Costing

Making Smart Investments: A Beginner's Guide

by Matthew Blume

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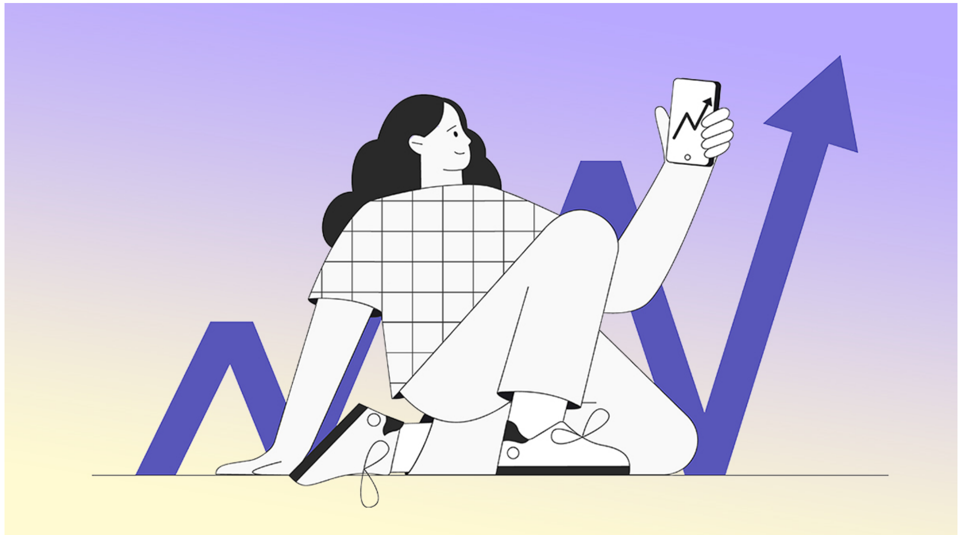

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Summary. If you make smart decisions and invest in the right places, you can reduce the risk factor, increase the reward factor, and generate meaningful returns. Here are a few questions to consider as you get started. Why should you invest? At a minimum, investing allows... **more**

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Are you a saver or spender?

If you went with the former, then you're in the majority. According to a 2019 Charles Schwab survey, around 59% of Americans said they considered themselves savers. Compare that to more recent findings, however, and you'll see that 63% of respondents in a similar demographic are currently living paycheck to paycheck.

Clearly, there's a disconnect between the financial goals we are setting and the steps we are taking to realize them.

Many of us are taught from a young age that saving is the most direct path to building wealth and achieving financial freedom. But this is a myth. While saving is key in the pursuit of both goals, making smart investments with your money makes them much more attainable.

The fear that stops most people from investing is a reasonable one: financial loss as opposed to financial gain. When we work hard and are disciplined enough to forgo consumption and save, the idea of losing our hard-earned dollars understandably makes us uncomfortable. As a result, we tuck our money away in an FDIC-insured bank account.

Here's the problem: The money we put into our accounts is *almost guaranteed* to lose value. The low interest rates that savings accounts offer can't even keep pace with inflation, meaning our money's purchasing power decreases the longer we save.

There is some good news, though. If you make smart decisions and invest in the right places, you can reduce the risk factor, increase the reward factor, and generate meaningful returns without feeling like you'd be better off in Vegas.

Here are a few questions to consider as you get started.

Why should you invest?

Saving versus investing is an oft-heard debate in financial circles. But they're two sides of the same coin.

When building wealth, saving is an indispensable part of the financial toolbox — not because it produces wealth on its own, but because it provides the capital necessary *to* invest. At a minimum, investing allows you to keep pace with cost-of-living increases created by inflation. At a maximum, the major benefit of a long-term investment strategy is the possibility of compounding interest, or growth earned on growth.

How much should you save vs. invest?

Given that each investor enters the market because of unique circumstances, the best answer to how much you should save is "as much as possible." As a guideline, saving 20% of your income is the right starting place. More is always better, but I believe that 20% allows you to accumulate a meaningful amount of capital throughout your career.

Initially, you'll want to allocate these savings to building an emergency fund equal to roughly three to six months' worth of ordinary expenses. Once you've socked away these emergency savings, invest additional funds that aren't being put toward specific near-term expenses.

Invested wisely — and over a long period — this capital can multiply.

How do investments work?

Understanding the market: In the finance world, the market is a term used to describe the place where you can buy and sell shares of stocks, bonds, and other assets. To enter the market, don't use your bank account.

You need to open an investment account, like a brokerage account, which you fund with cash that you can then use to buy stocks, bonds, and other investable assets. Big-name firms like Schwab or Fidelity will let you do this similarly to how you'd open a bank account.

Stocks vs. bonds: Publicly traded companies use the market to raise money for their operations, growth, or expansion by issuing stocks (small pieces of ownership of the company) or bonds (debt).

When a company issues bonds on the market, they are basically asking investors for loans to raise money for their organization. Investors buy the bonds, then the company pays them back, plus a percentage of interest, over time.

Stocks, on the other hand, are small pieces of equity in a company. When a company goes from private to public, its stock can be publicly bought and sold on the market — meaning it is no longer privately owned. A stock price is generally reflective of the value of the company, but the actual price is determined by what market participants are willing to pay or accept on any given day.

Other Types of Investments

You’re not limited to stocks and bonds, though. You can buy commodities, precious metals, investment real estate, or ...

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Stocks are considered riskier investments than bonds because of this price volatility. If bad news comes out about a company, people may want to pay less to buy shares than they did before, which will lower the stock price. If you bought the stock for a large sum of money, you risk losing that money if the stock price drops.

Stocks are also riskier because when companies go bankrupt, bondholders receive their money back — stockholders have no such guarantee.

Making (and losing) money: In the market, you make or lose money depending on the purchase and sale price of whatever you buy. If you buy a stock at $10 and sell it at $15, you make $5. If you buy at $15 and sell at $10, you lose $5. Gains and losses are only “realized” or counted when you make the sale of the asset — so the stock you bought at $10 could drop to $6, but you’ll only “lose” the $4 if you sell the stock at $6. Maybe you wait a year and then sell the stock when it’s up to $11, thereby gaining $1 per share.

Are you investing reasonably?

Now that you understand how investing works, it’s time to think about where you want to put your money. As a rule of thumb, remember that the best risk an investor can take is a calculated one.

But how can you be calculated? How can you distinguish a smart investment from a risky investment? Truthfully, "smart" and "risky" are relative to every investor. Your circumstances (e.g., age, amount of debt, family status) or risk tolerance can help you identify where you fall on the risk spectrum.

In general, younger investors with many years before retirement should have riskier portfolios. That longer time horizon gives investors more years to weather the ups and downs of the market — and during their working years, investors are ideally just adding to their investment accounts rather than taking money out.

Someone at or near retirement, however, is much more vulnerable to changes in the market. If you use an investment account to cover your living expenses, you could be forced to take that money out of the account during a downturn in the market, which would not only shrink your portfolio but also could ensure significant investment losses.

A higher-risk portfolio would likely encompass a significant number of stocks and fewer (if any) bonds. As young investors grow older and need to reduce the risk in their portfolios, they should reduce their investment in stocks and increase their investment in bonds.

The ebb and flow of life will influence your investments more than you may realize. Being realistic about your current financial prospects will keep you clearheaded about where to invest your money.

Are you building wealth that lasts?

Larger-than-average returns almost always require you to take larger-than-average risks, and there are no free lunches in investing**.** As you work to build wealth and secure your financial future, stay focused on three long-term investment musts:

Build a "just in case" nest egg: Nearly one-quarter of Americans have no emergency savings. Don't let yourself get caught in that trap. Retirement savings accounts are critical savings vehicles, but tapping into them before retirement typically brings steep tax penalties. To prevent this from happening, build an emergency fund — as described earlier — that amounts to roughly three to six months of your living expenses.

One of the most significant things you can do for your financial future is to make saving automatic — that is, have your bank automatically direct a portion of your paycheck into an account specifically for saving. This ensures you save consistently instead of forcing you to make an active choice to set money aside.

This sum should stay somewhere with low risk like a bank account, and it should remain liquid (i.e., cash or something else that's always available to you) to ensure you can access it if you ever need it. Once you've established an emergency fund, invest future savings based on your risk tolerance.

Steer savings in the right direction: Generally, you'll want to start by deciding what percentage of your assets you want to be in riskier assets (stocks/shares) and what percentage you want in safer assets (cash and bonds). This depends on your risk tolerance, as outlined above. Somebody young and working should be almost all in stocks, while somebody near retirement age should have a healthier allocation to bonds.

If you're just starting to invest, I believe you should look at mutual funds or ETFs (i.e., a collection of stocks, bonds, and other investment vehicles) rather than individual stocks (i.e., ownership in only one company) because it will be easier to create a diversified account using funds if the account in question is small.

Diversification (owning a variety of assets) is important because it lessens the chance that your whole portfolio will lose value in a market downturn. You'll want to find funds with solid track records and reasonable fees; plenty of popular press and dedicated research sites like Morningstar or Yahoo Finance will provide this information.

When you're ready to start investing in individual stocks, you'll want to do the same kind of research on any companies you consider: Do they have good track records? Do they have good management? Is the stock price reasonable? Does it add diversification to your portfolio, or is it similar to what you already hold? Spend some time on this step to ensure you're making informed investment choices.

Make variety a theme of your investments: Diversifying across your entire investment "portfolio" (i.e., all of the investments you hold) is critical to building wealth because it allows you to manage risk more effectively. Stocks are one of the most talked-about investments, but you wouldn't want to tie your entire financial future to the success of a single company — or even any broader market.

Depending on your financial circumstances and risk tolerance, you might want to consider investing in private equity, venture capital, precious metals, commodities, and real estate, all of which are available on the market. All these investments can be effective means to achieve portfolio diversification and manage risk.

Why? Because they rely on different underlying drivers. This means they generally operate in ways that are uncorrelated with each other and with more traditional investments like stocks and bonds, so they may be going up when stocks are going down.

A well-constructed portfolio should include several different types of assets (meaning stocks, bonds, etc.) that do not move in tandem. This reduces the volatility of a portfolio without necessarily lowering its return potential.

While these steps alone will not guarantee you complete financial independence, I believe they're a great starting point. They can help you amass savings, achieve portfolio diversification, and empower you to start building wealth for a better financial future.

Editor's Note: The opinions expressed here are for general informational purposes only. It is important to do your own research and analysis before making any financial decisions. We recommend speaking to an independent advisor if you are unsure how to proceed.

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Matthew Blume is a portfolio manager of private client accounts at Pekin Hardy Strauss Wealth Management. He also manages the firm's ESG research and shareholder advocacy efforts. He earned a B.S. in electrical engineering from Valparaiso University and an MBA from Northwestern University's Kellogg School of Management. Matthew is a CFA charterholder.