

A Beginner's guide to investing

Introduction to Investing

- Investing is the process of allocating money into assets with the expectation of generating a profit or income over time.
- Unlike saving, which typically involves keeping money in a low-risk account such as a savings account with modest interest, investing puts money into markets or assets that have potential to grow, sometimes significantly, but with added risk.
- Investing matters because of three main reasons:
 - (1) inflation erodes the value of money, and investing helps outpace inflation
 - (2) investing enables individuals to build wealth for large goals such as education, buying a home, or retirement
 - (3) investing provides opportunities to reach financial independence.
- The concept of time value of money underpins investing.
 - A dollar today is worth more than a dollar tomorrow because it can be invested to earn returns.
 - For example, if you invest \$100 at a 7% return, after 10 years it grows to nearly \$200. This compounding growth effect demonstrates why investing is powerful.
- Investing is not only for the wealthy
 - With fractional shares and low-cost index funds, beginners can start small.
 - By cultivating discipline and long-term perspective, ordinary people can turn modest savings into life-changing amounts.
- Key distinctions: saving is for short-term safety, investing is for long-term growth. Both are necessary, but investing builds wealth.

Risk and Reward

- All investments involve a trade-off between risk and reward.
 - Risk is the uncertainty of outcomes, including the chance of losing money.
 - Reward is the potential gain from taking on that risk.
- Types of risk include:
 - market risk (prices fluctuate with economic changes)
 - Inflation risk (cash loses purchasing power)
 - Credit risk (bond issuers may default)
 - Liquidity risk (difficulty selling quickly at fair value).
- Risk tolerance varies.

- A 20-year-old might accept higher risk by investing mostly in stocks since they have decades to recover losses, while a retiree may prefer bonds or CDs for stability.
- Risk capacity also depends on income, assets, and obligations.
- The relationship between risk and reward is direct:
 - High-risk investments (like startups or emerging market stocks) may generate high returns, but also high losses.
 - Low-risk investments (like U.S. Treasury bonds) provide safety but limited returns.
- Diversification, asset allocation, and understanding one's own psychology are critical in balancing risk and reward effectively.

Types of Investments

- Investments can be grouped into several broad categories.
- Stocks represent ownership in a company.
 - They are volatile but historically provide the highest long-term returns.
 - Investors may benefit from capital appreciation and dividends.
- Bonds are debt instruments.
 - Investors lend money to governments or corporations in exchange for periodic interest and return of principal.
 - Bonds are safer than stocks but offer lower returns.
- Mutual funds pool money from many investors to buy diversified portfolios of stocks, bonds, or other securities.
- They are managed by professionals but often carry higher fees.
- Exchange-Traded Funds (ETFs) are similar but trade like stocks and usually have lower costs.
- Real estate includes direct property ownership or investing through Real Estate Investment Trusts (REITs).
 - Real estate generates rental income and potential appreciation.
- Alternative investments include commodities (gold, oil), hedge funds, private equity, and cryptocurrency.
 - They can hedge against inflation but involve higher complexity and risk.
- Beginners are often advised to start with broad-market ETFs or index funds, which are low-cost, diversified, and easy to manage.

Diversification

- Diversification is the practice of spreading investments across different assets, industries, or geographies to reduce risk.
- The idea is that when one investment performs poorly, another may perform well, balancing the portfolio.
- Modern Portfolio Theory (MPT), developed by Harry Markowitz, formalized diversification. It shows that combining assets with low correlation can reduce overall portfolio risk without necessarily reducing expected returns.
- *Go look at my research paper on “Interventions of Modern Portfolio Theory and Behavioral Portfolio Theory”!!!*
 - For example, stocks and bonds often move differently: when stocks fall in a recession, bonds may rise as investors seek safety.
 - Holding both smooths returns over time.
- Practical diversification involves investing in a mix of domestic and international stocks, government and corporate bonds, and possibly alternative assets.
- ETFs make diversification accessible by allowing one purchase to spread across hundreds of companies.
 - An example diversified portfolio for a young investor might be 70% global stock ETFs, 20% bond ETFs, and 10% REITs. Adjustments can be made over time as risk tolerance changes.

Long-Term Strategies

- Successful investors adopt long-term strategies.
- Buy-and-hold involves purchasing quality investments and holding them for decades, ignoring short-term volatility.
- Research shows that time in the market beats timing the market.
- Dollar-cost averaging (DCA) is investing a fixed amount regularly regardless of price.
- It reduces the impact of volatility by buying more shares when prices are low and fewer when high.
- Index fund investing involves buying funds that track broad markets like the S&P 500
- They offer diversification, low fees, and strong historical performance.
 - Many experts, including Warren Buffett, recommend them for most people.
- Compounding magnifies long-term investing. For instance, investing \$200/month at 8% annual return grows to over \$600,000 in 40 years.
 - Patience and consistency are the keys. Long-term strategies require resisting the temptation to chase trends or panic during downturns.

Short-Term vs Long-Term Investing

- Short-term investing, such as day trading, aims to profit from price movements over days or weeks.
 - While potentially lucrative, it requires skill, time, and tolerance for risk.
 - Most short-term traders underperform.
- Long-term investing, on the other hand, involves holding assets for years or decades.
 - Historical data shows that long-term investors in broad markets generally succeed, despite short-term volatility.
- Short-term trading carries high transaction costs and tax burdens. Emotional stress can also lead to poor decisions.
- Long-term investors benefit from compounding, lower costs, and reduced stress.
 - For most individuals, focusing on long-term goals like retirement or buying a home makes more sense than short-term speculation.

Behavioral Investing

- Behavioral investing studies how psychology affects financial decisions.
 - Investors are not always rational; emotions like fear and greed often drive actions.
- Common mistakes include panic selling during downturns, buying high in excitement, and overconfidence.
 - Confirmation bias, loss aversion, and herd mentality also distort decisions.
- To combat these, investors should: create written investment plans, automate contributions, rebalance portfolios periodically, and avoid checking markets obsessively.
- Behavioral finance highlights the importance of discipline and awareness of one's biases.
 - Understanding these tendencies can help investors avoid costly mistakes and stick to long-term strategies.

Retirement Accounts & Tax Advantages

- Retirement accounts in the U.S. provide powerful tax benefits.
- 401(k) plans are employer-sponsored and often include matching contributions.
 - This is essentially free money and should be maximized when available.
- Individual Retirement Accounts (IRAs) come in two main forms.
 - Traditional IRAs allow tax-deductible contributions, while withdrawals in retirement are taxed.
 - Roth IRAs use after-tax contributions but allow tax-free withdrawals.
- These accounts enable compounding to work more effectively by minimizing taxes.

- For example, contributing \$5,000/year to a Roth IRA growing at 8% results in over \$600,000 tax-free after 35 years.
- Other vehicles include 403(b) for educators and 457 plans for government employees.
 - Health Savings Accounts (HSAs) can also function as investment vehicles with triple tax benefits.
- Starting early with retirement accounts maximizes long-term growth and security.

Building Your First Portfolio

- Building a portfolio requires thoughtful planning.
 - Steps include: defining goals (education, home, retirement), assessing risk tolerance, deciding asset allocation, and choosing specific investments.
- A young investor with high risk tolerance might choose 80% stock ETFs and 20% bond ETFs.
 - Someone older or risk-averse may choose 60% bonds and 40% stocks.
- Low-cost index funds or ETFs are preferable to high-fee mutual funds.
 - Rebalancing periodically (e.g., annually) ensures the portfolio stays aligned with goals.
- Diversification across regions (U.S., international) and asset types (stocks, bonds, real estate) adds resilience.
 - The portfolio should evolve as goals and risk tolerance change.

Tips, Red Flags, and Next Steps

- Key tips: start investing early, contribute regularly, and keep costs low.
 - Avoid chasing trends, timing the market, or investing in things you don't understand.
- Red flags include promises of guaranteed high returns, pressure to act quickly, and investments that lack transparency.
 - If it sounds too good to be true, it usually is.
- Next steps: practice with paper trading or simulation apps, open an account with a trusted broker, and continue learning through books, podcasts, or financial courses.
 - Building financial literacy is a lifelong journey.
- Investing is not about getting rich quick but about achieving long-term financial independence and security.
- By applying consistent strategies and avoiding emotional pitfalls, anyone can become a successful investor.