, tax-free growth, and tax-free withdrawals when used for medical expenses.
- With the right provider, you can invest the money like you would inside an IRA.
- There are no age limits when it comes to tax-free withdrawals for medical expenses. You can do so at any time.
- If you keep good records, you can even use the money to pay for medical expenses from prior years. (The expense must never have been reimbursed or claimed as an itemized deduction previously.)
- Once you are 65, you can withdraw the money for any purpose without penalty. It will be taxed if it’s not used for medical expenses, but in that case it will have functioned just like a 401(k) or Traditional IRA.
Summary of Cons

- If you don’t have a qualifying high-deductible health plan, you are not eligible to open an HSA.
- It can be hard to find an HSA provider with decent investment options, and even if you do those options are limited.
- Some HSA accounts have fees that make them less attractive.
- As of 2015, annual contributions are limited to $6,650 for families and $3,350 for individuals. If you are 55 or older, you can contribute an additional $1,000 per year.
- Before age 65, there is a 10% penalty plus taxes on any withdrawals that are not used for medical expenses.

Moral of the Story

- If you’re eligible to open an HSA, it can be an incredibly powerful way to save for financial independence.

Option 5: Taxable Account

If you’ve exhausted all the tax-advantaged accounts above, the next best place to put your savings is a regular old taxable account. While it doesn’t offer any tax breaks, it does have a few advantages.

The first is that you can invest in pretty much whatever you want. It’s similar to an IRA in that way in that the whole world of options is open to you.

The second is that, again like an IRA, you have a lot of control over how much you pay. You can keep costs to a minimum, leaving more of your money for yourself.

Third, there are fewer restrictions on a regular taxable account than there are on tax-advantaged accounts. Although you don’t want to be dipping into your savings on a regular basis if it’s meant to be set aside for financial independence, the money inside a taxable account is technically available to you at any time for any purpose. (Note: This flexibility can make a taxable account a useful way to fund the early years of financial independence if you get there significantly earlier than typical retirement age.)

Finally, while you won’t get any tax breaks, you can still make efforts to minimize the taxes you pay inside the account. Some examples of that include:

- Using tax-efficient investments like index funds (we’ll talk more about these below).
- Using a buy-and-hold strategy to minimize the number of transactions that might be subject to taxes.
- Tax gain harvesting (see here: http://www.bogleheads.org/wiki/Tax_gain_harvesting).
You can open a taxable account with most of the same companies that offer IRAs, so once again Vanguard would be my default recommendation.

Summary of Pros

- Full control over your investment options.
- The ability to minimize costs.
- No restrictions on when you can access the money.

Summary of Cons

- No tax breaks.

Moral of the Story

- Once you’ve maximized your tax-advantaged accounts, a regular taxable account is a fantastic option.

Non-Option 6: Life Insurance

I’m going to keep this short and sweet.

Life insurance is often sold as a way to save for retirement. Insurance agents will wax poetic about the benefits of products like whole life insurance, universal life insurance, variable life insurance, equity-indexed life insurance, and whatever variations they come up with next.

The sales pitch will sound good. It is also, in almost every case, a bad idea to listen to it.

Instead of getting into all the details here, I’m simply going to tell you that 99% of the time you will want to avoid any kind of life insurance when it’s being sold as an investment opportunity. I’ve written about this in extensively on my blog, and you can find all the gory details here: [http://momanddadmoney.com/why-whole-life-insurance-is-a-bad-investment/](http://momanddadmoney.com/why-whole-life-insurance-is-a-bad-investment/).

Now, with that said, there are a few exceptions that I will mention quickly:

- If you already have a whole life insurance policy, you will want to do a little research before you decide to cancel it. A policy that has already been in place for several years is in some cases worth keeping.
- If you are a high income earner and you have already maxed out all of your tax-advantaged space, it is possible to use life insurance as a reasonable investment. But you would need to make sure you work with an agent or financial planner who can design a policy that minimizes agent commissions and maximizes the return you receive. The run-of-the-mill policies most agents sell are not specially designed this way.
- There are some other potential uses for permanent life insurance, such as leaving money for a child with special needs or helping with estate taxes for especially wealthy individuals (generally those with $10 million or more). But those uses are rare exceptions
and have nothing to do with investing, so we won’t be going into more depth on them here.

But again, in almost all cases, you will be better off putting your investment money somewhere else. Life insurance is just very, very rarely a reasonable investment option.

**Quick note:** I do want to quickly mention that I am a big proponent of life insurance as a tool for financial protection, just not as a tool for investing. But in that case you will typically want term life insurance, which will never be sold as an investment opportunity anyways.

### Summary: Order of Operations

Whew! That was a lot of information!

So to sum it all up, here’s an order of operations for how you might prioritize your financial independence savings, in terms of where to put your money first:

1. 401(k) or 403(b) up to the full employer match.
2. HSA, if you are eligible.
3. Employer’s plan if it has good investment options and low fees.
4. IRA, either Roth or Traditional.
5. Taxable account.

This certainly isn’t a golden rule, but it will point you in the right direction.
"It is not necessary to do extraordinary things to get extraordinary results."

- Warren Buffett
Okay, so here’s what we’ve covered so far:

- A definition of financial independence, a similar but much more flexible goal than traditional retirement.
- A process for setting your financial independence goals.
- Why your savings rate is the most important part of your investment plan.
- How much you should be saving.
- Which accounts you should be contributing to.

If you’ve handled those five things, you’ve already done the hard work that will get you most of the way to financial independence. But you can make it even easier on yourself by taking all that money you’re saving and investing it well, and the rest of this guide will be dedicated to helping you do just that.

The five truths that come next answer the question, “what matters when it comes to investing?” Understanding them will help you make better investment decisions.

**Truth #1: Your Returns Are Mostly out of Your Control**

When you invest, you’re doing it because you expect some kind of return, right? If that’s the goal then it’s important to understand where that return will come from so that you can create a strategy designed to actually capture some of it.

*This paper* by Roger Ibbotson has all the details, but the upshot is that your investment return will be determined by three main factors:

1. **75% of your return** comes from something you have no control over: the overall market return. That is, simply deciding to invest at all will expose you to most of the same big market swings that everyone else experiences. What this really means is that most of your return is not at all a reflection of you as an investor or your specific strategy, but simply a reflection of what’s going on in the world as a whole.

2. **15% of your return** comes from how much you decide to expose yourself to those market movements. Technically this is called your asset allocation, and we will talk about it in more detail below. But, essentially you have to decide how much of your money to put in high-risk, high-return investments, and that decision will affect the return you end up receiving.

3. **10% of your return** comes from the specific investment choices you make. That is, the specific mutual funds, ETFs, stocks, bonds, etc. that you decide to use.

This might initially make you feel a little powerless, but you can actually use this information to your advantage.
First of all, the market will have big swings up and down from time to time. It’s just a fact of life. And when it does, most of the people around you are going to freak out.

When the market is up, people will get greedy and put more of their money into high-risk, high-return investments like the stock market. And when the market is down, people will run for the hills, sell all their stocks, and hide their money under a mattress.

That is exactly the kind of reactionary behavior that gets most investors into a lot of trouble.

And you can know better. Whether your account balance is way up or way down, you can step back and remember that most of that has very little to do with how you have decided to invest. You can keep a level head knowing that you’re neither a genius nor a failure, and you can stick to your plan instead of panicking.

You can also take some of the pressure off yourself to get your investment strategy exactly right. While it does matter, and while there are some simple ways to do it well — and we’ll talk about them in a bit — in the end they are not the primary determinant of your return.

Truth #2: Risk and Return Are Forever Linked

A big part of investing is managing the level of risk you want to take on. But risk is kind of a strange word in the investment world.

When an investment is labeled as “risky”, that simply means that there is uncertainty about the return you’ll get from it.

As an example, stocks are deemed to be risky because you can never be sure what they will do. Some years they’re up big. Other years they’re down big. There’s a lot of uncertainty involved.

At the other end of the spectrum is a savings account. Yes, interest rates change over time. But basically you know exactly what will be in your account from day to day. That’s as certain as it gets.

And there are two big points to understand here when it comes to your personal investment strategy.

First, if you want to implement a strategy that reaches for higher returns, you have to accept a lower level of certainty about actually getting those returns.

If someone is telling you about a way to get higher returns without increased risk, then they’re selling you something that doesn’t exist (unless they’re talking about diversification, which I’ll get to below).

Second — and this is a point that’s often overlooked — certainty about returns brings its own set of risks. This is why I say that risk is a strange word when it’s used in the context of investing.

With a savings account you can be certain of your balance from day to day but you’re running the very high risk that the value of your money will be lost to inflation. Over short periods this
isn’t a big deal. But over long periods of time it matters a lot. This is the main reason why people suggest that long-term investors put their money into riskier investments, like the stock market; there’s actually risk on both ends of the spectrum.

Here are the two big takeaways on risk and return:

- If you want the possibility of higher returns, you have to accept more uncertainty about whether you’ll get them.
- Over the long-term, there actually IS risk involved with even “low risk” investments. Yes, it’s confusing but it’s true.

**Truth #3: Asset Allocation Matters, a Lot**

**Asset allocation** is a term you’ll hear a lot when you read up on investing and, although it sounds fancy and technical, it’s actually a pretty simple idea.

Your asset allocation is simply the way in which you divide your money between different types of investments.

You can think of investing a lot like you think of cars. While there are a TON of different choices out there, each with their own unique set of features and nuances, they can all be grouped into just a few major categories that tell you most of what you need to know.

With cars, we have categories like “sedan”, “minivan” and “SUV.” Not all cars within each category are exactly the same, but they’re pretty similar along the major characteristics like size, power and gas mileage.

With investments, our categories are things like “stocks”, “bonds” and “cash.” Just as with cars, not everything within each category is exactly the same. But they share similar characteristics like expected risk and return.

And how much money you decide to put into each major type of investment — your asset allocation — is the most important part of your investment strategy for two reasons:

1. Your asset allocation is the single biggest piece of your investment return that you actually have control over; that 15% of your return that’s based on how much money you expose to the overall market movements.
2. Your asset allocation is also the primary way that you can control risk. A higher allocation to stocks will introduce the possibility for higher returns but will also expose you to bigger ups and downs along the way.

Since it’s so important, let’s dive into some more detail on the two big pieces involved in your personal asset allocation decision.
What Are the Major Investment Categories and How Do They Work?

Before deciding where to invest your money, you need to know what your options are. And, while there are all kinds of different investments that you’ll hear about, there are really only three that you need to worry about:

1. **Cash (e.g. savings accounts)** – Lowest expected return but also the highest amount of certainty. You know exactly what you’re getting here. This is the perfect place for short-term goals like building an emergency fund or saving for a house, but it usually isn’t ideal for long-term goals just because the return is so small that your actual purchasing power will decrease due to inflation (the flip-side of risk we talked about above).

2. **Bonds** – Medium expected return with a medium amount of risk. You don’t know for sure what you’ll get here, but the ups and downs won’t be as large as with the stock market. Bonds are particularly good as the conservative part of your long-term investment strategy.

3. **Stocks** – Highest expected return with the highest amount of risk. The ups and downs from year to year, and even from day to day, can be very high. But over the long-term the returns have always been positive, which makes them an important part of any long-term investment plan.

You might hear people talk about other types of investments like “alternatives”, “gold”, and “real estate,” but my honest opinion is that you can typically ignore them. All you need to build a strong investment strategy are the three above.

How to Pick Your Asset Allocation

So your big decision here is how much money to put into high-risk/high-return investments like stocks and how much to put into lower-risk/lower-return investments like bonds. More than anything else, this decision will determine how much risk you’re taking on, and therefore how big a return you might hope to receive.

And since it’s so important, you might think that you need to put a ton of time and analysis into this decision in order to make it as optimal as possible.

And a lot of people do exactly that — but I don’t think it’s necessary.

The truth is that there’s no right answer here. Instead, there’s a large range of good enough answers and the right one for you largely comes down to a matter of personal need and personal preference.

But I do think there are four helpful guidelines to keep in mind as you make your decision:

1. Never take on more risk than you need. If you only need a 4% return, it doesn’t make a lot of sense to take on the extra risk of reaching for an 8% return. This is one reason the simple act of saving more money can be so powerful, since it reduces the return you need to get in order to reach your goal.

2. For your long-term money, having a significant portion in the stock market is usually a good idea. Over the long-term the stock market has always gone up and having some
money there will make it easier to reach financial independence sooner.

So what counts as significant? For people in their 30s and 40s I generally think that 50% of your long-term money in the stock market would be a good starting point, but there’s no definitive answer there.

3. The conventional wisdom is that young investors should have a high percentage of their money in the stock market (around 90%). But don’t let that conventional wisdom encourage you to take on more risk than you’re comfortable with. Your comfort level is what’s most important.

4. Generally, you should be comfortable losing half of whatever you have in the stock market in any given year without giving up on your plan. So if you decide to put 80% of your money into stocks, you might see a 40% drop in the total value of your investments in a given year (of course the expectation would be that it would recover). If that feels like too much for you, then decide on a more conservative asset allocation.

Again, there really isn’t a right answer here. I would simply encourage you to pick an asset allocation that feels right to you for now, put it in place, and stick with it through at least one big market crash. Once you have lived through both that crash AND the subsequent recovery (it always comes), you can re-evaluate how you feel about the level of risk you’ve taken on and re-adjust if you want to.

**Truth #4: Diversification Is Your Good Friend**

In Truth #2, we talked about a golden rule in investing that’s virtually impossible to break: if you want the possibility of better returns, you have to take on greater risk of not getting them.

This is really the whole point behind the asset allocation decision above. You can put more money into the stock market if you want, and that WILL increase the possibility of getting higher returns. But it also increases the risk that you won’t actually get those returns. So your asset allocation decision is an exercise in deciding how much risk you’re willing to take on in pursuit of higher returns.

But there’s ONE way to decrease your investment risk WITHOUT decreasing your expected return.

It’s called **diversification** and it can be summed up by this idiom: don’t put all your eggs in one basket.

**What Is Diversification?**

Diversification is the act of spreading your money out over a lot of different investments so that you never have too much money invested in any one thing.

As an example, instead of trying to pick a few winning stocks and taking on the risk that one wrong pick will leave you with a huge loss, you can diversify by choosing to invest in the entire stock market.

When you own a little bit of every company, no single company can bring you down.
Why Does Diversification Work?

Diversification works for one simple reason: even the professionals aren’t good at picking stocks. Seriously, the best research we have tells us that stock-picking (or bond-picking for that matter) is mostly a matter of blind luck, even among the most highly trained and skilled investors out there.

So if stock-picking doesn’t work, that means that there’s no real reason to expect any particular stock to outperform another. Of course some will actually outperform, but it’s incredibly difficult to know which ones will do so ahead of time.

And if you don’t know which stocks will outperform, that means that all stocks essentially have the same expected return. So whether you invest in a single stock or the entire stock market, your expected return is the same.

BUT the amount of risk you take on varies a lot.

In the most extreme case, investing in the stock of a single company means that your entire investment return is dependent on the fortunes of that one company. That’s a lot of eggs in one basket.

If you instead decide to put your money into an index fund that tracks the entire stock market, no single company has too much importance. You’ve reduced your overall risk by spreading it around and your expected return is still exactly the same.

How to Diversify Your Own Investments

So diversification is a great way to decrease your investment risk, and the good news is that there are a few easy ways to do it:

- **Index funds** – We’re going to go into a lot of depth about index funds in just a bit, but at their core index funds were invented as a way to make it easy and affordable for you to invest in an entire market (like the stock market or bond market) with a single fund. So if you want diversification, index funds are your good friend.

- **Diversifying stocks** – One way to diversify within stocks is to buy an index fund that tracks the entire US stock market. But you could also go a step further and find another one that tracks all the international stock markets. That way you own a small piece of every company in the world, so no matter which country/industry/etc. is doing well, you’ll be in on the action.

- **Diversifying bonds** – You could do the exact same thing with the bond part of your plan, finding one fund that invests in all US bonds and another that invests in all international bonds. That’s the way to get maximum diversification.

- **Single fund approach** – One myth of diversification is that you need to invest in a lot of different mutual funds. That’s not the case. In fact, it’s possible to get access to all US stocks, all international stocks, all US bonds AND all international bonds with a SINGLE fund. Vanguard’s Target Retirement Funds and their LifeStrategy Funds are good examples. There are plenty of others and I would encourage you to do your own research before selecting your funds.
The moral of the story is that diversification is both incredibly effective at reducing your investment risk and incredibly easy to take advantage of.

**Truth #5: You Get What You Don't Pay For**

John Bogle, Vanguard’s founder, is famous for saying that when it comes to investing, you get what you don’t pay for.

It’s a little counterintuitive, because with most things we’re used to having to pay a higher price for higher quality. But that just doesn’t hold up when it comes to investing.

In fact, research has found that **cost is the single best predictor of an investment’s future return**. The less an investment costs, the more likely it is to produce a positive return.

And this is actually great news! Because while there are about a million parts of the investment process that you have no power over — what the markets are doing, inflation, interest rates, etc. — cost is something that YOU can directly control. You can easily make choices that lower the cost of your investments and improve your returns in the process.

But if you want to keep your investment costs low, you need to know what to look for.

So here are some common investment costs and what to watch out for with each.

**Expense Ratio**

Every mutual fund has something called an expense ratio, which is a percentage of your money that’s taken out of your investment every single year to pay the costs of running the fund.

As an example, let’s say a mutual fund has an expense ratio of 1% and you have $10,000 invested in that fund. That means that 1% of your investment is taken out of your account every year, which with a $10,000 investment would come to a $100 fee.

Even a seemingly small difference in the expense ratio between funds can add up to a HUGE difference over time. Here’s an example showing just how much it matters:

<table>
<thead>
<tr>
<th></th>
<th>Expense Ratio</th>
<th>Annual Contribution</th>
<th>Annual Return</th>
<th>Balance After 30 Years</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund #1</td>
<td>0.20%</td>
<td>$10,000</td>
<td>8%</td>
<td>$1,177,283</td>
<td>$166,553</td>
</tr>
<tr>
<td>Fund #2</td>
<td>1.00%</td>
<td>$10,000</td>
<td>8%</td>
<td>$1,010,730</td>
<td></td>
</tr>
</tbody>
</table>

In both cases, the investor is contributing $10,000 per year and getting an 8% return over 30 years. But when the expense ratio is 0.2% vs. 1% (only a 0.8% difference!), the end result is $166,553 more for the lower-cost fund.

I don’t know about you, but that kind of money would make a difference in my life.
There are a lot of great mutual funds (mostly index funds) with expense ratios right around 0.20%, and often even less. If it were me, I’d have to have a REALLY good reason to pay much more than that.

12b-1 Fees

The 12b-1 fee is also expressed as a percentage of your total investment and is typically already included in the fund’s expense ratio.

But when you look at a mutual fund’s information you will see it displayed separately from the expense ratio because it’s not really a cost of running the fund. It’s a cost of promoting the fund, primarily paid to financial institutions who sell the fund. In other words, it’s essentially a commission.

While the existence of a 12b-1 fee shouldn’t automatically send you running, it’s a cost that should likely be avoided if possible. It doesn’t serve to help you — why should you care if the salesman gets a commission? — and it does take money out of your pocket year after year. And there are plenty of great funds that don’t include these fees.

Loads

A load is a commission paid to the person who sells you the mutual fund. The most common is called a sales load, or front-end load, which takes a piece out of every single purchase you make in order to pay the salesman.

As an example, a mutual fund might have a 5% sales load, in which case $50 out of every $1,000 you invest will be paid to a salesman instead of your account.

There are also back-end loads, sometimes called a contingent deferred sales load (who makes up these names?). This works the same way except that the charge is applied whenever you decide to sell your shares of the mutual fund.

There is plenty of evidence that you should NEVER purchase a mutual fund that includes any kind of load. They typically perform worse than similar mutual funds that don’t have a load, even BEFORE you factor in the extra cost. So in most cases that extra cost is essentially just money that the salesman is asking you to throw away.

Transaction Costs

Transaction costs are the least transparent of all. These are the various costs incurred by the mutual fund whenever it makes trades.

Note that this is different than when YOU make trades. The mutual fund itself will buy and sell stocks or bonds or whatever it invests in, and those transactions have a cost. Different studies have found these costs to be anywhere from 0.1-2% per year, which can be a huge drag on your returns.

There’s no real good way to understand a fund’s transaction costs, but the best way I know is to look at what’s called turnover. Turnover measures the percent of the mutual fund’s holdings
that change in a given year. A turnover rate of 100% means that the fund changes all of its holdings during a given year.

You can find this information using a site like Morningstar or Yahoo! Finance. A higher turnover means the fund is making more trades, which means it’s more likely to have higher transaction costs.

As a point of reference, a good index fund like Vanguard’s Total Stock Market Fund (VTSMX) will have a turnover rate in the low single digits. That kind of low turnover can do a lot to keep costs low.

**Taxes**

If you’re investing within a retirement account like a 401(k), IRA or 403(b), then you don’t have to worry about this part of the conversation. Those types of accounts have tax preferences that make these points moot.

But if you have any money in a regular old taxable account, taxes can be another hidden cost that can really hurt your returns. Here are some examples where taxes might come up:

- When a mutual fund makes a trade, there may be tax consequences.
- Interest earned from a mutual fund’s bonds will be taxable.
- Dividends earned from a mutual fund’s stocks are taxable.

All of these things will be treated differently based on the specific mutual fund and the specific investor but it’s worth paying attention to. After all, the more you pay in taxes, the less you’re able to use for yourself.

One simple but imprecise way to estimate the tax cost of a fund is to again look at turnover. In general, funds with a higher turnover will have a higher tax cost.

If you want to get more precise, Morningstar has a measurement called the “tax cost ratio” that can help you determine how tax-efficient a given fund is. You can search for a fund and then look at the fund’s “Tax” tab to see its tax cost ratio displayed as a percentage in the same way that the expense ratio is displayed. A higher number here indicates that you should expect to pay more in taxes.

**Investment Costs Are One Thing Worth Worrying About**

The bad news is that there are lots of potential costs out there to watch out for.

But the good news is that you have the ability to directly influence the amount you spend on your investments, and that decision has a direct impact on your end result. It’s something that both matters AND is in your control. That scenario is actually pretty rare in investing.
That's the Truth, the Whole Truth, and Nothing but the Truth

So here they are in summary, the five fundamental truths of investing:

1. Your returns are mostly out of your control
2. Risk and return are forever linked
3. Asset allocation matters, a lot
4. Diversification is your good friend
5. You get what you don’t pay for

Keep these truths in mind as you create your investment plan.
“Everything should be made as simple as possible, but no simpler.”

– Albert Einstein
The Investment Strategy That Works

Now it’s time to put those five truths into action by choosing your actual investments.

I have an overarching approach for doing this that I use myself and that I recommend to anyone who asks me for advice. It’s called **index investing**, and there are two main reasons I like it so much:

1. It’s easier to implement than just about everything else, and
2. It works better than just about everything else.

Hard to beat that combo!

Index investing lies at the heart of pretty much everything I believe about investing. In this section I’m going to give you a complete overview of WHY it works so well and HOW you can put it in place yourself.

**What Is Index Investing?**

At its core, index investing is simply an investment strategy that makes use of index funds. So, what’s an index fund? Well, I’m glad you asked!

First, an index fund is just a type of **mutual fund**. And a mutual fund is simply a collection of investments (stocks, bonds, etc.) that you can buy as a package deal. For example, a single mutual fund might own a little bit of stock in many different companies.

Second, an index fund is a mutual fund that **tracks an index**. An index is simply a representation of a part of a market (e.g. the stock market, bond market, real estate market, etc.). For example, one of the most well-known indexes is the S&P 500, which includes the stocks of the 500 largest US companies. But there are many different indexes that track many different parts of many different markets.

Finally, index funds stand in contrast to **actively managed funds**. With an actively managed fund there’s a manager who’s paid to try and pick the best investments to include in the mutual fund. The manager’s goal is to use his or her skill to generate a better return than you could find elsewhere. But an index fund doesn’t try to pick the best investments. Its sole goal is to mimic the return of the part of the market it tracks. This is why these funds are often labeled as “passive”.

**Why Index Investing Works**

Remember those five investment truths from above? I’m going to refer back to them now to explain exactly why index investing is such a powerful strategy.

Here we go!
Active Investing Doesn’t Work

Remember above when we said that 75% of your return comes from the markets as a whole (which is out of your control), 15% of your return comes from your asset allocation, and 10% of your return comes from the actual investment decisions you make?

Well that final 10% is what’s called your active management, since that’s the part where you’re trying to choose the best investments possible.

But here’s the problem with that 10%: all of the data we have says that even the experts are bad at picking the investments that will perform best. We mentioned this up above in the section on diversification, but the research can basically be summed up in two points:

- Year after year, across all different markets and sub-markets, the majority of professional investors UNDERPERFORM the index they’re measured against. That is, they lose to the market.
- The professionals who outperform over one period are less likely than chance to outperform again over the next period. This makes it almost impossible to tell which professionals are actually good and which are just lucky.

And this has two big implications for you as an individual investor:

1. Attempts to beat the market are much more likely to fail than to succeed (that is, more likely to lead to lower-than-market returns).
2. If you want to fully capture the return of a given market, finding a way to mimic that market as closely as possible is going to be the most efficient way to do it (since that would remove all active management, which again is more likely to be harmful than anything else).

Which brings us to…

Index Funds Mimic the Market

If you want to mimic a market, an index fund is going to be the best way to do it; because that’s exactly what they’re designed to do.

A good, low-cost index fund will come as close as possible to giving you the full return of whatever market you want to invest in.

Index Funds Maintain a Consistent Style

We said above that your asset allocation is one of the most important investment decisions you will make. What that means is that you will first decide on the asset allocation you want and then choose the specific mutual funds that get you to that asset allocation.

Which means that you’ll need to know exactly what each mutual fund you choose actually invests in. Otherwise, it will be pretty difficult to match the asset allocation you want.
One of the really nice things about an index fund is that you KNOW what it’s going to invest in. An index fund tracking the US stock market isn’t suddenly going to start including international stocks as well. **If an index fund fits your asset allocation when you choose it, it’s going to continue to fit your asset allocation** unless YOU decide you want something different.

On the other hand, one problem with actively managed funds is that the manager can change his or her strategy at any time. Those changes force you to re-evaluate how the fund fits within your asset allocation and may force you to choose a different fund.

Not only does that put more work on your plate, but changing funds could cost you money in the form of taxes and trading fees.

So the consistency of an index fund makes your job a lot easier and potentially saves you a lot of money.

**Index Funds Make Diversification Easy**

If you own an index fund that mimics the entire stock market, you’re diversified within stocks. If you add another on that mimics the entire bond market, now you’re diversified within bonds too. And you’re also diversified across two different types of markets.

See how easy that was!

Now, I will say that a lot of actively managed funds are diversified as well. For example, most actively managed stock funds hold enough stocks that they aren’t too sensitive to the downfalls of any particular company. BUT there are a few reasons why this is less beneficial with an active fund than an index fund:

1. Active funds usually cost more — which, as we know, is not good.
2. Active funds have less consistency (see above), so you can’t always be sure that you’ll have the same level of diversification from one year to the next.
3. As Warren Buffett would tell you, if you REALLY wanted to pay someone for their stock-picking skill you would actually want them to be UN-diversified. You’d want them to put most of their money into their best ideas, because if they were truly skilled then that would be the best way to get the highest returns

So if you want the free lunch of diversification, index funds are the best way to get it.

**Index Funds Are Low Cost (at Least the Good Ones Are)**

There **ARE** some bad, high-cost index funds out there. You need to watch out for them.

But the best index funds are extremely low cost. And it makes sense, because they’re not paying anyone to try and beat the market. It’s simply easier and less costly to mimic the market than to try and beat it.

And since cost is the single best predictor of future returns, this is a pretty nice little feature to have.
It's Easier to Know a Good Index Fund from a Bad One

A good index fund is simply one that tracks its index well. Basically, you want the fund to deliver the full return of the market it is tracking, less any fees.

As an example, let’s say that the stock market as a whole returns 10% for the year and you’re looking at an index fund that costs 0.2% per year to own. In an ideal world, the return for that index fund would be 9.8% for the year. You got the 10% return of the stock market, less the 0.2% fee.

If the index fund’s actual return was significantly higher or lower than 9.8%, you might start to wonder whether it's actually doing a good job of tracking its index. If not, then it’s probably not a good fund to own because you can’t be exactly sure of what you’re getting.

The point here is that it’s a pretty simple process to determine whether an index fund is “good.” It will largely come down to cost, as a lower cost index fund will naturally be able to give you more of the total return than a higher cost index fund tracking the same index. But regardless, it’s just a matter of looking at the numbers.

This is in direct contrast to actively managed funds. While there are definitely good funds and good managers out there, there’s almost no way to know whether you’ve picked one of the few good ones or one of the many bad ones. Like we said above, you’re better off flipping a coin when trying to pick an active fund than you are looking at past performance.

I would much rather be able to know for sure that I’ve picked a good fund.

Index Investing Actually Works

All of the factors above are important, but none of them would matter if we couldn’t show that index investing actually works in real life.

We’ve already talked about the fact that active managers lose to the indexes. But the problem with that research is that no one can actually invest directly in an index. They have to invest in a mutual fund that tracks the index. So while that research shows us that active investing doesn’t work well, it doesn’t show us that the alternative DOES.

Luckily, we have some recent research that solves that problem.

You can read the details here, but in 2013 Rick Ferri and Alex Benke showed that someone who had invested in just a few simple, real-life index funds over the past 16 years would have gotten better returns than over 80% of other investors. And that was the low end. In some cases, index investing outperformed over 90% of the time with certain strategies.

This research was incredibly important because it showed that index investing was more than just a theory. It was something that could actually be applied in real life by real people to get better results with less effort.

I find it hard to argue with that.
It’s Simply Easier

The big downside of index investing — if you could even call it that — is that you remove the possibility of crazy-high investment returns. You aren’t going to get Warren Buffett results by investing in index funds.

BUT, if you pick a solid index investment strategy and stick with it, you will guarantee yourself two things:

1. You WILL get market returns. Over the past 100+ years, those returns have been really good. There’s really no NEED to do better.
2. You will get them with minimal effort. Most of those people who lose to index funds in the studies I talked about above spend a lot of time and effort trying to do better. And they fail. Why would you put all of that effort into something that’s likely to fail when there’s an alternative that’s not only better but easier?

Two Variations on Index Investing (and the One I Like Better)

So, it’s plain and simple; index investing works.

But people love to tinker, and over the years they’ve come up with different ways to actually implement an index investing strategy.

As of now there are two basic approaches, both of which can be done well. And in this section I will briefly describe the two approaches and explain why I personally like one better.

The most basic type is what I’ll call total market index investing. Basically, if you wanted to invest in US stocks, you would pick an index fund that represents the entire US stock market. Same for bonds, international stocks, and anything else you might choose to invest in.

The alternative is commonly called a slice and dice approach. There are a million different ways to do it, but basically it’s an effort to split each market up into different sub-markets, each with different risk/return expectations, and to invest in those sub-markets instead of the whole thing. A simple example would be splitting US stocks in big, medium and small companies.

When it’s done right, there is some really good evidence behind certain slice and dice approaches and I wouldn’t argue with someone who knew what they were doing and wanted to go that route. But when it’s not done right, it really just becomes another form of active investing where people are trying to guess which part of the market will do best.

Personally, I prefer a total market approach for a few reasons:

1. It’s easier for people to understand, which means they’re more likely to stick with it.
2. It’s simpler to implement and maintain and it still gets great results. Might there be something better? Maybe, maybe not. But do you really need something better to reach your goals? And if not, why introduce unnecessary complexity?
3. The more you slice and dice, the less sure you can be of getting market returns. In other words, you’re introducing more uncertainty than what already naturally exists in the markets.

There’s no right answer here; in the end you should go with the approach that feels right to you and a strategy you can stick with.

**What Are the Arguments Against Index Investing?**

There are plenty of people who will argue that index investing is the wrong approach. So here are some of the most common arguments I’ve heard against index investing, and my response to each of them.

**Index Investing Is Lazy**

Actually, there is a TON of academic research backing it up. A lot of really smart people have spent a lot of time and energy studying this stuff and found index investing to be incredibly successful.

If it’s lazy to take all of the best objective research we have and apply it in a way that gets top-notch results with minimal effort, well then I guess I misunderstand the definition of the word.

**Index Investing Will Only Get You Average Returns**

I love this one. People always say things like, “well sure, if you just want average returns then index investing is okay, I guess.”

Really? Average returns? What about the research showing that index investing beats active investing over 80% of the time? Winning 80% of the time is average? PUH-LEASE!!!!

**“But the Market Is About to [Rally/ Crash]! I Really Think You Need to [Get in/Get Out]!!!”**

Everyone has an opinion about what the market is about to do. A lot of those opinions can sound really convincing. Sometimes, it’s honestly hard to argue with the logic.

But here’s the thing: What evidence do you have that the person giving you this opinion has consistently been right in the past? Do you know about all of their opinions, including the ones that didn’t work out? Are you able to track how they’ve performed over time? Is their opinion founded on decades of research that’s also been proven in the real world?

Anyone can have an opinion, and some people are really good at making them sound very convincing. But again, the cold hard numbers we actually have say that those opinions aren’t likely to be worth much.

**This Guy Has a Great Track Record!**

It’s very tempting to trust your money with the guy who’s had a great couple of years recently. All I’ll say is that you should look back at the data showing that past performance is less useful
than a coin flip in predicting future performance. What someone has done in the past has very little bearing on what they’ll do going forward.

I Like to Be More in Control of My Money

A lot of people say they pick their own stocks because they like to be in control of their money. They say that no one has a stronger interest in their money than them, so why not take charge and pick their own investments?

Honestly, I get that sentiment. And actually, to a large extent I feel the same way. I have a pretty strong interest in seeing my own investments perform well, which is exactly why I choose to go with the approach that all the research has shown is most likely to make that happen: index investing.

But if you really want to try picking stocks, by all means give it a shot. Just go in with your eyes wide open to the probabilities.

Not All Index Funds Are Good

There are plenty of bad index funds. Whether they’re high cost or they track too small a market, etc. The fact that something is an index fund doesn’t make it good.

But the catch here is that it’s pretty easy to identify a good index fund. So, no, please don’t blindly go around picking index funds. There are plenty of bad apples out there. But since the good apples are pretty easy to find, the fact that bad ones exist doesn’t mean the strategy itself is faulty.

Index Investing Is Boring

I actually have no rebuttal for this one. It is pretty boring. But are you investing because you want excitement or because you want results? I know my answer.

Are You Still on the Fence?

I know I’m not going to convince everyone that index investing is the way to go. And that’s fine, because the most important thing you can do is to find a strategy you believe in and stick with it, no matter what that strategy is.

But before you decide to choose any investment strategy, ask yourself one simple question:

“How confident am I that this strategy is good enough to get me to my goals?”
"There are risks and costs to action. But they are far less than the long range risks of comfortable inaction."

- John F. Kennedy
Putting Your Plan in Place

Well, we’ve covered a lot of ground here. And we’re close to the finish line, but now it’s time for you to put everything you’ve learned in place.

1. Write Down What You’re Saving For

Before getting into all the logistics, it’s helpful to reflect on the *why* behind all your actions here. What’s your motivation for doing all of this in the first place?

We started this guide by introducing the idea of financial independence, which is simply the point at which you’re free to make decisions based on what makes you happy instead of what makes you money. That’s the overarching goal behind everything in this guide.

But the more you can take that broad idea and personalize it to reflect your specific goals, the easier it will be to not only take the action needed to put your plan in place, but to stick with it when the going gets tough.

So take a few minutes and write down what it is you’re working towards. What does financial independence look like to you?

2. Decide How Much You’re Going to Save

When you start out, your savings rate is, by far, the most important part of your investment plan. So once you have that goal in place, the very next task is deciding how much you’re going to save.

Go back to the calculation you did above that showed you how much you *should* be saving and decide what of that amount you can handle right now.

If you can hit that goal right away, great! Pat yourself on the back. You’re well on your way.

But if you can’t hit that target right now, don’t worry. Set a firm savings rate you can handle now, and then make a plan for how you can increase that rate over time.

3. Pick Your Asset Allocation

Using all the detail we went into above, about both asset allocation and diversification, decide on your overall asset allocation. How are you going to split your money up between the different types of investment categories available to you?

This can feel like a big decision, and, to some extent, it is. But I would like to remind you of a couple of things that can hopefully relieve a little bit of the pressure:

1. Remember that your returns won’t actually matter all that much for the first 10 years of your investment life. So whatever you end up choosing, it’s not going to make too big of a difference either way.
2. There is no right answer. Instead, there is a wide range of good enough answers and your job is just to pick one that feels right to you.

My overall suggestion is to pick something that you believe in for now, and then commit to sticking with it through at least the next market crash and the subsequent recovery. Once you’ve been through one of those full cycles, you can re-evaluate and possibly change things around based on what you learned through that experience.

One other note here: you may be using multiple investment accounts and that can make it a little more complicated to match your desired asset allocation. So here are a couple of tips along those lines:

- Don’t worry too much if you can’t match your asset allocation exactly. Getting as close as you can is good enough.
- You don’t need to make sure that each individual account matches your asset allocation. What matters is that the TOTAL across all accounts matches your asset allocation.

So for a simple example of that second point, let’s say that you want to have 70% of your money in stocks and 30% in bonds and that you have $10,000 total invested. $7,000 of that money is in your 401(k) and $3,000 of it is in an IRA.

You don’t have to get that 70/30 split in BOTH your 401(k) and your IRA. Instead, you could put the entire $7,000 in your 401(k) into a stock index fund and the entire $3,000 in your IRA into a bond index fund. While neither account would match your desired asset allocation, the TOTAL across both accounts would match it perfectly.

4. Start with Your Employer Plan

Now it’s time to actually start contributing and making the investment choices to put your plan in place. The first place to look is your employer plan.

Remember, if your employer offers a matching contribution, this is where you should start — even if the investment options aren’t great. Contribute at least enough to get that full match before doing anything else.

But beyond that, you can request a list of the investment options within your plan and the cost associated with each from your Human Resources department. If there are any low-cost investment options that align with your desired asset allocation, this is a good place to start.

It may also be that your employer plan is simply fantastic and you can work on maxing out your contributions here before you even have to look elsewhere. That would be the easiest option if it works out that way.

5. Fill Any Holes with an IRA or HSA

In many cases, your employer plan might have any of a few weaknesses:

- There are lots of fees.
- The investment options are all high-cost.
- It may not offer investment options that match your desired strategy.

If any of those are true, you can use an IRA or HSA as a way to lower your costs or fill out whatever part of your strategy you can't implement in your employer plan.

As an example, most employer plans that I’ve seen have at least one good, low-cost index fund for the US stock market. That can be a good place to get started.

Many don’t offer the same good, low-cost options for international stocks or bonds, so one option is to use your employer plan to get US stocks and then use your IRA and/or HSA to get the international stocks and bonds.

The bottom line is this: an IRA and HSA are both great ways to implement any part of your investment strategy that you can’t implement at a low cost within your employer plan.

6. Go Back to Your Employer Plan

Once you’ve maxed out your IRA and HSA options, it often makes sense to go back to your employer plan for any additional contributions, even if the investment options aren’t great. You’ll just have to make the best of what’s available.

There are some exceptions, but generally the tax benefits of your employer plan will outweigh the cost savings from choosing your own investments in a taxable account. That’s not always the case, but it’s a good rule of thumb.

7. Open a Taxable Account

Once you’ve maxed out all your tax-advantaged space, a taxable account is likely to be your next best option. And the good news here is, just like with an IRA, you can use it as a way to choose whatever investments you want and potentially make up for anything that’s missing inside other plans.

8. Rebalance Annually

Even if you never make a single trade beyond your contributions, your investments will slowly drift away from your target asset allocation over time. That’s just because the markets will move up and down, which of course will affect the amount of money you have in each type of investment.

As an example, let’s say you invest $10,000 with a 70/30 split between stocks and bonds. So you start with $7,000 in stocks and $3,000 in bonds.

Now, let’s say that over the course of the year stocks do really well and return 20%, while bonds do poorly and lose 5%. At the end of the year your stock portion would be worth $8,400 and your bond portion would be worth $2,850, for a total value of $11,250. How does that compare to your target percentages?
- Stocks: $8,400/11,250 = 74.7%
- Bonds: $2,850/11,250 = 25.3%

As you can see, simply because of normal market movements your investments have drifted from your desired 70/30 split.

So at the end of each year you can do a simple calculation like this, and if your asset allocation is off you can **rebalance** by selling some of the over-weighted investment (stocks in the above example) and buying some of the underweighted investment (bonds in the above example).

Doing so will ensure that your actual investments continue to reflect your desired investment strategy.

**What If You Don't Have a Lot of Money?**

You don’t need a ton of money to get started with any of this. There are some great ways to get going, even if you have very little to start with.

The first is your employer plan. There will almost never be any kind of minimum initial investment, and you should be able to get started at whatever contribution level you can afford. This is usually the easiest option if you’re starting small.

An IRA can be a little trickier. If you want to use Vanguard, they have at least a $1,000 minimum initial investment for all of their funds, so you will have to have that amount available before you can get started with them. One option is to simply put the money into a savings account for now and switch it over to Vanguard once you get to $1,000. The difference in returns between now and then probably won’t matter much anyways.

But there are other providers that you will let you open an IRA without any minimum initial investment, and you could certainly go that route as well. In fact, you could always get started with one provider and then transfer the money over to Vanguard (or whoever you end up wanting to use) once you hit that $1,000 minimum. It’s a little bit more of a hassle than starting with a saving account, but it would let you open the IRA sooner.

Just remember that again, the most important part of all of this is your savings rate, not your return or your account or your specific investment choices. The smaller your balance is the more true that is. Take heart in the fact that, as long as you’re saving, you’re on the right track.
"You are under no obligation to read or watch financial news. If you do, you are under no obligation to take any of it seriously."

- Morgan Housel
Conquering the Biggest Threat to Your Financial Independence

If you’ve handled all the steps above, I’d like to give you a huge CONGRATS!!! That’s a lot of work, and you’ve put yourself on the right path to reaching financial independence. Pretty cool!

Now I’m going to rain on your parade just a little bit. Because the truth is that the hardest part of investing, and the biggest threat to your financial independence, is yet to come.

The hardest part is not figuring out how much to save. It’s not picking a strategy or choosing the right funds to invest in.

No. The hardest part of investing is sticking to your guns when the world around you is freaking out.

It’s really hard. Whether the market is shooting up or falling like crazy, there will always be a temptation to tweak your plan or abandon it completely. It’s natural.

But I can’t emphasize this enough: staying consistent through the ups and downs is one of the most important things you can do.

The people who look the market ups and downs in the eye and refuse to flinch are the ones who end up winning over the long-term.

The Stock Market WILL Fluctuate Wildly

Over the long-term, the stock market’s track record is pretty impeccable. It has continued to climb ever higher, providing fantastic returns to anyone who is patient enough to stick with it.

But in the short-term the stock market can be a little crazy. There will be big drops, and when those drops happen, the media usually tries to whip us all into a frenzy. They make doomsday forecasts, wonder aloud whether now is the time to get out, and generally feed into the natural fear that comes with a market dip.

But here’s the thing: these big market dips are not only normal, they are EXPECTED. We never know when they are going to happen, but we do know that they are going to happen and we shouldn’t freak out or act surprised when they do.

And here’s the other thing: every single time it’s happened in the past, we’ve seen a recovery just after that’s been even bigger than the dip.

Here are a few recent examples showing just how meaningless these short-term dips are (all numbers use Vanguard’s Total Stock Market Index Fund (VTSAX) to represent “the stock market”):

- In August of 2013, the stock market fell 4%. The return for the year? 33.5%.
- In May of 2012, the stock market fell 6.7%. The return for the year? 16.4%.
- In 2010, over the 2.5 months from 4/23 to 7/2, the stock market fell just over 16%. That’s a pretty big drop over a pretty long time! And yet, the return for the year was 17.3%. 
**But We Can Go Even More Extreme**

My favorite example actually comes from the most recent big market crash in 2008.

From October 9, 2007 to March 9, 2009, a period of 17 months, the stock market lost 55% of its total value and produced an annualized return of -43%. That's about as bad as it gets.

So what's happened since then?

Well, from the very bottom on March 9, 2009 through April 10, 2015 (the day I'm writing this), the stock market is up 266% overall for an annual return of 24%.

And what if we start from October 9, 2007 and include the entire crash? Well even in that case the stock market is still up 64% overall for an annual return of 7%.

So even when you factor in the biggest market crash than most of us have ever seen (and maybe ever will see), the stock market has still produced pretty stellar returns.

**What Does This Mean for You?**

I want to help you focus on things that are legitimately important. Your family. Your life. Your financial independence.

Those are the things that matter to you. They are your long-term plans. They are **your** plans. And they don’t change just because some talking head is yelling at you from the TV that the stock market is about to implode.

The best investors are the ones who can tune out the noise and stick to their plan even when the rest of the world around them is freaking out.

And although it sounds simple, it’s not easy. It really isn’t. There will be many times when you’re tempted to change your plan based on what’s happening in the world around you.

So when you’re feeling like maybe you should make a change, just remember this:

> “Benign neglect, bordering on sloth, remains the cornerstone of our investment style.”

That’s Warren Buffett, probably the greatest investor you or I will ever see, and he’s saying that the single most defining characteristic of his investment plan is essentially doing nothing. He has his plan, it’s already in motion, and for the most part he never sees a reason to change it.

The only time you should consider changing your plan is when you’ve just had a life event that significantly changes your needs. Other than that, and other than the periodic rebalancing we mentioned above, there isn’t much you need to do with your investments, other than keep on contributing.
"You can only become truly accomplished at something you love. Don’t make money your end goal."

- Maya Angelou
Final Thoughts

Financial independence is the ultimate goal. It’s the point at which you can stop worrying about what you need to do and start doing what you want to do.

And you CAN reach it, probably sooner than you might expect. It may take some tough choices along the way, but with the right plan in place you can get to a point where your money gives you the freedom to live a life you enjoy.

More than anything, that’s what I hope this guide helps you achieve. After all, this is never really about money. This is first and foremost about the life you want to live and the money part of it is just a way to make that life happen.

So as you work to put the advice in this guide into place in your own life, remember that you don’t have to make all the right decisions. You don’t have to choose the best path. You certainly don’t have to get better investment returns than your friends or co-workers.

All you have to do is follow a plan that helps you reach your personal goals.

That is the only thing that matters.

Thank You!

Before I wrap up, I’d just like to take the opportunity to say thank you. Thank you for supporting what I do. Thank you for taking the time to read this. And thank you for placing even a small amount of trust in me. I know how valuable that trust is and I don’t take it lightly.

If you ever have any questions, or if you just want to share your experience, please feel free to email me at matt@momanddadmoney.com. You can also find me on Twitter (@momanddadmoney) or connect with me through my Facebook page. I’d love to hear your story and I’d also like to lend a hand if you’re ever feeling stuck. Nobody ever finds success all on their own, so please don’t hesitate to ask for help if you need it.

In the meantime, best of luck to you and your family!
Hi, I'm Matt Becker. I'm a fee-only financial planner and the founder of Mom and Dad Money, where my mission is to help new parents build a better financial future for their growing families.

I have two young boys myself, so I know first-hand how hard it can be to handle all the new financial responsibilities that come with starting a family. It's not easy to figure out what you're supposed to be doing, how to prioritize everything, and how to fit it all within a limited budget. And when you add all that on top of the challenge of caring for your children, it can create a lot of stress, anxiety and maybe even some tension between you and your partner.

I created my practice to make all of that easier and less stressful for you. Every day I help new parents just like you to set financial goals, create a spending plan that actually works, get the right protections in place, and start saving for the future. I know how confusing it can be to navigate all of that yourself (my wife and I had plenty of trouble ourselves) so my role is to act as an objective advisor who can help you see the big picture and figure out how all the pieces fit together. With the right plan in place, my clients spend less time worrying about money and more time enjoying their growing families.

If you would like someone to talk to about your money questions, I invite you to schedule a free, no-obligation phone call so that you can tell me a little more about your situation. Even the simple act of talking about your struggles and concerns can bring you a lot of relief, so please click the button below to schedule your call.

You can also go directly to this URL, http://momanddadmoney.com/consult, or just shoot me an email at matt@momanddadmoney.com and we'll work it out.

I'm looking forward to talking to you soon!
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