Foreword by Teresa Heinz Kerry

What Women Need to Know About Retirement

A joint project of the Heinz Family Philanthropies and
The Women's Institute for a Secure Retirement

Edited by Jeffrey R. Lewis and Cindy Hounsell

Foreword

By Teresa Heinz Kerry

There is great beauty, and great valor, in every woman's struggle to leave her mark on this world. We all know the women and the stories: The bravery of a single mother juggling two jobs; the strength of a grandmother who still goes to work every day to help raise her grandchildren and save enough to one day retire; the amazing grace of our aunts and sisters and best friends fighting to overcome breast cancer or another illness. The poise of every young woman who refuses to listen to the ads and institutions that tell her she is only valuable if she is blonde, and thin, and perfect.

We must celebrate these women's stories and what they tell us—that we are not alone, and that we can change the way things are. Today, at the start of the 21st century, when a woman decides to take her finances into her own hands, and to provide for a secure and comfortable and dignified retirement, she is confronted with having to make many complicated choices and many difficult decisions. And it's not surprising, then, for a woman to feel overwhelmed, alone and on her own.

This book and its authors are here to tell all working women two important things. First: You Can Do It. Second: You Are Not Alone. We are here to share the practical wisdom gained from experiences like yours, to help you take control of your life and prepare for your retirement.

We have to help each other prepare so that you, your mother, your sister, your daughter, your best friend, won't end up like so many elderly women today who are living in poverty and despair and disrespect. Many of these same women lived comfortably before retirement. Poverty in our country has a distinctly feminine face. The largest growing segment of our population is poor, elderly women.

We shouldn't let this happen in our lives. We must take charge and have faith that in unity there is strength, in knowledge there is power, and in our action there is a future.

Over the last several decades, women across generations have knocked down barriers in the workforce. Today we are doctors and lawyers and CEOs. We build cars and ships and machines and microchips. We design new products that protect our environment and our health. We tend to the sick and cure diseases. We drive trucks in wars. We are senators and governors. We are waitresses and chefs. And at the end of the day, we are still the caretakers of every home — the glue that keeps things from spinning into chaos. When our children, our spouses, or our parents need care and caregiving, we are called on and we are there.

This is what we have accomplished together after decades of hard work. And this hard work must continue in order to achieve equal pay, pensions, and the chance to be caregivers and not be penalized for it in retirement.

Today, our retirement system still functions as if most of the workers in America were men. But with 69 million women in the workforce—and 10 million of them the sole breadwinners in their families—it is time and past time to bring our retirement policies into the 21st century.

Women must do what we do best: take charge ourselves. The question is how. How do you juggle and try to balance one more thing when you are already so heavily burdened? How do you plan for 30 years down the road when you'd be happy getting through the chaos of the day: getting the kids to school, getting to work, and getting home at night?

I hope this book provides you with some answers. They aren't quick fixes, but they will help you get on a path to economic security. I have reached out to some of the most passionate and dedicated people and asked them to focus on writing clear and comprehensive chapters about different aspects of personal finance and retirement planning.

The financial security of women is something I have cared about for more than a decade. It is very personal. After losing my first husband, John Heinz, in a plane crash in 1991, I felt overwhelmed and helpless. Fortunately, I did not have to worry about financial problems. But I began to think, "What if my circumstances had been different? There are many who feel the way I do but few who are as fortunate. What can be done for those who find hardship behind each door?" That was the beginning of a personal commitment and vision for me.

That is why, a decade ago, I established the Women's Institute for a Secure Retirement (WISER) as part of the Heinz Family Philanthropies' efforts. We have now reached millions of women with timely and practical information about their financial rights and opportunities. We continue to lead efforts in Washington to change the laws that discriminate against women and saving.

At WISER, we have learned that most people—and most women—simply don't know the facts about women and retirement. For example, women still earn only 77 cents to a full-time working man's dollar.

Two-thirds of all working women earn less than $30,000 a year in jobs without pensions. Over a lifetime, women will spend 27 years in the workforce, while men will spend almost 40 years. Because women will leave the labor force to have children and care for family members, women retirees (and only the lucky ones at that) will receive about half the pension benefits retired men can count on. This also means a smaller Social Security check for women—who often count on it for the lion's share of their retirement income. Women live longer than men, which means they have to think about extended health care and long-term care costs.

It may seem that the decks are stacked against women. But once we understand and state the obvious differences between men and women when it comes to the workforce and retirement, we can begin to fix the problems they present. You have already started to do something by picking up this book, because this book tells you what you need to know. This book will tell you what you can do to start saving, and be your map for navigating the mazes of pensions, Social Security and Medicare. And it is important to reiterate that it is still important to save, even a little, while you are paying off your student loans.

A lifetime of hard work should bring economic security and the resources to enjoy a retirement earned over many working years.

It's time to close the wage gap and enforce and strengthen anti-discrimination laws. It is time to focus on increasing retirement security for *all* Americans by increasing private savings, pension stability, and protecting Social Security. And it is time for us to get to work and rid the current system of inequities facing working women.

We all know that women are the chaos managers of our society: juggling children, spouses and work in and out of the home. And I hope that this book will provide you with the tools you need to make that juggling a little easier.

Once you begin to learn and save and work toward your own retirement goals, perhaps you will share your story with someone else you know and care for or care about. These are the stories we all look forward to hearing the most: the ones filled with grace and dignity after a lifetime of work and care. That's the story we all dream of, and together we will write it by taking charge of our own financial destinies.

And, as you read this and have a story to share, please email me (teresa@heinzoffice.org), or write me a letter in care of the Heinz Family Philanthropies, 1101 Pennsylvania Avenue, N.W., Suite 350, Washington, D.C. 20004.

Finally, let me thank and applaud the efforts of Cindy Hounsell, the President of WISER, and Jeffrey Lewis, the WISER Board chairman, for bringing this information, at no cost, to all the women, and any enlightened men, who will read it.

Teresa Heinz Kerry

Dedication

In a conversation one day, Teresa Heinz Kerry, the chairman emeritus of the Women's Institute for a Secure Retirement (WISER), challenged WISER staff to compile a book about retirement issues that would provide women with information they could readily use. She believed, as do we, that because women live longer and because they are the majority of the nation's caregivers, that it was especially important for them to know how to take control of their own retirement future—if they don't, no one else will.

WISER began in 1996 because Teresa believed that all women needed access to up-to-date and easy-to-understand information about how to take control of their own financial lives, and to learn what they could do to assure their security in their retirement years.

Teresa has supported our work annually and without her help, encouragement, and vision, WISER could not have grown to bring together the partnerships and organizations that have helped us to reach millions of women. Teresa personifies the definition of a Renaissance woman.

Along the way, award-winning Broadway producer and director, Bill Haber, heard about what we were doing and immediately sent funds to further our work.

To create this book, we brought together a group of experts from across the United States to work with us on this project—a book on women's retirement issues that would be available to all women for free. Like Teresa, these individuals contributed their many diverse talents but all shared in the belief that we can and must make a difference.

There are others who provided help—including all WISER Board members and its Advisory Council. Special appreciation goes to Wendy Button, Maudine Cooper, Vickie Elisa, Mary Murphree, Camille Murphy, Mary Pettigrew, Donna Purchase, Anna Rappaport, Alma Morales Riojas, Margaret Scott, as well as Jenny Backus, Laurel Beedon, Bill Benson, Chris Black, Jeremy Button, Bonnie Coffey, Cheryl Gannon, Frank Gannon, David Koitz, Reina Montes, Bobbi Munson, Kathy Stokes Murray, Grant Oliphant, Martha Patzer, Charles Richardson, and Cliff Shannon.

But, eight individuals stand out because of their individual and collective commitment to helping women get a hand up, not a hand out: Melinda Blinken, Jerry Hodge, Lyle Howland, Ellen Levine, Karen Judd Lewis, David E. Shaw, Billy Tauzin and Elizabeth Vale. Each is a WISER Hero.

A unique group of women stands out because of their courage of conviction, women who reminded me every day why what we are doing is so important: Jessica Catto, Judy Davenport, Lori Ferrell, Peggy Grossman, Coco Kopelman, Dominique Laffont, Wendy Mackenzie, Singer Rankin, Doris Reggie, Linda Smith, Allyn Stewart, Diana Walker, and Wren Wirth.

And Cindy Hounsell (WISER's president) who personifies how one person really can, and does, make a difference every day.

WISER's mission, our goal, our desire is easily stated but hard to achieve: We want to help reduce and ultimately eliminate the poverty of America's older women. Our success is measured by the knowledge that every day, the poor, older women who have for far too long been out of sight and out of mind in America, increasingly are being seen and served and respected.

We have made a good start. We have come far. We still have a long way to go. If you have any questions, comments or ideas, please send me an email at jlewis@heinzoffice.org, or send a letter to Jeffrey R. Lewis, Chairman, Women's Institute for a Secure Retirement, 1101 Pennsylvania Avenue, N.W., Suite 350, Washington, D.C. 20004.

And every day we draw inspiration from the memory of the late Senators John Heinz and Patrick Moynihan and Congressman Phil Burton—to whom this book is dedicated.

Jeffrey R. Lewis, Chairman

Chapter Three: Understanding Stocks, Bonds, and Investing in Financial Markets

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Even though there's a pretty good chance you have some money invested in the stock market, the charts, ticker symbols, and jargon of the financial markets can leave many of us feeling like we've gone to another planet. TV reporters spend a lot of time talking about how well the Dow did or where Treasury yields are headed … but what does it mean?

More importantly, what does it mean to you?

This chapter can't decode all the ins and outs of stocks and bonds, but it should help you with the fundamentals so you can make the right investment choices for your future.

For many people, the stock market and discussions about bonds and mutual funds make them tune out. But with the decks stacked against women when it comes to preparing for their retirement, investing is one of the best ways to make your savings go a long way.

Some people approach investing as if they were shopping for a car. Some are drawn to the flashy convertible. Some want the sedan with a few bells and whistles that will get them to and from work in comfort. And some want the sturdy old station wagon. No matter how you approach investing your retirement savings, the most important thing is to know the basics so that you can make sound financial decisions.

Nobody can predict the stock and bond markets. Generally speaking, you have to accept some risk in order to have a chance to receive some reward. If anyone promises you a very high return with little or "no" risk, be skeptical. While relatively safe investments sometimes double or even triple in value in a short time, this is a matter of luck, not a sure thing. So the more knowledge you have, the better your chances are of having your retirement savings work for you for decades after you retire.

Let's begin with the basics facts about stocks and bonds.

Stocks 101

A **stock** is a measure of ownership in a company. Stock is sold in units called **shares**, each of which represents a bit of the company. Most major companies have literally millions of shares divided up among different people and financial institutions, all of which are collectively called **shareholders**.

Because investors are constantly buying and selling their shares, the price per share (the number you see quoted when you look up a stock or see a news story about it) changes every day and sometimes minute to minute, depending on how often the stock is traded.

Think of **stock trading** as organized haggling.

Someone who wants to buy a stock makes a bid of a certain amount of money per share and announces how many shares he or she wants. Meanwhile, investors who want to sell their shares are setting the asking price that would-be buyers will have to pay; this works a lot like an asking price when someone is selling a house. There are millions of people in the market and everyone is trying to get the best deal they can, so prices can move wildly in just a few minutes.

Any number of factors can influence a company's stock price, which is where the risk factor comes in. Sometimes a company or a whole industry simply becomes fashionable or falls out of favor, like Enron and many of the dot.com Internet companies did.

Investors also tend to react strongly to new information (or even rumors) that lead them to believe that a stock price will move up or down.

New information that indicates a company is doing better than expected tends to make its stock go up, while bad news can have the opposite effect as shareholders put their stock up for sale.

Investors are especially sensitive to news that affects a company's profits because a company that is making money (a profit) instead of losing money is obviously more likely to stay in business and even thrive. Every company that has publicly traded stock is required by law to report its financial performance every three months in a **quarterly earnings report**. This report includes an estimate of how much money the company made (or lost) per share. A good report can mean good news for the stock price.

However, the reverse can happen as well, with stocks going down after a company reports good news (maybe it wasn't good enough) or up after a bit of bad luck (maybe it was better than what most people expected).

What is the Difference between a Bull Market and a Bear Market?

When demand for stocks is generally rising (pushing prices higher as the number of would-be buyers climbs), we are in a **bull market** period.

When demand for stocks falls and prices slump, we call it a **bear market**.

Both bull and bear markets can last months, years, or even decades, but nobody has found a way to reliably predict when they will begin or end. (Sad, but true.)

How Do Stocks Make (and Lose) Money?

When you own stock, you don't get interest like you would earn if you kept your money in a savings account, but certain companies do pay **dividends** to every shareholder. Dividends are the way companies distribute their profits to the investors who own them and are entitled to share in their success. The amount paid per share tends to change as

the company's profits rise and fall. This is one reason why investors watch those quarterly earnings reports so closely.
Depending on the company, dividends can be paid every quarter, once a year, or whenever the board of directors decides to distribute the profits.

Old or conservative companies like banks and utilities generally pay dividends because they no longer need to use their profits to grow or improve their operations—they've gotten about as big as they're going to get, so they might as well share the profits. Younger companies in more innovative industries like computer technology or drug research tend to skip the dividend payment and plow those profits back into their research or marketing budgets.

When these growth-dependent companies ruled the market back in the 1990s, dividends became an endangered species, but they're making a comeback now as investors return to more tried-and-true types of stocks.

The other way to make money from stocks is to sell your shares for more than you paid for them. This is the old **"buy low, sell high"** approach that you've probably heard about.

It sounds easy in theory, but it's hard to achieve consistently because nobody really knows in advance the perfect time to buy or sell. Most advisors believe that the average person is better served by simply buying quality investments (of any type) at a reasonable price and then holding onto them until she needs the money to fund retirement or for some other purpose.

Of course, what counts as a "reasonable" price depends on your investment goals and how much you're willing to pay to achieve them. The ability of stocks to become more valuable is called **capital appreciation**, and your profit (or **capital gain**) from buying low and selling high is simply the difference between the two prices. Naturally, it's possible that a stock will decline in value after you buy it, in which case you would be looking at a **capital loss** if and when you sell. Every company is different, and there's no easy way to pick a winner.

What Are the Dow, S&P, and NASDAQ?

There are about 15,000 U.S. stocks that change hands every day, but not even Wall Street professionals can keep constant track of them all. Instead, people talk about the performance of the "stock market" as a whole, and Wall Street has developed some gauges to give investors a clearer perspective on where "the market" is moving. These are the various **averages** or **indices** that people make such a big deal about when they talk about financial markets. Think of them as thermometers, except instead of measuring temperature, they tell you whether the stock market is heating up or cooling down.

The Dow Jones Industrial Average (the "Dow") is the oldest and most famous index. It is an average of the stock prices of 30 of the largest companies, each hand-picked by the editors of the company (Dow Jones) that publishes *The Wall Street Journal.* These are McDonald's, Disney, Microsoft, and other household names—big stocks like these are called **blue chips**.

Since 30 stocks is only a small sample of the very biggest multi-billion-dollar companies, the Dow doesn't always provide an especially accurate reading of where the entire market is going.

The Standard & Poor's Index of 500 Stocks (S&P 500) provides a wider sample of the market. When this index was created back in 1957, those 500 companies accounted for about 80 percent of the total value of all American stocks, and even today, this index provides a fairly accurate look at what's driving the stock market as a whole.

The Nasdaq Composite Index (Nasdaq) contains about 3,100 of the more than 4,000 stocks that are bought and sold on the electronic NASDAQ network. This is the index that included many of the most famous (and infamous) high-tech and Internet companies of the late 1990s.

There are more indexes than the "big three" that offer investors options.

The Russell 3000 brings together 3,000 stocks that account for about 92 percent of the value of the entire stock market. They trade on both the NASDAQ and **The New York Stock Exchange (NYSE).**

The Dow Wilshire 5000 index is even more extensive, covering a large percentage of the stocks traded on the major exchanges. Despite its name, the Dow Wilshire 5000 is actually made up of approximately 6,700 stocks, drawn from a wide range of small, medium, and large companies. Its goal is to track practically every publicly traded stock, so it is often called the "total" market index.

How Can You Invest in Stocks Wisely?

Now that you have an overview of what stocks are and understand some of the factors that make their prices move, it's time to start talking about how you can invest in them.

In general, most individual investors should avoid owning individual stocks, because if you bet most of your money on the health of a single company, you become vulnerable if something goes wrong with that company.

What Are Mutual Funds?

A **mutual fund** is a financial product that combines the money of many individuals like you. The company that operates the fund collects the money and keeps track of how much each person puts into the pot.

Professional investors called **fund managers** determine what to buy with the money to deliver the best returns they can find, depending on the type of mutual fund. Some funds concentrate on various types of stock, while others hold bonds (more on those in a moment).

Because most mutual funds bring together tens or even hundreds of millions of dollars, fund managers have the money to spread out among many investments such as different stocks, for example. This is an advantage because it means that as an investor in the fund, you own a small slice of each of those stocks—possibly as little as a fraction of a share, but still some real amount worth a certain amount of money.

In other words, by dividing your savings into all of these small investments, mutual funds let you **diversify** and reduce the risk that you'll lose big if one of those stocks melts down.

What Is a Stock Mutual Fund?

Unless you are willing to bet on individual stocks, funds are probably the way to go. **Stock mutual funds** will invest in individual stocks for you, while spreading your risk. You can still lose money, but it's generally less risky than choosing a single company's stock.

It would be hard to find two stock funds that are exactly alike. **Large-cap** funds invest in only the biggest companies (generally, these companies are worth tens or even hundreds of billions of dollars) while **small-cap** funds focus on smaller ones. **Mid-cap** funds, naturally enough, fall somewhere in the middle. **International** funds invest in foreign stocks; some concentrate on just a specific country. There's a whole group of **emerging markets** funds that invest in stocks from countries that have yet to develop their economies to the extent of areas like the United States, Japan or Western Europe. Specialized **sector** funds focus on a particular industry, like technology or health care. Every stock fund has its own investment approach and its own balance of risk to potential returns.

However, the main distinction you need to know is between **actively-managed** funds and their **passively-managed** (or **index**) counterparts. As their name implies, actively managed funds are run by people who take an active hand in managing their investments. These managers are constantly making decisions about which stocks to buy, which ones to sell and which ones to hang onto. When you invest your money in one of these funds, you're really betting on the managers' ability to buy the right stocks.

Index funds are considered "passive" because their managers simply buy the stocks that make up a specific market index, like the S&P 500. They don't make any active decisions on which stocks to own, and so they don't have the costs of actively-managed funds for things like research or high-powered investment advice. This translates into savings for you in terms of lower overall fees over the long run.

Even the best active manager can have a bad year, and there's no guarantee that you'll be able to pick the best manager. Over the long haul, research shows that you would generally be better off investing in index funds that follow the stock market as a whole.

The Big Secret of Stock Investing: Fees Matter

Now that you know the stock basics, you're ready for perhaps the most important information in this chapter: fees matter.

There's nothing magical about index funds. If the index they track goes up, the fund goes up with it, and you make money. If the index goes down, the fund goes down, and you lose money. Actively-managed funds tend to be a lot more expensive than index funds, and these added costs take a bite out of the money that these funds can make for you.

Every mutual fund company charges its investors an annual fee in order to cover its costs, pay its managers and other employees, and make a profit. This fee, called the **expense ratio**, varies widely from fund to fund, but is always a percentage of the money you have in a particular fund. For example, if you have $1,000 invested in a fund that carries an expense ratio of 1.83 percent, the fund company will automatically deduct $18.30 from your account.

In late 2006, the average actively-managed stock mutual fund carried an expense ratio of 1.49 percent, or $14.90 on every $1,000 you invest. On the other hand, you can find index funds that charge as little as 0.07 percent, or 70 cents on every $1,000. While performance will vary from fund to fund and from year to year, this fee gap means that, everything else being equal, your actively-managed fund has to beat the index fund by an extra 1.42 percent every year just to break even. Over the long haul, there aren't too many active managers who can do that.

If you invested $1,000 in an index fund and your friend invested the same amount in an actively-managed fund—both returning the same eight percent per year—after 10 years, you'd have $266 more than your friend because the average managed fund costs so much more than the index fund. Go back to 20 years ago, and you'd be ahead by $1,071 today.

Whether you choose an index fund or an actively-managed fund, focus on lower fees.

Many mutual fund companies also make investors pay an added fee called a **load**. There are several types of loads, but they all boil down to a sales charge or commission—again, a percentage of your investment—that you pay either to buy into a fund or sell your shares. There's no evidence that funds that charge a load do any better over the long run than those that don't, so you should definitely avoid the added fees whenever you can. There are over 2,000 no-load funds to choose from.

What Types of Index Funds Are Out There?

Just as there are several indices that track stock market activity, several varieties of index funds exist.

You can buy shares of index funds that only invest in the 30 stocks of the Dow Jones Industrial Average, but while these companies are some of the biggest and most reliable blue chips in the world, a portfolio with only 30 stocks in it isn't going to provide you with true diversification in case huge companies fall out of favor.

Instead, most investors gravitate toward S&P 500 index funds, which include 500 stocks ranging from the global giants to somewhat smaller or more specialized companies. Some of the lowest-priced mutual funds in the market are S&P 500 index funds.

If you'd like even better diversification, you can buy into index funds that invest in broader slices of the stock market, including a greater number of smaller companies in their portfolios.

Some index funds reflect the Nasdaq Composite, while others track the Russell 3000 index and still others broaden their horizons to the entire Dow Wilshire 5000 equity index, which invests in practically every major publicly traded U.S. stock.

Bonds 101

If a share of stock represents ownership in a company and its profits, a **bond** is basically a temporary loan that you make to a company, the US Treasury, or a local government entity.

Bonds are created when an organization (called the **issuer**) decides that it wants to borrow a certain sum of money from investors. As with any other loan, the issuer promises to pay the money back after a fixed period of time (a **term**) and agrees to pay the investors a fixed interest rate as well. This rate of interest, expressed as an annual percentage, is called the **coupon** rate. The total amount of debt that the issuer is taking on is then divided up into smaller chunks, each representing a fixed dollar amount of the money being borrowed (the **face value**) and sold to investors. These are the **bonds**.

At the end of the term, a bond **matures** and the issuer repays the original money borrowed. However, because you can buy or sell bonds like shares of stock, the person holding the bond at maturity may not be the original buyer. In the meantime, the issuer keeps making interest payments to the current bond owners.

How Bonds Make (and Lose) Money

Bonds are generally considered less risky than stocks for a number of reasons, but they aren't a risk-free place to invest your money. When you own an individual bond, you generally have two choices: You can buy it and hold it until it matures, or you can sell it for a profit (or a loss).

Sometimes investors decide to sell a bond before it matures. Perhaps they've found a better place to put their investment, or maybe they simply want (or need) to get their money. In this case, they may have to take a loss if they can't find a buyer willing to pay face value to buy the bond.

Of course, this process also works in reverse. If enough people want to buy your bond—because its coupon rate is higher than prevailing rates on similar types of bonds—you can sell it for more than its face value and collect a profit. This sort of active trading approach to bonds can be risky, however, and is best left to the experts.

If you follow the news from the bond market, you'll probably hear a lot of talk about how the "yields" on various types of bonds are changing from day to day. The **current yield** is simply a way to express as a percentage the interest rate a bond would actually pay if you bought it at the current market price, as opposed to the coupon rate it offered people who bought it at face value when it was first issued.

As an example, take a $1,000 bond with a coupon rate of five percent. No matter what price it trades for, it will still pay five percent of its original value, or $50 in interest a year. If, for any reason, demand for that bond increases to the point where people are paying $1,100 for it, those people would receive a current yield of that $50 interest payment divided by the current market price ($1,100), or about 4.5 percent.

The Risks of Bonds

One of the main risks of a bond is the possibility that financial trouble could make the bond's issuer unable to pay the interest or even give you back your principal as originally agreed. The issuer may even declare bankruptcy.

If this happens, the issuer **defaults** on the debt it owes you, which can make it difficult or impossible to get all of your money back. Different issuers carry different risks. The highest-quality bond issuer is the U.S. government. A superior credit rating makes Treasury bonds the safest investment in the world when it comes to default risk. Corporations, in contrast to government issuers, must depend on their revenues to repay their debt, which means that strong and large corporations will generally be considered better bond credit risks than smaller, less profitable companies. Some low-quality issuers can only offer what are called **high-yield** or **junk bonds**, which can provide high rates of interest, but also carry the risk of paying nothing at all if the issuer defaults.

Bond investors are also affected by **inflation.**

The problem here is that the interest rate bonds pay is locked in when you buy them, so if everyday prices go up too fast before the bond matures, the money you get back won't go as far as it did when you bought the bond in the first place.

Say you buy a $1,000 bond with a term of one year and a five percent coupon rate. When the bond matures, you'll have earned $50 in interest. Unfortunately, if the price of everything climbs three percent during those 12 months, your $50 only has the buying power of $48.50 in next year's dollars (this "after-inflation" value of an investment is called its **real return**). Furthermore, when you get your $1,000 back, its buying power will have shrunk also. You haven't technically lost principal, but you haven't done quite as well as it might look on paper. And if you depend on income from your bonds to pay your living expenses, you could have to cut back if faced with rising inflation.

Inflation forecasts are always changing as the market receives new information about the way prices are going. The quality of a bond can also change if something happens to make the issuer more or less able to pay its debts. New bonds are always being issued at whatever interest rate people are willing to accept in return for the loan of their money, and old bonds are always changing hands as investors look for a better deal.

How Can You Invest in Bonds Wisely?

It's generally considered a good idea to invest at least some of your retirement money in bonds. After all, bonds can provide steady income while helping to protect your principal from potential losses. However, the range of options available can be confusing.

Savings Bonds: Super-Safe Alternatives

If you want to get into bonds for a relatively small amount of money, the government still sells traditional U.S. savings bonds (now called **EE Bonds**). Savings bonds are extremely safe, but the trade-off is that they pay a fairly low interest rate, currently 3.6 percent. The minimum you need to invest in EE Bonds is $25. They're available in increments of $25 from banks, or in any amount of $25 or more (up to the annual purchase limit set by the Treasury) from www.TreasuryDirect.gov. All EE Bonds will pay monthly interest for up to 30 years, but unlike Treasury bonds, you won't be getting a check every six months—you need to cash them in (also called **redeeming** them) to get the money. You can redeem these bonds at any time after one year, but beware: If you cash in a savings bond before five years, you'll have to pay a penalty of three months' worth of interest.

Another type of savings bond that anyone can buy is Series I savings bonds—**I Bonds**, which are like traditional savings bonds with an extra shield against inflation. In late 2006, I Bonds paid 1.4 percent in interest **above inflation**, which the government re-measures every six months before announcing the new rate. If the official rate of inflation comes in at 3.1 percent (for example), new I Bonds would yield that amount plus 1.4 percent, or 4.5 percent.

Unlike EE Bonds, I Bonds are sold at face value and accumulate interest over time. You can start buying I Bonds with as little as a $50 initial investment from a bank or as little as $25 through the TreasuryDirect program. They can be cashed in any time after a year, up to 30 years after you buy them. As with EE Bonds, there's a three-month interest penalty if you cash them in before five years.

Savings bonds are non-marketable, meaning that they cannot be sold in the secondary bond market. They can only be redeemed for their current value from the Treasury or a Treasury agent (which includes most financial institutions).

Buying Individual Bonds

If you have more money to invest and can stomach a little more risk in order to get a higher return, there are a few things you need to consider. The government sells marketable securities, known as **Treasury** bills, notes, bonds, and TIPS (Treasury Inflation-Protected Securities), with maturities ranging from one month to 30 years. Treasury securities are considered among the safest in the world in terms of default risk, but tend to pay a slightly higher coupon rate compared to savings bonds or I Bonds. You can buy these in $1,000 increments from the government's TreasuryDirect.gov Web site.

You can buy them from a broker as well (see below), but it's cheaper to get them direct from the source.

To tempt investors away from the relative safety of Treasury bonds, other issuers have to offer higher coupon rates—and the riskier the issuer, the higher the rate. For example, agencies like the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") issue bonds that aren't officially backed by the U.S. Treasury, and so carry a higher coupon rate.

State and local governments also issue bonds to fund various projects, again with a somewhat higher risk of default. Most of these bonds also carry lower coupon rates than federal government bonds, however the interest on these bonds is generally exempt from federal income taxes and (in some cases) from state and local income taxes as well, which makes them more desirable to investors in high tax brackets. Generally, these bonds are not a wise choice for lower-income investors. It is important to compare returns on an after-tax basis.

Corporations and foreign governments also issue bonds. Much like people, different companies, countries, and government issuers have different credit ratings that gauge the likelihood that they'll be able to meet their debt obligations. In general, the better the credit rating, the lower the risk of something going wrong—and usually, the lower the coupon rate will be.

You can buy corporate bonds from a broker, usually in $1,000 chunks, but it can get very expensive, especially if you're only buying a few bonds at a time. Bonds purchased through brokers often include a mark-up in price that is imbedded in the transaction cost. Every broker has different rules and charges different fees; in general, expect to pay a minimum of $20 to $50 or more, depending on how many bonds you're buying. The added cost of purchase reduces the effective yield you receive on the bond.

What Is a Bond Mutual Fund?

Since most types of corporate and government bonds (with the exception of savings bonds) carry a price tag of $1,000 or more per bond, it can be hard for the average person to put together a truly diversified bond portfolio. The sheer variety of bonds available also makes it difficult to choose which ones are best for you. Should you buy a one-year bond or a 30-year bond with your $1,000? Should you buy it from the government or a corporate issuer? And if the bond is from a corporate issuer, which one should you choose?

Many mutual funds invest in bonds. Just as bonds are less risky than stocks, bond mutual funds tend to be less risky than stock mutual funds, but pay generally lower returns. There are exceptions. Junk bond funds, for example, can be as risky as many stock funds.

It is critical to understand one thing: Unlike an individual bond that you can hold until maturity, a pool of bonds has no maturity date. With a bond fund, there's no guarantee that as of a given date, you will receive your investment back. If the fund managers make bad trades, you could end up losing a lot of money.

What Are the Different Kinds of Bond Funds?

As with stock funds, fund companies have created bond funds tailored to suit many different investment interests and tax brackets. Some concentrate on bonds issued by low-risk borrowers with rock-solid credit to provide a relatively low but steady income. Others take a chance on somewhat shakier issuers (again, junk bond funds come to mind here) and hope that the high yields will make up for any defaults. Some bond funds take a long-term approach, while others will only look at short-term debt. Most bond funds invest in government or corporate bonds; these funds are also called "taxable" bond funds. Some invest only in state and local government bonds (which, remember, are generally not a wise investment for investors in low tax brackets).

Just as it is essential to consider expenses and fees when investing in stock funds, it's just as important to do so when evaluating bond funds. The average taxable bond fund charges an expense ratio of 1.1 percent; this can be a very high cost relative to the return you receive, particularly in an environment where interest rates are low. In contrast, the best bond index funds (bond funds that attempt to invest in broad market indices representing all bonds) often charge less than 0.2 percent a year.

The Big Secret of Bond Funds: Fees Matter More

Research has proven that the skill of a bond fund manager is a less reliable predictor of future performance than one simple fact: how much his or her fund charges. This is true for many of the same reasons that we've covered with stock funds, but added factors make it even more important when we're dealing with bond funds.

All other things being equal, stick with bond funds that charge the lowest fees you can find.

How Do You Choose?

With thousands of mutual funds—investing in stocks or bonds—currently on the market, you can find yourself dragged down by the sheer number of investment choices available. Even the experts have a hard time agreeing on which funds the typical person should buy. We've already seen that in the long run, fees are the critical factor. The big question is what funds are right for you?

Diversification Is Key

It all depends on the amount of risk you're willing to live with and the amount of investment income you need to live on in retirement.

For example, if you have many years left to let your money build up before you retire, and if you're willing to take a chance, you may want to put a bigger percentage of your money in stocks or other investments that offer relatively high rewards at higher levels of risk.

On the other hand, if you expect to retire in a few years and you don’t want to risk losing any savings, you’ll probably want to keep a good portion of your money in safer investments like bond funds. Your money won’t grow as fast as it would if you put everything into stock funds, but you don’t want to risk your hard-earned nest egg when you’re so close to your goal.

The other factor to consider is how much risk you can stomach. Remember, small company stocks tend to be riskier on average than blue-chip stocks.

Finding Good Advice

Many people discuss their investment choices with a financial advisor. Keep in mind that there are numerous types of advisors and many have vested interests. Stockbrokers and bank employees usually earn a commission if they sell you certain types of investment products, even if these products might not be the absolute best fit for your needs. Financial planners usually charge a fee—this is often a small percentage of your portfolio’s value, much like the expense ratio that mutual funds charge.

Sometimes, however, a planner will ask you to pay a fixed sum of money for a certain service, or will charge an hourly rate. In general, advisors who work on a “fee-only” basis have fewer conflicts of interest. This doesn’t mean advisors who charge commissions are bad; it’s just something you should be aware of.

If you decide to go it on your own, you can narrow your choice of funds with an online “screener.” This is a computer tool that researches funds based on criteria you set and produces a list based on those criteria. Many Web sites host free screening tools. For example, you could search for growth funds with no loads and an expense rate no higher than one percent. If the list is too long, add more criteria to narrow it down.

Conclusion

In the end, how well your money works for you depends on your understanding of the fundamentals. Knowing, for example, to focus on fees and avoid sales commissions will improve your returns. Understanding the risks that come with different types of investments can help you invest in a way that makes sense for your time horizon and the amount of risk you are willing to take.

No one ever said that understanding stocks, bonds and investing is easy, but it also isn’t as hard as a lot of people think. Knowledge is power, and you now have the power to take control of your financial future. So—go forth and invest!