

Where to Invest in 2009

Featured in this booklet

10 Best Companies in the World	4
The Best Funds for 2009	14
Retirees' 2009 Survival Guide	19
Clip and Save: 20 Common Investing Mistakes	24

Compliments of Morningstar Library Services

Even tough markets have opportunities. Our top analysts map out the New Year with tips for where to invest in 2009.

The past year has been unforgiving, to say the least. Dramatic market fluctuations, historic government intervention, and hard-hitting corporate failures have struck fear in the hearts of many investors.

That is why we have created the “Where to Invest in 2009” guide.

There’s never a “sure thing” in investing, but there are certainly steps you can take to make informed decisions and stack the odds in your favor. This booklet maps out what our top analysts are saying about 2009 and some decisions you can make to diversify your portfolio, create long-term wealth, and secure your future. Remember, tough markets can present opportunities.

This booklet includes insight from some of Morningstar’s top analysts, who cover:

- ▶ The 10 Best Companies in the World—Paul Larson, *Morningstar StockInvestor* Editor
- ▶ The Best Funds for 2009—Andrew Gogerty, *Morningstar Mutual Funds* Editor
- ▶ Retirees’ 2009 Survival Guide—Christine Benz, Director of Personal Finance and Editor of *Morningstar PracticalFinance*
- ▶ Clip and Save: 20 Common Investing Mistakes—Russel Kinnel, Director of Fund Research and Editor of *Morningstar FundInvestor*

This booklet is just one of the many Morningstar tools available to you. If you would like to research the particular investments discussed in this booklet or learn more about investing in general, visit your local library and log on to Morningstar Investment Research Center.

You will immediately gain access to valuable research and analysis on nearly 35,000 stocks, mutual funds, and exchange-traded funds, as well as in-depth industry data and our numerous investment-specific articles. The Morningstar Investment Research Center Portfolio X-Ray[®] tool can even help you analyze your current portfolio holdings and help you decide where you might make changes.

If your library does not subscribe to Morningstar Investment Research Center, let your librarian know that you are interested, or suggest that they request a 30-day free trial. You can even e-mail us at libraryservices@morningstar.com to find out more about the database and how you can help bring it to a library near you.

10 Best Companies in the World

By Paul Larson, Editor of
Morningstar StockInvestor

We have more than 2,000 companies in our stock coverage universe at Morningstar. Only about 9% of these companies have sustainable competitive advantages large enough to warrant our wide economic moat rating. This report whittles the list down even further to what I feel represents the very best of the best, the companies with what might be called “superwide” moats.

Let me explain why moats are so important. When a company develops a profitable product or service, it isn't long before other firms try to capitalize on that opportunity by producing a similar—if not better—version. Basic economic theory says that in a perfectly competitive market, rivals will eventually eat up any excess profits earned by a successful business. In other words, profits attract competition, and competition makes it difficult for firms to generate strong growth and earnings during an extended period. But the outlook for companies with wide moats is considerably better because they have structural barriers in place that will allow them to earn excess profits for many years.

Although we have some guidelines—most notably a return on capital that exceeds a company's cost of capital—our moat ratings are more art than science. No single figure in an annual report will tell us the width of a moat. Rather, it takes a careful qualitative analysis of the business, backed up by empirical financial evidence that excess profits are being created, to see if a company has a moat.

Not all wide-moat companies are created equal. Some sit right on the border between a wide moat

and a narrow one. If there's any doubt, we generally assign a company a narrow-moat rating because we'd rather err on the side of conservatism. On the other hand, there are some companies with such obvious competitive advantages and fantastic profitability that it doesn't take any deliberation at all to assign them wide-moat ratings. These are the components of a buy-and-hold investor's “dream team.” These firms typically increase their intrinsic value year after year, putting time and the miracle of compounding on your side.

That said, no matter how great a company is, discipline and valuation are still critical aspects of the investment process. Buying great companies when they're expensive is a recipe for mediocrity; buying them when they are cheap works very well.

So keep your eye on these wide-moat companies in 2009: Monitor their fair values and star ratings on Morningstar Investment Research Center. And if they fall into buying range, back up the truck!

Berkshire Hathaway BRK.B

For decades, Berkshire Hathaway has been a wealth-creating machine for owners. While we expect some eventual changes at the top, we still believe the conglomerate will do well by its shareholders for decades to come.

The key question surrounding Berkshire has been what will happen to the firm once longtime chairman Warren Buffett and his partner, Charlie Munger, either step aside or pass on. While it is highly unlikely that whoever succeeds this duo will be able to replicate their success—in part

because of Berkshire's massive size now—we think the model that Buffett has built will give his eventual successor a leg up on the competition.

For example, on the operating side of the business, Berkshire is run in a decentralized fashion, which obviates the need for layers of management control and pushes responsibility down to the subsidiary level, where managers are empowered to make their own decisions. To us, this makes intuitive sense, given that these managers know the most about their respective businesses. As such, we expect the bulk of the responsibility for whoever eventually takes on the CEO role will be determining incentives for each business and monitoring succession planning at the subsidiary level.

On the investing side, while it's unlikely that Buffett's eventual replacement will be able to outshine his results, we think the organization's patient culture and long-term time horizon will give this person a slight edge over peers on investing Berkshire's prodigious cash flow in equities or business acquisitions.

Regarding the latter, we think Berkshire's model of "buying forever" creates an advantage vis-a-vis private-equity firms, as many entrepreneurs seek to find a home for their life's work and often offer a buyer like Berkshire an attractive entry price, helping to boost Berkshire's long-term returns.

Today's tumultuous markets have created opportunities for Berkshire to buy assets on the cheap, in typical Buffett fashion. Through the first part of 2008, Berkshire deployed significant amounts of

cash into fixed-income securities. More recently, Berkshire's MidAmerican subsidiary agreed to purchase **Constellation Energy** CEG, and Berkshire also made a significant investment in **Goldman Sachs** GS. In each of these cases, Berkshire acted as a liquidity provider for a very good businesses in need of cash, and as such was able to extract very favorable terms.

Given these investments, we expect that Berkshire's returns will moderately increase over the next few years, which should help accelerate the conglomerate's continued wealth creation for owners.

Analyst: Justin Fuller

Chicago Mercantile Exchange CME

CME Group was formed from the merger of the Chicago Mercantile Exchange and the **Chicago Board of Trade** CBOT in 2007. It is the largest futures and options exchange in the world serving the hedging, speculation, and asset allocation needs of institutions and individuals. CME Group has been able to generate profit margins exceeding 50% for the last three years, but it's unknown if the company will be able to defend its profitability from its powerful customer base, competitors, and government regulators.

CME Group has a powerful business model that comes from the synergy of its vertically integrated clearing house, liquidity pool, and products. CME possesses its own clearing house that acts as the buyer to every seller and seller to every buyer. Having a central clearing house as the

counterparty enables the efficient offset of contracts and reduces counterparty credit risk. Consequently, the clearing house locks customers into having to deal with CME. The basic function of an exchange is to provide a locus for buyers and sellers to meet. Being the largest futures and options exchange gives CME a large self-perpetuating pool of liquidity that reduces market impact costs for customers. Even though liquidity by itself is a powerful enough force to ensure that CME keeps its customers, several of CME's products, such as futures tied to equity indexes, are based on exclusive licensing agreements, so aren't available anywhere else.

Customers, competitors, and regulators have taken notice of CME's margins and are itching for a redistribution of its economic profits. Many of its customers are investment banks and hedge funds that would benefit from lower transaction and clearing fees. To stimulate lower pricing, investment banking customers have even gone so far as to form a consortium backing the nascent **Electronic Liquidity Exchange** ELX. ELX's first product is likely to compete with the interest rate futures which comprise more than 30% of CME's daily contract volume. Other exchanges have also been eyeing CME's products. The **Intercontinental Exchange** ICE has gained exclusive licensing for futures related to Russell indexes that for years have been traded at CME. Government regulators have taken a look at the vertical integration of clearing houses and exchanges and it is a possibility that legislation could be proposed that decouples this relationship and would erode one of CME's primary competitive advantages.

The costs to run an exchange are mainly fixed, so additional revenues flow largely to the bottom line. CME Group's high degree of operating leverage is the main reason that CME's operating margins have doubled from approximately 30% in 2001 to almost 60% in 2007. It is also this leverage that made CME's merger with CBOT a logical choice and makes its proposed acquisition of the **New York Mercantile Exchange** NMX also compelling.

Analyst: Michael Wong

Fiserv FISV

Bank technology provider Fiserv benefits from its sticky customer relationships and a leading market position. We think its new focus on cost-cutting will drive some incremental improvement in its already solid performance. Also, the acquisition of CheckFree will only improve Fiserv's competitive position.

Fiserv's main business, which accounts for more than 70% of pro forma revenue (excluding pass-through items), is core processing and related products for banks. Core processing is the nuts-and-bolts system that banks need to maintain their deposit and loan accounts and to post daily transactions. Given the integral nature of core processing to their operations, banks rarely switch systems. Besides the potential for interruptions, converting to a new system would require the banks to retrain employees. Customers typically sign three- to five-year contracts and customer retention is very high, about 99% annually, excluding customers lost because of acquisitions by another bank. Its leading 34% market share gives

Fiserv an edge in this scalable business. Fiserv's sticky customer relationships and cost advantages add up to a wide economic moat, in our opinion.

Fiserv historically has been very acquisitive, completing more than 140 acquisitions since its inception in 1984. In the past, Fiserv has generally been content to leave acquired companies free to operate their business independently. However, recently CEO Jeff Yabuki has led a move to focus on cost saving through centralization. The fact that Fiserv has 68 internal e-mail systems suggests that there is plenty of low-hanging fruit. Overall, we think this change in course should create modest margin improvement.

Fiserv has also made moves recently to reposition its business. The company has been selling its nonbanking businesses and recently acquired electronic bill payment provider CheckFree in a deal valued at \$4.4 billion. We like both moves as we think the sale of its nonbanking businesses will allow the company to focus on its most attractive segment and the combination of leading positions in core processing and electronic bill payments will cement Fiserv's position as the leading bank technology provider. As the first mover into the electronic bill payment industry, CheckFree has been able to build a huge lead. This gives the company a marked cost advantage because of the scalability of the business. Furthermore, CheckFree has a big growth runway in front of it. Only about 30% of bills are currently being paid electronically, and electronic bill payment adoption is expected to double during the next five years.

Analyst: Brett Horn

Intuit INTU

Intuit is the undisputed leader in the accounting software market. The company has built a loyal customer base for its Quicken and TurboTax (personal finance and tax) and QuickBooks (small-business accounting) products, which simplify difficult and unpleasant tasks of preparing tax returns and keeping accounting records.

Intuit's franchise is protected by a wide moat based on high switching costs. Once customers become familiar with a product, the time it takes to learn a new application and to transfer data makes it uneconomical to switch to a competing product. Such switching costs lay the foundation of Intuit's competitive advantage and serve as a deterrent for new challengers.

In spite of its dominant market share, Intuit continues to get bigger. The company grows along with its 3.5 million small-business clients who buy QuickBooks upgrades as their needs become more complex. And with 600,000 new small businesses formed every year and 24 million already in existence, Intuit still has room to grow. On the TurboTax front, its potential is equally good. In 2007, TurboTax was used to file more than 21 million tax returns out of 132 million, representing only 16% of the total market. Intuit's strategy is to go after nonusers and the pen-and-pencil filers and to disrupt more expensive alternatives like the **H&R Block** HRB franchise.

The company continues to charter unknown territories. In 2006, it bought Digital Insight, a provider of online banking applications for small banks.

Through the acquisition, Intuit gained a new customer base comprising millions of online banking customers. In essence, Digital Insight has created a new channel for Intuit to distribute its products to consumers who prefer to use Internet banking to track their finances rather than buy accounting software.

Intuit's business is not without its challenges. In the TurboTax market, the company is vulnerable to Free File Alliance, a free tax-filing offering from the IRS and 20 tax software companies. This offering is available for taxpayers who make less than \$50,000 annually—70% of all the tax-filing population. Although Intuit claims that eligible Free File consumers are willing to pay for TurboTax because it saves time on data entry, Free File could curb TurboTax growth in the long run. In addition, we expect TurboTax business to decelerate given its past explosive growth and the intensifying online competition.

.....
Analyst: Morningstar Analysts

Johnson & Johnson JNJ

Johnson & Johnson stands alone as a leader across the major health-care industries. The company maintains a diverse revenue base, a robust research pipeline, and exceptional cash-flow generation that together create a wide economic moat. Patent losses on antipsychotic Risperdal and neuroscience drug Topamax, as well as recent side-effect concerns with anemia drug Procrit, will weigh on near-term performance. However, we remain confident that the company's breadth can overcome these issues.

Johnson & Johnson holds a leadership role in diverse health-care segments, including medical devices, over-the-counter medicines, and several pharmaceutical markets. Contributing approximately 40% of total revenue, the pharmaceutical division boasts several industry-leading drugs, including rheumatoid arthritis drug Remicade. The medical device and diagnostics group brings in more than 33% of sales, with the company holding controlling positions in many areas, including DePuy's orthopedics and Ethicon Endo-Surgery's surgical devices. The consumer division largely rounds out the remaining business lines. The recent acquisition of **Pfizer's** PFE consumer business further solidified Johnson & Johnson's position in this market.

In addition to the existing product lines, research and development efforts are resulting in next-generation products. The pharmaceutical group has a robust late-stage product pipeline with more than 10 potential blockbusters in Phase III development. The company has also created new medical devices, including ceramic orthopedics and minimally invasive surgical tools.

These multiple business lines generate substantial cash flow. Johnson & Johnson's healthy free cash flow (operating cash flow less capital expenditures) is close to 20% of sales. Strong cash generation has enabled the firm to increase its dividend for the past 44 years, and we expect this to continue. It also allows Johnson & Johnson to take advantage of acquisition opportunities that will augment growth.

Diverse operating segments, coupled with expected new products insulate Johnson & Johnson from the research and development cycle facing the pharmaceutical group. While the company faces more than \$6.3 billion (10% of sales) in patent exposure through 2009, we project strong growth from the remaining business lines to offset these losses and yield slight growth over the next two years. After 2009, the company's patent exposure is greatly reduced, setting Johnson & Johnson up for steady growth.

.....
Analyst: Damien Conover, CFA

MasterCard MA

MasterCard operates the second-largest open-loop card network in the world. The firm's clients are financial institutions that issue MasterCard cards to their clients and process card transactions. When a cardholder swipes a MasterCard card, the merchant transfers the card information with the transaction details to an acquirer—a transaction processor such as First Data, which services merchants by connecting them to the card network. MasterCard then facilitates the authorization, clearing, and settlement of the transaction and charges different fees for each processed transaction. In addition, MasterCard also charges card issuers assessments for the right to issue its cards.

We think that connecting thousands of financial institutions through a card network garners MasterCard a wide economic moat. MasterCard has contracts with thousands of issuers around the world that offer its cards to their customers. For issuers, switching from one card network

to another is costly, and the incentives aren't that high. On the merchant's side, merchant acquirers have an interest in acquiring as many transactions as possible and have no incentives to stop acquiring MasterCard's cards. Merchants cannot afford to reject MasterCard because of the potential loss of sales. MasterCard invests heavily in its brand to ensure that spending on its cards continues. With its "Priceless" marketing campaign, the brand is now better recognized globally and cardholders all over the world know they can shop with it anywhere.

With all these competitive advantages, we think that MasterCard is one of the few companies that is set to benefit from the global trend of moving away from cash and checks toward electronic forms of payment, including cards. We believe this shift, along with increased acceptance of cards for almost any type of payment, paints a picture of a very fertile field of long-term growth for MasterCard.

MasterCard's Achilles' heel is its legal problems. Most of the lawsuits against the firm relate to alleged anticompetitive behavior by the firm in prior years. Another problem is regulators scrutinizing the interchange fee, set by MasterCard, that is paid by merchants to card issuers. We have incorporated a reserve for future legal liabilities in our valuation, and we are monitoring developments on the legal front.

We are also watching very carefully the change in the competitive dynamics in this sector in the United States. **American Express** AXP and

Discover Financial DFS are changing their business models in order to take market share from MasterCard and **Visa V**. At this point, we don't model dramatic drops in MasterCard's volumes in the U.S., but we will monitor the situation and adjust our expectations pending any new information.

.....
Analyst: Michael Kon, CFA

McCormick MKC

McCormick's dominant scale and command over the spice and seasoning market make for a wide economic moat.

McCormick controls at least half of the market for spices and seasonings in North America and is more than twice the size of its next-largest branded competitor. With leading brands such as McCormick, Lawry's, and Old Bay, the company has sustained solid sales growth and profitability in its category. Over time, the company has introduced new products on top of its trademark brands while maintaining its value-added focus on flavor. At the end of 2007, about 10% of sales were from products introduced in the last three years, and the bulk of consumer sales came from value-added products, such as grinders and unique ethnic seasoning.

McCormick is able to dominate the spice and seasoning market because of one of the biggest problems facing consumer packaged-goods companies: private labels. Many consumers choose the less expensive private-label offerings. However, McCormick is also the largest producer

of private-label spices and seasonings in North America. This allows it to limit the threat posed by private labels, ensuring that no other company gains enough scale in this segment to significantly affect the pricing of McCormick's branded offerings.

McCormick also dominates in the industrial business and is a leading supplier to the largest multinational packaged food, beverage, and restaurant companies. McCormick is one of only a handful of global firms that has expertise across all flavor disciplines, making it a one-stop shop for packaged-food companies and restaurant chains looking for new flavors or textures to add to their products.

To spur sales growth, McCormick has looked to product innovation and acquisitions. The company is revitalizing its U.S. spice business with contemporary labels, new flip-top caps, and gravity-fed merchandising systems, which have improved product awareness and sales. McCormick also acquired Thai Kitchen and Simply Asia in 2006, both of which are well-positioned in the fast-growing Asian packaged-foods category. Additionally, the company recently purchased Lawry's, its only real remaining competitor in the spice and seasoning aisle. We wouldn't be surprised to see more acquisitions, especially as **Kraft Foods** KFT is rumored to be shopping some of its smaller brands that may interest McCormick, such as the A.1. steak sauce brand and Grey Poupon mustard.

.....
Analyst: Ann Gilpin

Microsoft MSFT

Microsoft's traditional software businesses are firing on all cylinders, but the advent of Web-based software will pose a significant challenge for the firm in the decade ahead.

Although Microsoft has ventured into other markets, the majority of its revenue and profits still flow from three exceptional businesses: Windows, Office, and Server & Tools. These three segments accounted for roughly 80% of Microsoft's \$60 billion of revenue in fiscal 2008. While we think Microsoft's competitive position is very defensible, due to the powerful network effects associated with an almost universally adopted operating system, it is not unassailable. The disruptive change presented by the software-as-a-service (SaaS) model has the potential to slowly erode Microsoft's moat.

In the SaaS world, software is delivered on-demand over the Internet and paid for with traditional licenses, subscription fees, or even advertising. The success of **Salesforce.com** CRM is a prime example of the allure of SaaS to enterprise customers, and **Google** GOOG is beginning to build a credible Web-based competitor to Office. Microsoft is acutely aware of the threats and opportunities posed by what Bill Gates has called the "coming services wave," and the firm is willing to sacrifice near-term profitability to address it. We think this is absolutely the right decision. The industry is changing, and if Microsoft does not adapt, its competitive advantages will one day disappear.

SaaS brings a new set of challenges, but we believe Microsoft is one of the few firms with the resources to get in the game. The infrastructure cost required to provision SaaS on a large scale will total in the billions, and this will be a significant barrier to entry. On the other hand, to succeed in a Web-based world, Microsoft must build businesses whose sole strategic mission is to destroy the cash cows of Windows and Office. Microsoft has thus far been reluctant to fully embrace the services model. Instead, it prefers a "software plus services" approach that helps protect its legacy franchises in desktop software.

We have become more concerned with Microsoft's capital allocation in late 2008 because of the **Yahoo** YHOO imbroglio. We believe an outright acquisition of Yahoo would be an unmitigated disaster. If Microsoft wishes to deploy its cash hoard, we think shareholders would be better served if potential acquisitions complimented Microsoft's core strengths. For example, an acquisition of **SAP** SAP (enterprise software) or **Research in Motion** RIMM (mobile platform development) would be much more sensible.

Analyst: Toan Tran

Procter & Gamble PG

Procter & Gamble built its moat with product development and marketing, but the firm's strengths go beyond skills in brand building. The company consistently reinvents itself and refocuses on improving its capabilities where it sees opportunity. In 2000, after years of brand underperformance, P&G renewed its focus on rebuilding

core brands like Olay and Crest. As these brands were enjoying a resurgence, the firm acquired Gillette in 2005, adding new brands to the fold, and boosting P&G's global reach and top-line growth rate.

Now, after successfully integrating Gillette, the firm has directed its efforts on improving productivity. Given rising manufacturing input costs, these initiatives couldn't come at a better time.

P&G is the largest consumer products manufacturer in the world, with 24 brands that each earn more than \$1 billion in sales. The company's products range from household staple brands like Charmin, to personal care products such as Old Spice, prescription drug brands like Actonel, prestige fragrances, and health-care products.

The company's leading brand positions allow it to be a price leader in its categories and give P&G unparalleled marketing firepower when competitors like **Colgate CL** or **Kimberly-Clark KMB** take aim. Perhaps most important is that P&G's broad lineup of brands bring balance to the company and give it a baseline of relatively consistent, predictable growth.

With so many brands and such tremendous global reach, it would be easy for the firm to become bloated with unnecessary overhead, but it is clear that management has its eye trained on controlling costs. The firm estimates that since 1980, productivity has improved 6% annually, based on metrics such as sales per employee. P&G's management believes it can improve productivity to 7% or

8% annually by putting strict controls on overhead growth, depending on what stage of development a business unit is in. Businesses that are growing below target levels, for example, must show declining overhead.

The renewed focus on productivity is undoubtedly warranted after absorbing Gillette, and at a time of rising input costs and a pullback in consumer spending, P&G is wise to squeeze any costs out of the system. The risk, however, is that the firm neglects its brands or doesn't support them as much as it should. With some of its core beauty-care brands like Pantene showing weakness in U.S. markets, this concern isn't insignificant. Knowing P&G, however, we doubt the firm will go off the rails with its productivity efforts, and we take comfort in the fact that the company has always been able to strengthen itself over time.

Analyst: Lauren DeSanto

Strayer Education STRA

Strayer Education is one of the better-performing companies in the for-profit education industry. Along with its regional accreditation, its focus on working adults has helped the company establish a wide economic moat in our opinion. Excellent management, good growth opportunities, and some of the best operating margins in the industry put Strayer at the top of its class.

With strict regulatory barriers to entry, government-aided financing, and a limited amount of competitors focusing on adult education, Strayer deserves a wide moat rating. Strayer's schools

are all regionally accredited, a level of accreditation that is more valuable and more difficult to obtain than national accreditation. It makes transfer credit more likely to be accepted at traditional universities.

Accreditation is a difficult and time-consuming process and makes government loans available to students. These loans are a crucial part of revenue for any school, and without them it would be hard to operate in the industry. The availability of these loans as well as corporate tuition assistance limit the immediate out-of-pocket costs that students incur and have helped Strayer raise tuition 5% annually, with little pushback from customers.

By focusing on working adults, Strayer has been able to grow in both strong and weak economic environments. Education tends to be counter-cyclical, and enrollment growth typically decreases during stronger economic times. However, Strayer is more acyclical than some of its competitors. Unlike for-profit schools that focus on diploma and certificate programs, Strayer's students are older and are enrolled in undergraduate and graduate courses. In good economic times these types of students are less prone to choose employment over schooling. Strayer's focus on online programs gives working adults the flexibility they need to work and pursue a degree at the same time.

With roughly 25% geographic penetration throughout the 50 states, Strayer has plenty of opportunities for growth. Its roughly 37,000 students represent only a small fraction of the more than 17 million students enrolled in higher education.

Recently, Strayer has been adding around eight campuses a year, but it still operates physical campuses in only 13 states. Adding physical campuses as well as additional online students has helped fuel an average 18% annual enrollment growth during the last five years, even as some competitors have seen declines.

Due to many competitive advantages, Strayer has been able to raise tuition and at the same time increase enrollments at a rate well above the industry average. With a low penetration rate and a focus on working adults, Strayer is positioned to outperform going forward.

Analyst: Todd Young

The Best Funds for 2009

By Andrew Gogerty, Editor of
Morningstar Mutual Funds

If 2007 was a stressful year for investors, then 2008 has been a sucker-punch to the stomach. The credit crisis stemming from the default of sub-prime mortgages continued its spread this year, and in effect caused a complete upheaval of U.S. investment-banking landscape. Who would have thought that Lehman Brothers and Bear Stearns would no longer exist, and that Merrill Lynch's MER survival would likely depend on ceding a 20% ownership stake to a Japanese bank? The financial sector's troubles bled through to all areas of the market, as concerns about the future profile of global credit access and stability of money market funds sent both stocks and bonds on a roller coaster ride. In fact, in a 30-day span during September and October, investors were subject to both the biggest one-day gain of the Dow Jones Industrial Average and one of its worst losses since the Great Depression.

The gyrations have pummeled investor confidence, and the industry has seen outflows from money market and equity funds as investors headed for the safety of cash. For the short run that may appear prudent, but for the long run now may be a great buying opportunity. Just like fund managers who salivate at the prospect of buying individual stocks below their fair value estimates, the market's broad declines have put on sale whole portfolios of high-quality holdings. While the losses this year made many investors re-examine their risk tolerances, I urge them to continue to invest in high-quality, lower-cost funds in line with their personal asset-allocation targets. That is truly the way to build long-term wealth.

With that advice in mind, I've divided the following list into three sections. The Portfolio Anchors are no-hassle ways to begin a new portfolio or leading candidates for a prominent spot during a reallocation. Our Opportunity Hounds have the guts to wade into downtrodden areas and pick out gems, while our Role Players are: a few additional funds that can round out the edges of your portfolio. These picks may look to zig when the rest of your funds zag but at the same time will still contribute to long term total returns. I'm not saying that these funds will be top-performers on a year-in, year-out basis, but over the longer term of five years or more I think they will come out on top.

Portfolio Anchors

Fairholme FAIRX

This fund has suffered right along with the rest of our picks in 2008. Through October 13, its 22% decline was likely of little comfort to investors, despite being well ahead of the more than 30% decline of the S&P 500 Index and large-blend category. But one year doesn't shake our confidence in manager Bruce Berkowitz and team, and we appreciate that he believes that the key to a fund's success is finding management teams that are serial winners with whom the fund can partner for the long haul. Fund investors who take the same approach won't be disappointed here, as the fund's long term returns are among the best around. The fund is positioned relatively conservatively, with an almost constant double-digit cash stake. Turnover is excruciatingly low, and the portfolio typically contains fewer than 30 holdings. Berkowitz's focus on cash—both as an investment and in evaluating management—has keyed the

fund's outperformance this year. Although the portfolio has had upwards of 30% of assets in the financial sector this year, he sidestepped disasters such as insurer American International Group and investment bank Lehman Brothers because he was concerned with the companies' exposure to derivatives and the estimates they make when valuing large portions of their assets. If his team can't understand how a firm gets its cash, or what is behind its balance sheet, the fund will gladly take a pass. I like this approach and have made this fund the largest holding in my portfolio.

T. Rowe Price Blue Chip Growth TRBCX

A broadly diversified large-cap portfolio typically keeps this fund out of too much trouble. In 2007, for example, strong showings from **Amazon.com** AMZN, **Apple** AAPL, and others outweighed disappointing performances from **Goldman Sachs** GS, **UBS** UBS, and other financials. We like the fund's steady approach, and we like manager Larry Puglia's long track record. He's led the effort here for almost 15 years, so he's seen his share of extreme market environments. Investors looking for a large-growth offering that doesn't go to the extremes will like what they find here.

Fidelity Spartan Total Market Index FSTMX

The U.S. market has been quite the disaster this year, but over the long term this fund will likely remain a legitimate rival to higher-priced, actively managed large cap funds. This fund tracks the Wilshire 5000 Index, which includes nearly all of the publicly traded stocks in the United States. That profile gives it unparalleled breadth and

makes it an ideal choice as an anchor or stand-alone U.S. equity holding. Vanguard, of course, has a suite of topnotch index funds, including a total stock market index offering like this one. Fidelity upped the ante in the index-fund fee wars, however, by permanently reducing the costs of this and four other domestic-equity index funds to just 0.10%. That makes Fidelity's index offerings the cheapest nonexchange-traded funds around.

Sound Shore SSHFX

Managers Harry Burn and Gibbs Kane largely avoided subprime problems by sticking to their knitting of seeking out beaten-down firms with solid fundamentals. They have no interest in finding the turnaround stories with the potential for the greatest gains if there's a real risk the company could fail. Rather, they want the companies with the best balance sheets and a high level of confidence of what a company will earn in the next few years. Their patient and careful strategy has helped the fund deliver solid long-term results, and its year-to-year returns have also been remarkably consistent, with the fund ranking in the large-value category's best half in six of the past seven years. We wouldn't expect the latter to continue, especially during a growth-fueled rally, but the fund is in position to remain a winner over time.

Vanguard GNMA

How can we recommend a mortgage fund when the mortgage universe has come under such fire? Easily. For starters, it holds a diversified mix of Ginnie Mae mortgages, which, unlike other mortgage issues, are backed by the full faith and credit

of the U.S. government and have been for some time. Second, its ultralow expense ratio provides it a nearly insurmountable advantage over its government-focused peers. The fund's expense advantage has helped it post strong long-term results, while its focus on government mortgages has kept it out of trouble. Its focus is narrow, but we think it has broad appeal.

Dodge & Cox International DODFX

This offering has quickly emerged as one of the standouts in its class. That's because it draws upon a highly experienced management team. The typical skipper here has nearly two decades of experience at Dodge & Cox, and several members of this fund's management team also serve as managers on the superb **Dodge & Cox Stock DODGX**. As with the other Dodge & Cox funds, the managers apply a patient, bargain-hunting approach here. (The fund's turnover rate is invariably in the single digits, and its portfolio's price multiples are low relative to other value-oriented foreign funds.) We're not surprised by the fund's consistent success and that it has gotten off to a strong start—Morningstar named this fund's management team its International-Stock Managers of the Year for 2004—and we think its future prospects remain equally bright. In addition to having an experienced management team plying a time-tested strategy, the fund also has the benefit of very low costs: Its 0.65% expense ratio is one of the cheapest levies for a no-load, foreign large-cap offering. Like the U.S. market, foreign stock markets have been weighed down by global credit concerns and overall slower growth, but

international exposure still remains a core foundation to any well-constructed portfolio.

Opportunity Hounds

Third Avenue Value TAVFX

Marty Whitman (like all of our picks in this section) made our list last year, and we continue to think he is one of the better bargain-hunters around. He has been known to bulk up on junk bonds, small-cap stocks, overseas issues, or nearly any other investment type that he sees as cheap. That flexibility can make this fund hard to slot into an asset-allocation plan, but it means the fund has the potential to deliver good results in a variety of market conditions. Indeed, the fund delivered strong results in 2000, when the market struggled, but also put up big numbers from 2003 to 2006, when the market rallied. We also like the fund's quarterly shareholder letters, which keep investors very informed about what Whitman is buying and selling, and why.

Primecap Aggressive Growth POAGX

This fund's approach can cause some ups and downs, but it's a proven one that has been in place for almost 10 years at **Vanguard Capital Opportunity VHCOX**. When management finds cheap, out-of-favor growth stocks it will look to take advantage of them, even if owning them means holding outsized stakes in specific sectors of the market. This fund's smaller asset base allows it to be flexible and opportunistic, in that management can build up meaningful positions quickly and exit just as fast. That's not to say the team trades rapidly. In fact, the fund has

one of the lowest turnover rates in the mid-growth category.

Loomis Sayles Bond LSBDX

Managers Dan Fuss and Kathleen Gaffney have more latitude than most to take advantage of market volatility. The duo will venture into junk bonds, emerging markets issues, government bonds, and currency in an effort to deliver superior results. Fuss and Gaffney also position the fund based on their interest-rate outlook. Added interest-rate sensitivity and added credit risk make this fund a risky option for bond investors, but market volatility means opportunity for Fuss and Gaffney. The fund has dug itself somewhat of a hole in 2008 with its stakes in corporate and high-yield bonds, but over the long term we think investors comfortable with its potential for ups and downs will continue to like what they find here.

Metropolitan West Total Return MWTRX

The management team at Met West has been tracking subprime mortgages in earnest since 2004. That homework helped them largely avoid the problems associated with the sector in 2007, and they used their research heft to emphasize residential-housing related fare—prime and subprime—given high yields, significant total-return potential, and good protection from actual loan losses in 2008. To be sure, management was on the other side of the table in 2002, when it was caught off guard by extreme volatility in the corporate-bond sector. However, good bottom up research helped the fund recover the ground it lost during the market's subsequent rally. We

expect that research will again pay off for shareholders here going forward.

Role Players

T. Rowe Price Real Estate TRREX

Manager David Lee just celebrated his 10-year anniversary as lead skipper on this offering, and his experience, combined with the fund's low fees, increases its odds of staying ahead of the pack. Lee doesn't have an army of analysts behind him but has managed to beat them nonetheless. More importantly, this fund shares the broader T. Rowe Price philosophy of long-term investing. In fact, the fund has been one of the most consistent offerings in the category, and its expenses have come down as assets have grown. So, while we don't expect real estate funds to be a ray of hope in every down market, their diversification value makes adding exposure to this sector a no-brainer.

Vanguard Inflation-Protected Securities VIPSX

This fund's appeal is more narrow, but it has a number of valuable traits, including rock-bottom fees. Its primary asset, however, is its ability to defend against inflation by holding U.S. Treasury Inflation-Protected Securities, commonly called TIPS. These securities have a fixed coupon rate, but their principal value adjusts based on changes in the consumer price index. As this principal is revised upward, the bonds pay more interest to bondholders. To be sure, the fund isn't immune to interest-rate risk, but overall we think it can play an important role within a broadly diversified portfolio.

Brandywine BRWIX

Manager Bill D'Alonzo's go-anywhere portfolio can play a suitable supporting role within a portfolio dominated by large-cap stocks. His team focuses on identifying companies that they believe will beat the next round of earnings estimates. But rather than just evaluating the business prospects and financial statements, D'Alonzo's analysts work the phones and contact suppliers, customers, and competitors to get the full picture of a company's potential. The results have been good thus far and its returns haven't been closely correlated with those of the S&P 500 Index. We remain fans of this unique approach and continue to expect good things from this fund in the years ahead.

Retirees' 2009 Survival Guide

By Christine Benz
Director of Personal Finance
and Editor of
Morningstar PracticalFinance

With the market schizophrenia we endured during 2008, I've been fielding a lot of reporter calls about what people should do. It's a cliché to tell investors not to panic, but that's pretty much the only one-size-fits-all directive. Beyond that, your response to the tumult depends completely upon where you are in your investing life.

For younger investors with long time horizons, the buy-and-hold, ride-it-out mantra makes all the sense in the world. I don't know when the market will turn around—no one does—but I do know that periods of market panic have usually proved to be fertile ground for investors with the willpower to hold tight or even add more amid the tumult. If you have a longer time horizon, standing pat in stocks and stock funds truly is the right answer, because stocks offer the best growth prospects over longer periods of time and you're certainly better off buying them at a low ebb than at high tide.

For those investors approaching or already in retirement, however, the calculus is completely different. Encountering a bear market during retirement—particularly during the early years—can be devastating for those with stock-heavy portfolios. A recent study by T. Rowe Price showed that encountering poor market performance or outright losses in the first five years of retirement significantly increases the chance of an individual outliving his or her money during a 30-year retirement period. The reason is pretty straightforward: Just as starting investing later in life reduces the benefits of compounding, so does locking in losses early in your retirement career stymie your port-

folio's future growth. (Encountering a bear market in years six through 10 of one's retirement is injurious, but far less so than sustaining big losses in the first five years of retirement, according to T. Rowe.)

So what should you do if you're retired or getting ready to retire amid the current market upset? Here are some tips. (Hint: Moving everything into ultrasafe investments isn't the answer.)

Tips for Those Already Retired

Reduce Withdrawal Rates

In its study, T. Rowe Price assumed a retired individual had a \$500,000 portfolio composed of 55% stocks and 45% bonds. It further assumed the individual was taking withdrawals that amounted to 4% of assets per year, then increasing the withdrawal amount by 3% per annum to account for inflation. (The 4% withdrawal rate with inflation adjustment is a fairly standard rule of thumb to ensure that one doesn't outlive one's portfolio; the basic logic is that even a fairly conservative portfolio can earn enough to support withdrawals at that level.) T. Rowe then examined a variety of actions that the same retiree might have taken in re-sponse to the bear market earlier this decade. Which of those actions would most help the portfolio last throughout a subsequent 20-plus-year retirement period?

The firm found that reducing one's withdrawal rate by 25%, from 4% to 3%, following the bear market in late 2002 gave the hypothetical portfolio its best shot of lasting for the rest of the individual's retirement, based on the firm's projections of future

market returns. By leaving more assets to work in the market rather than withdrawing them, the portfolio had a much better shot at recouping its bear-market losses. Once the individual's portfolio had recovered to a level where it had a high probability of lasting throughout retirement—in this case, in 2008—the individual could again raise the withdrawal rate.

In the above scenario, the individual would reduce his or her withdrawal rate from 4% to 3% but still increase the 3% each year to account for inflation. (So in this example, the individual would withdraw 3% of his or her investment portfolio in 2003, then 3.03% in 2004, and so on.)

Even so, reducing one's withdrawal rate by 25% may not be realistic for many retirees, even with the inflation adjustment. Although inflation appears to be cooling, there's no denying that a number of household expenses, notably food, gas, and home heating costs, have risen substantially over the past few years. Moreover, many retirees want to spend the most in their early retirement years, for travel, leisure pursuits, and gifting to children and grandchildren. For those for whom a 25% reduction in withdrawal rates isn't realistic, T. Rowe's analysis found that holding withdrawals steady at 4%, but then forgoing the subsequent annual inflation adjustment (rather than adjusting the withdrawals upward by 3% to account for inflation) also helped improve the odds that the retirement portfolio would last throughout retirement.

To further explore your own optimal withdrawal rate, I'd suggest you check out T. Rowe's free Retirement Income Calculator at <http://www.troweprice.com/ric>. You can input your own variables, such as your age, your approximate asset allocation, and your current or desired withdrawal rate. The calculator will then show you the likelihood that your assets will last throughout your retirement, based on the firm's projected returns for various asset classes and expected life spans for you and your spouse. If there appears to be a risk that you'll outlive your assets, you can tinker with the variables, such as adding more to equities or reducing your withdrawal rate, to arrive at a better outcome. Ideally, you'll be able to arrive at a livable withdrawal rate and your portfolio will have a 75% or better chance of lasting throughout your expected retirement years.

Don't Get Too Conservative

At the opposite extreme, the T. Rowe study found that the worst response to the bear market would have been to shift out of stocks entirely and move all of one's assets into bonds following a bear market. The reason is that the portfolio, having incurred the full wrath of the bear market, would be starved of its growth prospects and therefore less likely to last throughout an individual's retirement years. That's a compelling argument that one's gut reaction to a bear market—to hunker down in ultrasafe investments—is often a counterproductive response.

Watch Where Your Withdrawals Come From

While we're on the topic of locking in losses, retirees should consider where they're withdrawing

assets from—particularly during and after a bear market. Rather than tapping the assets in your equity accounts, make sure you're pulling your assets from short-term, cashlike instruments. That way you won't turn the paper losses in your equity accounts into real losses; you can give your stocks and stock funds time to rebound.

For most individuals who are withdrawing assets in retirement, I'd recommend creating a "pool" of short-term, cashlike assets that will cover two to five years' worth of expenses. You can take periodic distributions from the pool, then "fill it up" as you deplete it. Unlike equities, these short-term assets will exhibit little if any fluctuation in principal value, so there's little risk of pulling your money out when your account is at a low ebb.

That said, there's a broad variation in short-term, supposedly "safe" investments, so it pays to select with care. The situation last year with a large money market fund "breaking the buck"—or letting its net asset value drop below \$1—exemplifies the perils of gunning for a very high yield with your short-term investments. Any time you see a fund with a far higher yield than its peer group, it pays to ask what types of risks the fund is taking to achieve it. The Reserve Primary Fund (which broke the buck) had the highest 12-month yield of any money fund in Morningstar's database, fueled in part by stakes in securities issued by financial companies like Lehman Brothers.

In the wake of this news, the Treasury in mid-September 2008 rolled out a plan to guarantee money market funds against losses of up to \$50

billion, at least temporarily, assuming the investor deposited funds before September 19. That's a reassuring safeguard, but I still think it wise to do your own due diligence on your cash investments. One option is to stick with FDIC-insured investments, such as savings accounts, checking accounts, money market accounts, or CDs. Just make sure you don't hold more than \$250,000 per individual at any one firm: The government recently increased the FDIC insurance limit to \$250,000 until the end of 2009. If you do venture into money market funds, which are not FDIC-insured but may offer a more attractive yield than CDs or FDIC-insured instruments, focus on those with the lowest possible expense ratios—ideally 0.40% or less.

Sequence Withdrawals Properly

To further improve your portfolio's chances of lasting throughout your retirement, take care to use a well-thought-out sequence for tapping your various accounts. Although there are certainly variations, most individuals will want to tap their taxable assets first, followed by traditional IRAs and company retirement-plan assets, then tapping Roth assets last. To the extent that you own securities that have appreciated in your taxable accounts—and I hope that you do—take care to limit taxes by offsetting capital gains with capital losses.

Don't Be a Yield Hog

If your portfolio has taken a hit, it's natural to want to hang on to what you've got, and that's especially true if you're already retired. One way to do that is to increase your portfolio's income stream so that you won't have to tap your capital. That's not

unreasonable—to a point. Gunning for yield without paying due attention to the risks you’re taking on is one of the biggest investing pitfalls out there. My colleague John Coumarios recently shared an old Wall Street saying with me: “More money has been lost chasing yield than at the point of a gun.” That may be hyperbole, but only partly so. Because the highest-yielding stocks and bonds often also entail outsized risks, make sure you’re going in with your eyes wide open. If you pocket a high yield but the security declines in price, you could end up worse off than if you had focused on total return and made periodic withdrawals of your principal.

If you’re venturing beyond Treasury bonds, don’t try to select individual bonds on your own. (If the past few years have taught us anything, it’s that a bond’s credit rating doesn’t always offer a lot of insight into a company’s health.) Instead, delegate bond-picking to a professional money manager; bond funds from Vanguard, Harbor, Dodge & Cox, and Metropolitan West are among my favorites. If you’re buying individual stocks for yield, make sure to do your homework to ensure that a company has the financial wherewithal to keep up its dividend payments. Stock Analyst Reports on Morningstar Investment Research Center are a great way to get your arms around the health of a company. Morningstar’s analysts currently have a number of blue-chip stocks that land in 4- and 5-star territory and boast rich yields. Most mutual funds that focus on dividend-paying stocks have fairly low yields because their expense ratios gobble up all of their income, but one I particularly like is **Vanguard Equity-Income** VEIPX.

Tips for Preretirees

Play a Good Defense

For preretirees facing down a bear market in retirement, the best offense is a good defense. I frequently chat with individuals who are nearing retirement but still have close to 100% of their assets in stocks. On the one hand, stocks are the best way to reduce the risk that you’ll outlive your assets. On the other, by holding a portfolio that’s too heavy on stocks as retirement nears, you could run headlong into a bear market, thereby reducing the odds that your portfolio will last throughout your retirement years.

As retirement grows closer, it pays to not only build up your exposure to bonds and other more stable-investments but also begin to alter the types of stocks and stock funds that you hold. As we saw in 2008, the value style of investing isn’t inherently lower risk than growth investing. However, it stands to reason that a valuation-conscious approach that allows for a margin of safety will help limit losses more than a growth-at-any-price approach. Among my favorite core stock funds for investors approaching retirement are **Dodge & Cox Stock** DODGX, **Dodge & Cox Balanced** DODBX, **Sequoia** SEQUX, and **Lionleaf Partners** LLPFX, all of which have reopened to investors over the past year.

You can also reduce your bear-market risk by trimming or cutting niche investments such as sector and regional funds and exchange-traded funds. Because of their extreme volatility and investors’ tendency to buy and sell them at inopportune times, I tend not to be a big fan of these

investments even for those with very long time horizons; these vehicles are even less appropriate for those nearing or in retirement. Another preemptive move is to reduce your international exposure as retirement nears. I'm as big a believer in global growth as the next person, but international investing typically entails a risk that's completely out of your control: currency risk, or the chance that the dollar will depreciate versus the currency in which your foreign holdings are denominated. For that reason, I'd argue for scaling back foreign stocks and stock funds once you're within five years of your expected retirement date.

Evaluate Your Options

But what if you're nearing retirement and the recent bear market has already exacted a toll? That's almost as painful a predicament as someone who is already retired would face, but not quite. You can take heart in the fact that you have more options to consider than the individual who has already begun taking distributions from his or her retirement nest egg.

Whereas reducing withdrawal rates may be the best course of action for the already-retired, a pre-retiree facing down a bear market has several different options to consider. You, too, could reduce your anticipated withdrawal rate. But you could also plan to work longer, defer Social Security, save more, and/or adjust your portfolio in an effort to achieve a higher return. Again, I'd recommend T. Rowe Price's Retirement Income Calculator (<http://www.troweprice.com/ric>) because it's easy to use and allows you to see how adjusting these variables would affect your stan-

dard of living in retirement and the odds that your portfolio will last.

A version of this article appeared in the September 2008 issue of *Morningstar PracticalFinance*.

Clip and Save: 20 Common Investing Mistakes

Russel Kinnel,
Director of Fund Research
and Editor
of *Morningstar FundInvestor*

I talk with investors almost every day, and over time the same themes emerge. Although investors cover the gamut of sophistication levels, I hear the same mistakes over and over again. So, in order to help save you from repeating the same mistakes and losing a lot of money to learn the lessons, I've jotted down 20 of the most common investing mistakes.

Most come down to two basic types of errors. One error is to let emotions get the better of you. I'm amazed at the logical reasons people build to justify making the investments that make them feel better even if in the long run they'll be poorer for having done it. The second error is to not build a plan and think things through. As one planner told me, "People don't know what they bought or why they bought it."

Mistake 1 | Reacting to short-term returns.

Every day people go to their online 401(k) accounts and sell the fund with the worst one-year returns and buy the one with the best one-year returns. It makes them feel better, and they will tell you that their new fund is ahead of the curve and run by a smart manager and the old one has lost its touch. What they won't say is that they are buying high and selling low. Nor will they say that short-term returns are just noise. You are better off buying funds with lagging short-term performance than those with top-quartile returns.

Mistake 2 | Basing sell decision on cost basis.

You bought fund A at \$10 and now its NAV is at \$5 and fund B at \$10 and now it's at \$20. Which should you hold, and which should you sell? I have

no idea. The amount you paid is relevant only to tax planning. What matters is which will have better returns over your investment horizon. If the answer is fund B, then sell fund A (you'll have a tax benefit if it's in a taxable account) and put the proceeds in fund B. The problem is that people have an emotional attachment to the price. Some are afraid to book losses, and others are too anxious to sell a winner for fear that they'll miss out on gains. What matters is whether the funds have strong fundamentals.

Mistake 3 | Selling after the market falls.

The short-term direction of the stock market is unpredictable; yet selling in reaction to market moves implies that you can predict short-term moves. What we fail to account for is that the market's price in the same news that we are hearing—often before we hear it. The markets are not perfectly efficient from minute to minute but they quickly reflect a best guess based on new information. Fear is one of the greatest enemies of successful investing. When you're worried about your money, you want to make it safe. However, you risk missing out on the next rally, and you might not even keep pace with inflation. From a long-term perspective, cash is very risky and stocks are low-risk. Put another way, this is another example of selling low and buying high. Savvy investors get excited when the market is oversold; you should, too.

Mistake 4 | Accumulating too many niche funds.

We get mailings all the time telling us about hot new investments. Last year, commodity funds and BRIC (Brazil, Russia, India, and China) funds

were the rage. Next year it will be something else. These specialist funds are exciting and fun to buy but they will mess up your portfolio if you let them. Most niche funds charge more than more-diversified funds, and they typically have third-tier managers and less analyst support. Yet you can get the same exposure to sectors and regions through more-diversified funds. Niche funds drive up your costs, add extra volatility, and make managing your portfolio more difficult.

Mistake 5 | Failing to build an overall plan.

This is a biggie. Spend a little time to spell out your goals, how you'll meet them, and the role of each investment. This is an enormous help in figuring out how to get to your goals and how to adapt along the way. Make a little plan, and your day-to-day investment decisions will become easier and less stressful.

Mistake 6 | Failing to write down your reasons for buying and selling.

Once you've got your plan, spell out why you own each investment and what would lead you to sell. For example, you could say that you own **Fairholme FAIRX** as a long-term 20-year investment for its manager and its low costs. You'd sell if the manager left, costs were raised, or asset bloat forced a change in strategy. When you have your doubts about the fund, you can turn to that document in four years when you may well have forgotten what the draw was in the first place.

Mistake 7 | Ignoring costs.

Expense ratios matter across the board. Most of the best managers work for low-cost funds. So,

don't listen to the siren song of a high-cost mutual fund or hedge fund. Results won't live up to expectations. Expense ratios are the best predictor of future performance.

Mistake 8 | Making things needlessly complex.

This one comes courtesy of Christine Benz, editor of *Morningstar PersonalFinance*: Wall Street works overtime to sell the message that investing is complicated, messy stuff that you couldn't possibly undertake on your own. Is it any wonder that so many investors are paralyzed with fear and indecision?

True enough, there are a handful of investors who have delivered tremendous returns by using swashbuckling investment strategies and zooming in and out of arcane investments. For the rest of us mortals, though, buying and holding a portfolio composed of plain-vanilla stocks and bonds—with perhaps a dash of a “diversifier” such as commodities or real estate—is more than adequate to help us reach our goals. That's also the kind of portfolio that you can easily manage yourself. By building a sturdy, streamlined portfolio, you'll have fewer moving parts to monitor.

Mistake 9 | Not understanding the risks.

Narrowly focusing on recent returns can blind investors to risks. If a fund has a long track record, you can easily get a handle on risk by looking at annual returns. In a bad year, the stock market can lose 30%. In a bad three-year period, it can lose 60%. It's reasonable to assume that nearly any stock fund can do at least that badly. This is why stocks are for 10- or 20-year time horizons

or longer. If you know that going in, you stand a much better chance of earning a healthy return. Most bond funds can lose 5% or 10% in a year. If they have long maturity or own mostly junk-quality bonds, you can double those losses or more.

Mistake 10 | Not diversifying properly.

The harsh market in 2008 punished financials the most while energy has done best. Large growth got crushed in 2000–02, and small-value stocks as well as bonds held up like champs. Every down period is different, so be sure to diversify between stocks and bonds, between foreign and domestic, and among sectors. The key to that is to have meaningful exposure to a lot of areas and to build up your core.

Mistake 11 | Not saving enough.

I'd encourage you to preach the benefits of early saving to relatives and friends in their 20s or 30s. If they make regular contributions to their 401(k) and IRA accounts, reaching their goals will be quite manageable. If they don't, they better make a killing or they'll be behind the 8 ball.

Mistake 12 | Failing to rebalance.

My 401(k) plan has a tool that automatically rebalances my investments for me. When the markets really move, your portfolio can go off-kilter and mess up your nicely laid plan. Rebalance yearly so that you'll be buying low and selling high.

Mistake 13 | Failing to factor taxes into portfolio decisions.

Like expenses, taxes play a huge role in your long-term success, but they're no fun. So, a lot of

people ignore them in the hopes that their funds will make such big returns that taxes won't matter. There's a better way to think about it. Simply putting less-efficient investments in tax-sheltered accounts and more-efficient ones in taxable accounts will pay off in a big way. In addition, when you're shopping for a new fund for a taxable account be sure to look for those that should be efficient, such as tax-managed funds, index funds, low-turnover actively managed funds, and, of course, municipal-bond funds.

Mistake 14 | Not building up a sufficient money market position.

Christine Benz recommends that you have six to 12 months' worth of living expenses in a money market account. As the messes in short-term bond funds and auction-rate securities show, there's no substitute for money market funds. This emergency stash is vital in case you lose your job or have another emergency, such as unexpected home repairs. In addition, it will make market downturns less stressful.

Mistake 15 | Ignoring costs in money market funds.

Many fund companies and brokerages charge high expenses on money market funds because investors don't pay attention. So, go with Vanguard or Fidelity or someone else who charges less than 40 basis points to manage your cash.

Mistake 16 | Failing to look at the big picture across accounts.

Roger Ibbotson argues: Investors tend to view each investment and each account—401(k), IRA,

college-savings account, etc.—in isolation rather than in aggregate. Trying to make every investment a winner can throw off the overarching asset allocation. It can also lead an investor to chase hot stocks, trade excessively, and sell at the wrong time. If all of an investor's accounts and individual investments are up at the same time, they should be alarmed rather than proud. It's a sign that they may be underdiversified and taking on too much risk.

Mistake 17 | Misreading your own abilities.

People who treat gambling addicts say that it's the big winning bet that hooks gamblers. They get high and want to repeat that high. Fund investors can be a little like that. They remember that one time they accurately called the direction of the market or picked a sector fund and forget all the times their calls were off. Go back over your past investments and see what you do well and figure out a solution to the areas where you didn't do well. Maybe your individual stock picks aren't that great overseas, so you should buy a foreign fund. Maybe your bond fund blew up, so you should change the way you pick bond funds and tone down the risk.

Mistake 18 | Focusing on the fund instead of the manager.

I exchanged e-mails with a customer recently who didn't understand why **Clipper** CFMIMX was a pick despite its bad five-year returns. I explained that the current managers have been there for only two years and their long-term record is outstanding. The fact that previous managers did well or poorly is rarely relevant unless it reflects institutional

strength or weakness. **Fidelity Independence** FDIFFX has a great record, but so what? The current manager started in 2007.

Mistake 19 | Ignoring the fund company behind the fund.

You may like a fund, but if the fund company has mostly lousy investors, a bad record of sticking it to fundholders, or both, you may pay the price in the end. Over a long time horizon bad things happen to good funds at bad fund companies. Hancock Regional Bank was once a diamond among dross, but the parent company pushed it down the tubes. John Hancock's penny-pinching deprived the fund of sufficient support.

Mistake 20 | Worrying about daily ups and downs.

Don't get stressed watching business TV or tracking the market online. It's exciting and often informative but not always helpful for long-term investors. Reporting on the markets, whether in print or on TV, requires putting a lot of experts on to make predictions. If they were honest and said they didn't know what would happen the next week but that you should buy and hold, no one would watch. All those ups and downs have no bearing on your long-term goals. Warren Buffett advocates buying stocks that you feel so strongly about you wouldn't care if the stock market took a two-year holiday. The same goes for funds. Buy them and tune out the noise.

A version of this article appeared in the September 2008 issue of *Morningstar FundInvestor*.



22 West Washington
Chicago
Illinois 60602

For more information about Morningstar Investment
Research Center and our other library products, please
contact Morningstar Library Services.

Phone: 866-215-2509

E-mail: libraryservices@morningstar.com