Investing Made Simple

Invest well and save for retirement the smart way, no matter where you’re starting from.

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What This Guide Is All About

This guide is for everyone who knows that it’s important to start investing but isn’t sure how to do it right.

Investing can feel complicated, intimidating, and overwhelming. There are strange new words to learn, a million decisions to make, and a whole lot of uncertainty about whether you’ll make money or lose it.

It’s normal to be scared of investing. In fact, it’s normal to be so scared of investing that you avoid it entirely.

But here’s the thing: investing doesn’t have to be scary, or complicated, or difficult. It can actually be pretty simple if you know what’s important and what isn’t. Which decisions matter and which don’t.

You can create an investment plan that helps you reach your goals, no matter where you’re starting from.

This guide will show you how to do it.

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

- A clear set of specific goals that you’re working towards.
- A precise monthly savings target for reaching those goals and a plan for getting there.
- An investment strategy you understand that includes which accounts to use, how to invest within each, and how to maintain it over the years.
- Confidence that you’re making good investment decisions.

It doesn’t matter where you’re starting from or how much you know about investing. This guide makes it as easy as possible for you to get yourself on the right track.

Let’s get started!
“Everything around you that you call life was made up by people that were no smarter than you.”

– Steve Jobs
Re-Thinking Retirement

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.

There are more exciting possibilities available to people who are willing to think a little bit differently. And in this case, a small change in mindset can make a big difference in your investment success.

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 has to 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’d like to be able to retire at some point, but I also want to enjoy myself along the way and give my family the freedom to live how we want to live now.

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

Instead, I like to talk about financial independence.

Here’s what financial independence means to me:

“\textit{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 somewhat similar to 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 sustainable while still handling my family’s needs.

We weren’t fully financially independent. But we were independent enough to allow me to build my business from scratch.

When you’re willing to think in degrees of financial independence, you open up a world of opportunities over the course of your lifetime.

**Finding 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.

What’s more appealing: the idea of gritting your teeth through a terrible job just so you can quit decades down the line, or the idea of spending your days doing work you love because your financial position allows you to do so?

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, you give yourself so much more opportunity to create a life you enjoy, both now and in the future.

It’s no longer about reaching the same end point that everyone else reaches 30-40 years down the road; it’s 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.

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.

And there are much simpler examples from the lives of my clients. I’ve worked with people who decided to start a yoga studio, stay home with their kids, and go back to school. All of those choices required giving up income and having the savings in place to make up the difference. They required a degree of financial independence far before traditional retirement age.

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
Financial independence allows you to think about what you want out of life now instead of having to wait 30-40 years, and that’s why I think it’s such a powerful mindset. It allows you to prioritize the things that are important to you instead of following a predetermined path.

But there’s a question 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 articulate specific goals that enable us to work towards something concrete.

Here’s 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.

**Important Note:** This guide is all about helping you take action. There’s a lot of advice packed in here, but none of it is worth anything unless YOU do something with it.

At the end of this section, and at many other points throughout the guide, you’ll see a big yellow box marked **TIME FOR ACTION**! Every time you come to one of these boxes, please stop reading and follow the steps laid out for you. Doing so will ensure that you are actually putting your investment plan in place instead of just thinking about it.

**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**

If you have a spouse or partner, ideally he or she has gone through the first three steps as well and now the two of you can come together and talk about it. And if your children are old enough, you should consider bringing them in on this discussion as well.

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 when everyone is in the right mood.

But it can also be a difficult 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 obviously important to set priorities, but it’s 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, a few years ago I finally admitted to myself that I no longer cared about sports quite as much as I used to. That may sound silly, but this was a hard thing to admit. A large part of my life had revolved around sports for a long time.

But that realization 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 made it easier to afford things like childcare and travelling to see my family that lives 1,500 miles away. I never would have been able to do that if I hadn’t intentionally acknowledged that watching ESPN was no longer on my list of priorities.

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 clearly defined in a way 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 often keeps people from taking action.

So let me spoil the surprise: you WILL make mistakes. We all do. I’ve made plenty of them myself, some more than once, and continue to do so. It’s just part of the process.

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 the good news is that you’re not alone here. The rest of this guide is dedicated to helping you take the right actions so you 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.

Set a calendar reminder to re-visit this process once per year and update your vision.

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

You can only get where you want to go if you know where you want to go. This process will help you make investment decisions that actually lead to a better, more enjoyable life.

**TIME FOR ACTION!**

Complete the following steps before moving on to the next chapter:

1. Work through the first 6 steps above, both alone and, if relevant, with your spouse or partner.

2. Once you have your SMART goals, write them down in your Investment Plan Workbook under the My Goals section.

3. Set a calendar reminder to revisit this process in 12 months.
“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. Even if you plan on being fully financially independent in a couple of years, you’ll 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 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 stock market’s good periods. 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):
<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</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></td>
</tr>
<tr>
<td>3</td>
<td>$17,404</td>
<td>$30,000</td>
<td>Frank</td>
</tr>
<tr>
<td>4</td>
<td>$22,894</td>
<td>$37,500</td>
<td>Savings Rate</td>
</tr>
<tr>
<td>5</td>
<td>$28,934</td>
<td>$45,000</td>
<td>Rate of Return</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</td>
</tr>
<tr>
<td>8</td>
<td>$50,923</td>
<td>$67,500</td>
<td>Rate of Return</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>
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<td>12</td>
<td>$91,960</td>
<td>$97,500</td>
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<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 savings and shows the number of years it takes to reach financial independence at different savings rates. It doesn’t matter what your income 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 you extend the Frank vs. Sarah chart from above, Frank’s balance starts growing significantly faster than Sarah’s after Year 14 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. Mistakes are okay, because the return you earn, good or bad, doesn’t have much of an impact anyways.

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 most of your energy into increasing your savings rate to wherever it needs to be, not on choosing the “perfect” investments.

Let’s talk about how to do that.
"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: https://momanddadmoney.com/fi-calculator.

To access it, simply click the link, click File in the top menu, and either Make a copy... to use it in Google Sheets or Download as to download it in Excel.

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’re 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/partner’s age if 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 or partner.

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.

If you’d like, 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 at FI

- 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 2016 Trustees Report on Social Security, it should still be able to pay out about 74% of the current estimated benefits through the year 2090, 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 estimate 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 or partner, 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 2017 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.

- Switch to a **lower-cost cell phone plan**, make the leap and **cut cable**, or otherwise lower your monthly bills one at a time and start putting the savings towards financial independence.

- It’s not all about cutting costs! Finding ways to increase your income can be incredibly powerful, especially over the long term. Don’t be afraid to **ask for a raise** or try out a side hustle to get more money coming in.

- Every time you do get a raise, put 50% of the increase towards your monthly financial independence savings.
• 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 four points especially is that 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.

Re-visit this process on a regular basis to see where you stand and whether you need to adjust your savings target. Setting a calendar reminder to re-evaluate your savings plan each November is a good idea, so that you have time to make any necessary adjustments to your contributions for the new year.

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**TIME FOR ACTION!**

Complete the following steps before moving on to the next chapter:

2. Work through the steps above to calculate your Savings Target.
3. Enter your Savings Target from the calculator on the My target monthly savings line of your Investment Plan Workbook.
4. Enter the monthly amount you can commit to saving right now on the What I can save per month now line of your workbook. It's okay if this isn't the full amount yet. Just make sure it's an amount you can actually commit to right now.
5. If you’re not able to hit the full target right now, fill out the Commit to save more section of your workbook:
   a. Set a target amount by which you’d like to increase your monthly savings. This doesn’t have to be the entire gap between your current savings and your Savings Target. It should just be a mini-goal you can achieve in a relatively short amount of time (up to 12 months).
   b. Specify the date by which you will hit that target.
   c. Specify how you will free up the extra money for saving.
   d. Set a calendar reminder, put it in your to-do list, or otherwise hold yourself accountable to that savings increase and that deadline.
"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’s the place to start pretty much 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.

A typical employer match might look something like this:

1. **100% match up to 3% of your salary.** If you save 3% of your salary, your employer will put in another 3%. You immediately double your money simply by contributing.
2. **50% match above that, up to 5% of your salary.** If you contribute another 2% of your salary, your employer will match half of that additional contribution.
3. You’re allowed to contribute more than 5% of your salary (up to the annual limits), 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’ll find anywhere else.

Now, all matching programs look different and some employers don’t offer a match. You can request your 401(k) plan’s Summary Plan Description to get 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 might 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.

Keep in mind that the money YOU contribute is always 100% yours. It may gain or lose value based on investment performance, but there is no vesting schedule. That only applies to contributions your employer makes.

**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 don’t offer an employer match.)

One big advantage of these plans is that it should be relatively easy to get started. You can simply ask your 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 2017, 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 later on. 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 tax deduction but *would* allow you to eventually withdraw the money tax-free.
- High annual contribution limit ($18,000 for 2017). 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.
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.

For more on this topic, check out the detailed breakdown in the following mini-guide: Traditional vs Roth IRA - Some Unconventional Wisdom for Young Investors.

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 an automated investment platform like Betterment 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, 2017 to make your 2016 contributions.

Summary of Cons

• As of 2017, your annual contribution is limited to $5,500. If you are 50 or older, you can contribute an additional $1,000 per year.

• That contribution is further limited, and potentially even eliminated, for high-income earners. Here’s an overview of those income limits: IRS - IRA Contribution Limits.

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 2017, 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 20% 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 three different companies as the best places to open a health savings account. Each one offers access to high-quality, low-cost index funds, which we’ll talk about more below. And while they all charge at least a small fee for the opportunity to invest, the fees are smaller than the other options I’ve seen to this point.

Here’s the list:

• **Alliant Credit Union** ([http://www.alliantcreditunion.org/bank/health-savings-account](http://www.alliantcreditunion.org/bank/health-savings-account))
• **HSA Bank** ([http://www.hsabank.com/](http://www.hsabank.com/))
• **Saturna Capital** ([http://www.saturna.com/individual/hsa/](http://www.saturna.com/individual/hsa/))

Again, all three are good options and will serve you well. But they do each have a different fee structure and one of them may save you more than the others depending on how you plan to use it. I wouldn’t worry about it too much since none of these companies are gouging you, but it’s worth doing a little research into their fees to see if one stands out as better for your specific situation.
You can also use the following tool to do even more research into the health savings accounts available to 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 2017, annual contributions are limited to $6,750 for families and $3,400 for individuals. If you are 55 or older, you can contribute an additional $1,000 per year.

- Before age 65, there is a 20% 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: Backdoor Roth IRA**

If your income is too high to either deduct contributions to a Traditional IRA or contribute directly to a Roth IRA, you may still be able to take advantage of that IRA space by executing what’s called a **Backdoor Roth IRA**.
Here’s a basic overview of how it works:

1. Open a Traditional IRA.
2. Contribute to the Traditional IRA up to the annual max.
3. Convert the Traditional IRA to a Roth IRA anywhere from one month to one year after making the contribution.

This works for a few reasons.

First, you are allowed to contribute to a Traditional IRA even if you make too much money for the contribution to be deductible. It’s simply counted as a non-deductible contribution, meaning that there is no immediate tax benefit gained from making the contribution.

Second, you are allowed to convert money inside a Traditional IRA to a Roth IRA at any time, regardless of income. You will be taxed on the conversion, but in this case you will only be taxed on the earnings since the contribution was made after-tax. So if you contribute $5,500 and convert after the account has grown to $6,000, you will only be taxed on $500 of the conversion.

Third, once the money is inside the Roth IRA, it will grow tax-free and be available for you to withdraw tax-free in retirement. In other words, you’ll have achieved essentially the same result as if you had contributed directly to a Roth IRA.

Now, there are a few potential pitfalls to watch out for.

The biggest is that there could be unintended tax consequences if you have other Traditional IRAs. Because even if you make your non-deductible contribution to a brand new IRA, the IRS considers all of the money inside all of your Traditional IRAs to be part of one big pot. And it considers any Roth IRA conversion to be a pro-rata distribution of pre-tax and post-tax money from that single pot, meaning that significant pre-tax savings in other Traditional IRAs could cause most of your conversion to be taxed.

The bottom line is that you need to be careful before executing a Backdoor Roth IRA, but that when it's done right it's a great way for high-income earners to get tax-free money in retirement.

For more detail, including how to avoid the biggest pitfalls, you can refer to this mini-guide: The Backdoor Roth IRA.

Summary of Pros

- High earners ineligible for direct Roth IRA contributions can take advantage of tax-free growth and tax-free withdrawals.
- You get all the other advantages of IRAs, including the ability to minimize costs and choose from a wide range of investment options.
Summary of Cons

- It's a more complicated strategy with more room for error.
- There are potential unintended tax consequences if you have existing Traditional IRAs, though there are ways around that.

Moral of the Story

- You should proceed with caution, but this can be an effective way to create tax-free retirement income, no matter how much you make today.

Option 6: Mega Backdoor Roth IRA

Most people don't have this option available to them, so I won't spend a lot of time on it here. If you'd like to learn more, there's a link to the mini-guide on this topic at the bottom of the section.

The Mega Backdoor Roth IRA is similar to the regular Backdoor Roth IRA, with the main difference being that the initial contribution is made to a 401(k) rather than a Traditional IRA.

All 401(k)s allow for traditional contributions that are tax-deductible now and will be taxed when withdrawn in retirement. Some 401(k)s also allow for Roth contributions that are not deductible now but can be withdrawn tax-free in retirement.

Then there's a small percentage of 401(k)s that allowed what are called non-Roth after-tax contributions. These contributions are not deductible, they grow tax-free while inside the account, and the earnings (but not the contributions) are taxed as ordinary income when withdrawn in retirement.

And there are two big reasons why this type of contribution can be incredibly valuable:

1. They don't count towards the $18,000 maximum annual employee contribution ($24,000 if you're 50+). The only limit you have to worry about is the $54,000 combined annual limit across all types of 401(k) contributions, including both employee and employer contributions.

2. You can eventually roll this money over into a Roth IRA. Some 401(k) plans even allow you to roll it over while you're still working for the company.

In other words, it's a way to indirectly contribute a LOT of money to a Roth IRA each year, potentially leading to a significant amount of tax-free income in retirement.

Now again, it's pretty rare for 401(k)s to allow for non-Roth after-tax contributions, and even if yours does there are a number of other complicated logistics to navigate.

But if you've already maxed out your other tax-advantaged investment accounts and you'd like to save more money, this is definitely worth exploring.

Here's the mini-guide that gets into all the details: The Mega Backdoor Roth IRA.
Summary of Pros

- You can potentially contribute an extra $36,000, per person, every year to Roth IRAs, no matter your income. The exact amount depends on how much other money is contributed to your 401(k) through normal employee and employer contributions.

Summary of Cons

- Most 401(k) plans do not allow for this.
- It’s a complicated process with a number of potential pitfalls along the way. You need to do your research well and communicate your goals very clearly to the people you’re working with at every step along the way.

Moral of the Story

- While rare, this can be a powerful way to supercharge your retirement savings.

Option 7: 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 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 8: 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 that’s being sold as an investment opportunity. I’ve written about this extensively, and if you’re interested you can find all the gory details here: Why Whole Life Insurance Is a Bad Investment.

With that said, there are a few exceptions that are worth mentioning 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 the agent’s 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 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.

**What If You’re Self-Employed?**

If you’re self-employed, your retirement account options look a little different. You’re still able to contribute to an IRA or HSA, but you won’t have a 401(k) or other employer-provided plan.

The good news is that there are still a number of excellent options available to you. Here’s a quick overview of what they are:

- **IRA** – The contribution limits, income restrictions, and everything else are the same whether you’re self-employed or an employee. This is a great first option that keeps things simple.

- **HSA** – Again, this works exactly the same for a self-employed individual as it does for a regular employee. If your health insurance allows it and if you don’t need the money for medical expenses, this would be a good first or second step.

- **Solo 401(k)** – This is a 401(k) specifically designed for people who work for themselves and don’t have any employees (other than a spouse). For 2017, you can contribute up to $18,000 per year as an employEE AND up to 25% of your net income as an employER, with a combined $54,000 max. This is my favorite self-employed retirement account because of the large contribution limits.

- **SEP IRA** - These are a little simpler administratively than Solo 401(k)s, but they only allow the employER contribution of up to 25% of net income, up to a $54,000 annual max (as of 2017). One other advantage is that you have until April 15 of the following year to make a contribution, whereas Solo 401(k)s have a December 31 deadline.

- **SIMPLE IRA** - These allow for up to $12,500 in employEE contributions (for 2017) and EITHER a 3% employER match OR a 2% automatic employER contribution. Again, you’re both the employee and the employer.

The options get a little more complicated as you add employees, so if that’s the situation you’re in then I would suggest talking to a professional before setting up a retirement plan.

But if it’s just you and your business, the Solo 401(k) is generally the most flexible option. Though the SEP IRA also allows for significant contributions and comes with a slightly reduced administrative burden.

For more on these options, you can refer to the mini-guide: [The 5 Best Retirement Accounts for the Self-Employed](The%205%20Best%20Retirement%20Accounts%20for%20the%20Self-Employed).
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. Backdoor Roth IRA, if you’re not eligible for a regular IRA contribution.
6. Mega Backdoor Roth IRA.
7. Taxable account.

This certainly isn’t a golden rule, but it will point you in the right direction.

TIME FOR ACTION!

Complete the following steps before moving on to the next chapter:

1. In the My Accounts section of your Investment Plan Workbook, write down which accounts you are going to use and how much you are going to contribute to each one on a monthly basis.

2. The total monthly savings across all accounts should add up to the number you entered for What I can save per month now in the My Savings Plan section of your workbook.

3. Write down the date by which you will have each account set up with those monthly contributions in place.

4. Set up automatic contributions to each account so that they happen every single month without you even having to think about it. You can read more about how to do this here: How to Automate Your Savings.
"It is not necessary to do extraordinary things to get extraordinary results."

- Warren Buffett
5 Fundamental Investment Truths

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. Seriously, the simple act of saving money into the right accounts is 90% of the battle when you’re starting out.

But you can do even better 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’ll 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'll 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 of time 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 the truth is that there’s no surefire way to determine the exact right asset allocation for you. It’s a decision that’s part science and part emotion.

But there are some ways to get in the ballpark and that’s exactly what I’m going to share with you here.

Here’s essentially the same questionnaire I use with my clients to get an initial sense of their investment profile:

**Mom and Dad Money Asset Allocation Questionnaire**

Click the link, answer the questions, and you’ll get a target asset allocation based on your responses.

Now, keep in mind that the answer you get here is NOT a specific recommendation. There are many factors that go into this decision, including your specific goals, values, and circumstances, and no questionnaire can factor all of that in.
But it's a good start that gets you in the ballpark, and from there it's a matter of making adjustments based on your personal situation.

So now let's talk about why you might make adjustments.

Potential Reasons to Invest More Aggressively

What are some situations in which you should increase your allocation to stocks, exposing yourself to more risk in search of higher returns?

To be quite honest, unless you’re an experienced investor there aren’t many cases where I would recommend doing that.

Most people don’t really have a good sense of their personal risk tolerance until they’ve lived through a big market crash, and in the meantime sticking to a more conservative portfolio is more likely to lead to better behavior.

Still, here are a few situations in which you could at least consider investing more aggressively.

1. You’ve been through a market crash and it didn’t scare you

If you’ve already lived through a big market crash like the one in 2008, didn’t sell out of your investments at the time, and actually kept contributing all the way through it, you’ve proven that you can handle that kind of downswing.

If doing that was difficult, it’s probably good evidence that your asset allocation at the time was exactly what it should be. Sticking with it was hard, but you made it through.

If doing so was easy, and if you weren’t scared or concerned as the market continued to fall, then maybe you can handle an even larger allocation to stocks.

2. Your investment timeline is flexible

The benefit of the stock market is a higher expected return. The downside is that there’s huge variability in the returns you actually receive.

You can’t count on the stock market to help you hit a specific financial target on a specific date, because you just don’t know what it’s going to do during any given day, month, year, or even decade. That’s why using the stock market for short-term goals is generally a bad idea.

But if you have a lot of flexibility with your goal, and if you could delay it for a potentially significant amount of time without stress or hardship, then you may be able to take on some extra risk with the hope of getting higher returns and reaching your goal even sooner.

3. You’re saving more than you need to be

If your savings rate is significantly higher than what it needs to be, you could consider investing more aggressively for the potential of a double bonus.
If it works out and you get higher returns, that will compound with your savings rate to get you to your goal even quicker.

If it doesn’t work out and you get lower returns, your savings rate will help to offset that loss and keep you on track.

**Potential Reasons to Invest More Conservatively**

On the flip side, there are a number of reasons to consider investing *less* aggressively and put more of your money into bonds than what the questionnaire suggests.

Here are a few.

1. **You don’t need higher returns**

Here’s a simple spreadsheet that helps you figure out the rate of return you need given your savings goal, your current savings, and your monthly contribution. Here it is: [Mom and Dad Money Savings Calculator](#).

If you run the numbers yourself and find that you can reach your goal with lower returns, why take the risk of NOT reaching it by stretching for higher returns?

Investing more conservatively will not only increase your odds of hitting your goal on time, but it will make for an easier ride along the way.

The trade-off will be the lost potential to end up with even more money, but as the saying goes: “pigs get fat, hogs get slaughtered.”

2. **You haven’t experienced a market crash**

If you haven’t lived through a big market crash, the truth is that you don’t know what it feels like to watch your account balance drop and drop and drop with seemingly no end in sight.

It’s a scary thing to live through and even the most experienced investors have trouble sticking to their plan when things get bad.

Until you’ve been there you don’t know how you’ll react, and there’s also a decent chance that you overstated your risk tolerance when completing the questionnaire, leading to a more aggressive recommendation than what you can truly handle.

I’m a big fan of [Rick Ferri’s Flight Path approach to asset allocation](#) because it factors in this very thing. It encourages investors to start out relatively conservatively and get more aggressive as you gain experience, IF that experience suggests that you can handle being more aggressive.

Remember that when you first start out your savings rate is far more important than your investment return. So you’re not missing much if you invest more conservatively at the start, and the potential bonus is that the next market crash doesn’t scare you off from investing altogether.
3. Investing makes you nervous

If you know you’re supposed to be investing but you’re scared about the possibility of losing money, it’s okay to be more conservative than the “norm”.

Like I just said, your savings rate is far more important as you start out anyways, so start making those contributions, dip your toes into investing with a conservative plan, and if needed make adjustments as you gain experience.

4. Your investment timeline is not flexible

If you’re dead set on reaching your goal at a specific point in time, and especially if that time is in the near future, the stock market carries some significant risks.

If you have a strict timeline, just know that a higher allocation to stocks introduces more uncertainty about hitting that timeline.

When to re-evaluate your asset allocation

In most cases, your investment plan should largely be set-it-and-forget-it. Other than occasional rebalancing, your job is to keep contributing and let your investments do their thing through the ups and downs.

But it is worth re-evaluating your asset allocation from time to time, especially when something significant has changed in your life or when your financial goals have changed. In those cases your need and/or ability to handle risk may change as well, meaning that a new strategy might be a good idea.

Here are a few examples of situations where it’s worth re-evaluating your asset allocation:

- Marriage or divorce
- Receiving an inheritance
- Significant change in retirement goals
- You just lived through a big market crash AND the subsequent recovery (perfect time to reflect on your true risk tolerance, once things are calm again)
- A big, unexpected financial commitment, such as caring for aging parents

Make Your Best Educated Guess and Get Started

Even with the help of a questionnaire, deciding on your asset allocation can be intimidating. It feels important and there are a lot of unknowns, which may make you hesitant to pull the trigger.

So know this: there is no perfect answer but there are plenty of “good enough” answers. If you follow the steps laid out here, you will almost certainly end up in the “good enough” camp with plenty of time over the rest of your investment life to make adjustments as needed.
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 ahead of time which ones will do so.

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.

- **Invest in different stock markets** – 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.

- **Invest in different bond markets** – 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>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 $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>
</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.

Case Study: Finding the Cost of an Investment

Figuring out how much a specific investment costs can be tricky, so let’s work through an example together.

The American Funds Growth Fund of America is one of the largest mutual funds in America. It invests primarily in stocks, though it can also invest in bonds and other instruments if it sees fit. As of this writing it has over $74 billion in assets.

So, let’s say that you’re considering investing in this fund and you’d like to know how much it’s going to cost you. How would you go about doing that?

First, look for the ticker symbol. The ticker symbol is a short string of letters that serves as a unique identifier for the mutual fund. When you Google “American Funds Growth Fund of America ticker symbol”, you’ll find that its ticker symbol is AGTHX.

Second, go to the website morningstar.com and enter the ticker symbol into the Quote field at the top of the page. That will bring you to a page with a lot of detailed information about the fund in question.

Third, review the various fees as they’re outlined on the page. Here’s a screenshot for this particular fund that points out where each fee is shown (next page):
As you can see, this particular mutual fund has the following fees:

- Expense ratio = 0.66%
- Sales load = 5.75%
- Turnover = 31% (not a direct fee, but an indication of potential transaction costs)

Then, if you click over to the Tax tab, you can find the Tax Cost Ratio. As of this writing, the tax cost ratio for this fund ranges from 1.00% - 1.92% depending on the time period you’re looking at.

So, how does this stack up? Let’s compare it to a different mutual fund with a similar balance between stocks and bonds, Vanguard’s LifeStrategy Growth Fund (ticker symbol = VASGX).

According to Morningstar, here are the fees for that mutual fund:

- Expense ratio = 0.15%
- Sales load = 0%
- Turnover = 5%
- Tax cost ratio = 0.64% - 1.02%

Clearly, there’s a big difference in the fees charged by these mutual funds. The Vanguard fund is significantly less expensive across the board.

Now, this isn’t to say that the Vanguard fund would always be the better choice. Cost is just one part of the equation when making investment decisions.

But cost is one of the only investment variables that both matters AND is in your control. That scenario is actually pretty rare in investing and you should make the most of it.
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.

TIME FOR ACTION!

Complete the following steps before moving on to the next chapter:

1. To get an initial sense of your target asset allocation, complete the following questionnaire and write down the suggested result: https://momanddadmoney.com/asset-allocation-questionnaire.

2. Work through the potential reasons listed above to make your asset allocation more aggressive or more conservative. If necessary, make adjustments to the suggested asset allocation from the questionnaire.

3. Write down your final target asset allocation in the My Asset Allocation section of your Investment Plan Workbook. Just fill out the overall stock/bond allocation for now.

4. For most, that will be plenty. But if you’d like, you can also enter a more detailed target asset allocation that includes a breakdown between US and international stocks and US and international bonds. You could even include other asset classes if you’re knowledgeable about them and believe they will help. Here are two resources that list several example portfolios:
   - Bogleheads – Lazy Portfolios
   - Oblivious Investor – 8 Lazy ETF Portfolios

Remember, your overall stock/bond split is by far the most important part of this decision, so if going further than that feels overwhelming, just skip it. You won’t be hurting yourself.
"Everything should be made as simple as possible, but no simpler."

– Albert Einstein
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.

But if you’re unsure, start with a total market strategy. It’s the one I use personally, it’s the easiest to implement, and it’s just as likely to outperform as the slice and dice approach.

**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.
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.

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.

There are plenty of bad index funds. Some are high cost, some track too small a market, and some don’t track their index well at all. 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.

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.

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?”
"Progress isn’t made by early risers. It’s made by lazy men trying to find easier ways to do something.”

- Robert A. Heinlein
How to Beat 80% of Investors With 1% of the Effort

Okay, so with index investing as the overall philosophy, how do you go about picking the actual investments within each of your accounts? With dozens, and sometimes even thousands, of choices, how do you know which ones are right for you?

There are plenty of ways to do it, and honestly you could spend your entire life debating all the nuances of this decision and never feel 100% sure that you’ve got it exactly right. And many people do just that, because the truth is that there’s no way to ever know for sure that you’ve chosen the best investments possible. Without a magic crystal ball, we simply don’t know which investments will perform the best over the coming years.

So you’re mission here isn’t to be perfect. Your mission is to find investments that are good enough to help you reach your goals. Which really just means you need to find investments that:

1. Match your target asset allocation (or get close enough)
2. Are low cost
3. Follow the principles of index investing
4. Are easy to manage

And really, that’s it! If you can save money into the right accounts and choose investments that meet those four simple criteria, you’ll have handled all you need to handle and will be well on your way.

Still, how do you do that?

Well, remember the research we cited above showing that index-based investment portfolios outperform professionally managed investment portfolios 80-90% of the time? There are a number of easy ways to use that information to your advantage and create, implement, and manage an index-based investment plan on your own that not only increases your odds of getting good returns, but requires minimal ongoing effort on your part.

Here are a few different ways to do it.

1. All-In-One Funds

Most investment companies now offer all-in-one funds that are essentially an entire investment portfolio in a single fund.

For example, Vanguard offers its LifeStrategy Growth Fund that looks like this:

- 48% Vanguard Total US Stock Market Index Fund
- 32% Vanguard Total International Stock Index Fund
- 14% Vanguard Total Bond Market Index Fund
- 6% Vanguard Total International Bond Index Fund

With a single fund, you get access to the entire world of stocks and bonds. You never have to worry about rebalancing, since the fund does that for you. And the total cost is only 0.15% per year.

This is as easy as it gets. Literally all you have to do is find a fund that approximates your target asset allocation, set up automatic contributions to that fund, and you're done! You've created an index-based investment strategy that requires almost no ongoing work and, according to the research, has an 80-90% chance of outperforming the professionals.

You can find more Vanguard all-in-one funds [here](#) and [here](#), and plenty of other companies offer them as well.

The big "but" here is to watch out for costs. Some of these all-in-one funds are more expensive than others, and since cost is the single best predictor of future returns, this is something you'll want to pay attention to.

### 2. Robo-Advisors

Robo-advisors are automated investment platforms that perform essentially the same role as a good all-in-one fund. They create and manage the investment portfolio for you, meaning all you really have to do is set up your contributions and let the platform do the rest.

On the plus side, the good ones make it easy to get started, give you access to a top-notch index-based investment portfolio, and cost much less than an investment professional.

On the down side, they cost a little more than using one of the best all-in-one funds. For example, Betterment currently charges a management fee of 0.15%-0.35% per year, on top of the costs of the individual funds in their investment portfolio.

All in all, the higher quality platforms like [Betterment](#) are really good, giving you access to essentially the same type of portfolio that most good investment managers have been using for years at a fraction of the cost.

### 3. DIY

Of course, you don't have to rely on someone else to do it for you. If you have a specific strategy you'd like to implement, and if there's no all-in-one fund or robo-advisor that does it, you can pick your own funds and manage it yourself.

This obviously requires more work than the options above, but it doesn't have to be much more. And anyways, the only reason to go this route is if you have a strong conviction about a particular investment philosophy, which means you probably nerd out on this stuff and are okay with a little extra work!

The good news is that going the DIY route is easier than ever. There are more low-cost index funds available than ever before, with plenty of easy and free ways to access them.
For example, you can trade Vanguard funds for free if you invest with Vanguard, and the same is true with Fidelity, Schwab, and many of the other major fund companies. And if you'd rather mix and match, many trading platforms offer a strong lineup of commission-free ETFs so you can choose the best from each investment company.

The bottom line is that once you choose your funds, which will require some up-front work, it's simply a matter of opening the accounts, automating your savings, and rebalancing once per year or so. After that initial work, it doesn't have to take you more than 15-30 minutes PER YEAR to manage.

If you’d like to go this route, here are some examples of low-cost index funds you could use to construct your portfolio. Keep in mind that these are just examples, not recommendations, and that information about these funds may have changed since the date of this writing.

**Quick note:** Vanguard always has two versions of its mutual funds: **Investor Shares** and **Admiral Shares**. I have included the Investor Shares versions below because they’re easier to access. Admiral shares require you to have $10,000 or more in the fund before you qualify, but they are also less expensive. So just know that if you invest in one of the Vanguard mutual funds and stick with it, your expense ratio will eventually decrease.

**US Stock Market Funds**

<table>
<thead>
<tr>
<th>Company</th>
<th>Fund Name</th>
<th>Ticker Symbol</th>
<th>Mutual Fund/ETF</th>
<th>Expense Ratio</th>
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<tbody>
<tr>
<td>Vanguard</td>
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<td>0.16%</td>
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<td>Total Stock Market ETF</td>
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<td>Core S&amp;P Total U.S. Stock Market ETF</td>
<td>ITOT</td>
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**International Stock Market Funds**

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<thead>
<tr>
<th>Company</th>
<th>Fund Name</th>
<th>Ticker Symbol</th>
<th>Mutual Fund/ETF</th>
<th>Expense Ratio</th>
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<tbody>
<tr>
<td>Vanguard</td>
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### US Bond Funds

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<td>Mutual Fund</td>
<td>0.20%</td>
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### International Bond Funds

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<th>Company</th>
<th>Fund Name</th>
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<tr>
<td>iShares</td>
<td>Core International Aggregate Bond ETF</td>
<td>IAGG</td>
<td>ETF</td>
<td>0.11%</td>
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</tbody>
</table>

### How to Choose Investments Within Your 401(k)

Your 401(k), or other retirement plan, is unique in that your investment choices are limited to whatever your employer has decided to include. In some cases those options may be great, but in many cases they aren’t.

Either way, you’ll have to make the most out of what’s available to you. Here’s how I would do it.

#### 1. Gather Information

Contact your Human Resources representative and ask for “a list of my 401(k) investment options and the fees associated with each”.

Sometimes this will be a one-page resource with a simple list of funds and expenses. Sometimes this will be a long document with detailed information about each fund option.

No matter what, you need to know what your options are and how much each one costs. This will make sure you have it, and you can always use a website like Morningstar to get detailed information about each fund as well.
2. Focus on Asset Allocation

When your options are limited, you may not be able to implement the exact investment strategy you’d like. For example, it’s often hard to find low-cost international stock market funds within a 401(k), which may be frustrating if that’s something you’d like to include in your plan.

So now’s a good time to remind yourself that by far the most important part of your strategy is your overall split between stocks and bonds. Whether you include international stocks and bonds or other subsets of those categories is much less important than simply getting the overall asset allocation right.

If your 401(k) allows you to implement the detailed investment strategy you want, then great! But if not, that’s okay. All you really need to worry about is finding one decent stock fund and one decent bond so that you can get that overall asset allocation right.

3. Check for Target Date Options

Most 401(k)s now offer a lineup of target date retirement funds, which are really just all-in-one funds that give you access to a wide range of investments within a single mutual fund.

These funds aren’t perfect, but they can be a good and easy way to implement your investment strategy, so this is where I would look first.

Find the target date funds in your list of investment options and check the expense ratios. If they’re reasonable (below 0.50% or so, though ideally below 0.25%), then you can keep going. If not, move on to Step 4.

What you want to do is find the target date fund that best approximates your target asset allocation. You probably won’t be able to hit it exactly, but you can likely get close.

So, how do you figure out a target date fund’s asset allocation?

First, ignore the year in the title of each fund. Those often don’t correspond to your personal investment preferences.

Second, you may be able to find each fund’s asset allocation in the document you received that lists all of your investment options. Look there first.

If you can’t find it there, you can look it up on Morningstar using the following steps:

1. Enter the fund’s ticker symbol into the Quote field at the top of the page.
2. Click on the Portfolio tab.
3. In the Asset Allocation section, add the value in the % Net column for Cash to the value in the % Net column for Bond to figure out the percentage of the fund that should count as “bond” in your asset allocation.
4. If that matches or comes close to the bond percentage of your personal asset allocation, you can feel comfortable using that target date fund.
4. Try to Find Two Reasonable Funds

If you don’t have good target date funds, you’ll have to see if you can find at least one reasonable stock fund and one reasonable bond fund so that you can match your target asset allocation.

The good news is that most 401(k)s, even the bad ones, have at least one low-cost S&P 500 index fund that you can use. So in most cases, handling the stock portion of your asset allocation should be fairly simple.

Bonds are less reliable. Look for funds with the word “index” in the title, and also look for funds with titles similar to the bond funds listed above as potential DIY options. And of course, look at the expense ratio of each fund to make sure it’s not overly expensive.

In some cases you’ll have a number of great options you can be really happy with. In other cases you may not have any. Just do the best you can with the options you have.

5. Fill out Your Portfolio Elsewhere

Remember that even if your 401(k) is filled with terrible mutual funds, it’s still worth contributing enough to get the full employer match. That’s still a better deal than you’ll find elsewhere.

Beyond that, if you don’t have a reasonable target date fund and you can’t find two low-cost mutual funds to match your target asset allocation, it’s probably best to contribute to other tax-advantaged accounts before contributing to your 401(k) above what’s necessary to get the employer match.

And remember that when it comes to hitting your target asset allocation, the real goal is to make sure that your portfolio as a whole has the right asset allocation. Each individual account can differ as long as it all adds up when you total everything across all accounts.

So if you’re in the situation of having one good S&P 500 index fund in your 401(k) and nothing else, it could make sense to put 100% of your 401(k) into that fund and fill out your bond funds elsewhere. You may or may not be able to do that depending on your balance in each account, but it’s certainly an option.

TIME FOR ACTION!

Complete the following steps before moving on to the next chapter:

1. Using the My Investments section of your Investment Plan Workbook, write down the specific investments you will choose within each of your investment accounts.

2. Remember that your primary goals are adhering to your overall stock/bond asset allocation and minimizing costs.

3. If you’re new to investing, simpler is better. And not just because it’s simpler. It’s very likely that keeping things simple will lead to better returns.
“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.

Here’s an overview of the steps you should take, and you can go back through the Action Steps throughout the guide for more detailed guidance.

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 the time to really think about 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 your goals in place, the very next task is deciding how much you’re going to save.

Go back to the calculations 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 it 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.

**9. Re-Visit Your Savings Rate Annually**

It’s a good idea to re-visit the **Financial Independence Savings Calculator** once per year to see how your savings target may or may not have changed.

And if you’re not yet hitting that full savings target, see if you can increase your overall savings rate by 1% each year. That kind of small increase probably won’t make much of a difference in your day-to-day budget, but that year-after-year increase will make a HUGE difference in the long-term.

**10. Re-Visit Your Investment Options**

The investment options in your IRA and/or taxable account likely won’t change much year to year. It’s a good idea to keep tabs on things like expense ratios, but for the most part you can be confident that the investment options you had last year will be pretty much the same as the investment options you have this year.

But within a 401(k) or HSA, there’s a much higher chance that your investment options will change from year to year.

Open enrollment is a great opportunity to revisit your 401(k) investment options. Ask again for “a list of my 401(k) investment options and the fees associated with each”. Make sure that the funds you’re currently invested in are still available. See if there are any new options that are either lower cost or better fits for your preferred strategy. If so, log into your account and make any updates needed.

It’s also a good idea to re-visit your HSA each year, since HSAs also typically have limited investment options and that lineup may change over time. You can go through the same process you did with your 401(k) to make sure you’re invested as efficiently as possible.
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.

TIME FOR ACTION!

Complete the following steps before moving on to the next chapter:

1. This entire section is a list of action steps! Follow them to get your investment plan in place.
"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 predictions, 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 it 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 09, 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 January 29, 2017 (the day I'm writing this), the stock market is up 307% overall for an annual return of 19%.

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 85% 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?

You deserve to spend your time 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.
TIME FOR ACTION!

Complete the following steps before moving on to the next chapter:

1. Review your Investment Plan Workbook. Make sure that it makes sense to you and feels like a plan you can follow through on.

2. Read the words that are written in the My Pledge section of your workbook. If you agree with them, sign and date your workbook. If relevant, ask your spouse or partner to sign it too.

3. Put the signed copy somewhere you’ll remember. Any time you feel uneasy about the stock market or you feel like tweaking something about your plan, take out this workbook and look through it. Remind yourself that you signed it as a commitment to you and your goals.

4. If your personal situation has changed, and therefore your goals or needs have changed, work on updating your plan to accommodate those changes. If not, you can stop worrying and get back to your life.
"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. And 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 any time 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, thanks again and best of luck to you and your family!
About the Author

Hi, I'm Matt Becker. I'm a fee-only CERTIFIED FINANCIAL PLANNER™ and the founder of Mom and Dad Money, where my mission is to help new parents take control of their money so they can take care of their families.

I have two young boys myself, so I know first-hand how hard it is to balance all the 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 raising kids, it can create a lot of stress, anxiety and maybe even some tension between you and your partner.

I created Mom and Dad Money to make all of that easier for you. Every day I help parents just like you to set financial goals, take control of their money, build financial security, and save for the future. I know how confusing it can be to navigate all of that yourself (my wife and I have struggled plenty 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 lives.

If you’d like someone to talk to about your money questions, I invite you to check out my pay-what-you-can Jump Start Session. It’s an hour-long planning session designed to answer your biggest financial questions so that you can make progress quickly, and because you set the price it’s available no matter your budget.

Here’s the link where you can learn more:

-> Click here to learn more about the Jump Start Session

You can also email me at matt@momanddadmoney.com and I’ll be happy to answer any questions you have.

I'm looking forward to talking to you soon!
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