The Best Ways to Invest $5,000

Where should you invest your money for the greatest return? Financial experts break down your options.

Before putting your money in investments such as index funds or mutual funds, you should consider paying down debt and stashing away some money for retirement.

By Stephanie Steinberg | April 10, 2014, at 6:28 a.m.

You've padded your emergency fund, paid off your debt and saved up a few thousand dollars – $5,000 to be exact – that you're ready to invest. But is it best to put it in a mutual fund, certificate of deposit, index fund or exchange-traded fund?

"If you're asking what's the best way to invest $5,000, it's kind of like asking what should I have for dinner tonight? Well, it depends," says Greg McBride, chief financial analyst of Bankrate. "What do you like? What don't you like? Do you have any allergies? What are you in the mood for? The same thing [applies] here."

Before you get to specifics, such as how much risk you can stomach or what to choose off the menu of investments, start with the basics.

"The first question you need to ask yourself is, 'When do I need to spend that money?'" says Manisha Thakor, founder and CEO of MoneyZen Wealth Management. "My rule of thumb is investing is something you do for the long run, which I would define as a minimum of five years and ideally 10-plus years. Once you are sure it's long-term money, now you're ready to really get into the nuts and bolts."

To help you delve into those nuts and bolts, we asked financial experts for advice on the best way to invest your $5,000. They suggested options for both the short and long term, if you're hoping to grow that money for retirement decades down the road.

[See: U.S. News Financial Advisor Finder.]

Short term

Online savings account. The best place for money you need in a moment's notice is an online savings account, McBride says. Even though interest rates for online savings accounts are low – hovering around 1 percent – they "pay the best returns relative to the savings account offers among all the financial institutions," he says. The returns currently compare to those of CDs, but without the early withdrawal penalties.

CDs and money market accounts. If your time horizon is less than five years, Thakor recommends putting the money in a CD with a maturity date that matches your goal. This option may be ideal if you have a low risk tolerance, since CDs are insured by the Federal Deposit Insurance Corp. up to $250,000 per depositor. The downside? You can't touch those dollars for a predetermined time without paying a penalty.

Alternatively, money market accounts, which are also insured by the FDIC, earn slightly less interest than CDs, but you can withdraw the money at any point. Just keep in mind that interest rates are generally inversely correlated with access to your money. As Thakor puts it: "If you want unlimited access to your money, you'll get slightly lower rates. If you don't mind tying it up for a defined period of time, which is what you do with a CD, then you can get a slightly higher rate."

Given their low yields, CDs and money market accounts are better for shorter-term investments, since they don't always keep up with the cost of inflation. "Even though on paper it might look like you're protecting your principal and [your] deposit is growing a little bit in value, you're actually losing ground because the purchasing power is not holding," says Paul Granucci, a financial solutions advisor with Merrill Edge.

[Read: How to Invest Your First $1,000.]

Long term

Actively managed mutual funds. Investors with a longer time horizon can afford to take on more risk for a greater return by putting their money in the stock market. Mutual funds offer an easy way for investors to gain exposure to a broad range of stocks. If picking stocks makes you nervous, fear not. With actively managed funds, a fund manager makes all the decisions for you, including what sectors of the economy to invest in and which companies are undervalued or poised for growth. But beware: Mutual funds come with fees. The average actively managed stock fund charges an annual fee of 1.26 percent, according to fund tracker Morningstar, and Thakor advises against buying mutual funds with an expense ratio of more than 1 percent.

If you do go the actively managed route, Granucci recommends a globally balanced mutual fund, which is diversified in stocks, bonds and cash and contains domestic and international investments.

Index funds. "If the goal is to try to achieve a lot of diversification and build a portfolio that you can more or less kind of set and forget, it's hard to beat index funds," says Christine Benz, director of personal finance for Morningstar.

With index funds, you don't have the opportunity to beat the market, but you can keep up with the market, "which is not a bad place to be given that most active fund managers do not outperform their benchmarks over long periods of time," Benz adds.

Thakor points out that index funds are the healthiest option on the menu – without organic food prices. "Index funds are the financial equivalent of a superfood like chia seeds or kale," she says. "Depending on what type you pick … you can get exposure to literally thousands of stock and bond issues at a very nominal fee." The average expense ratio for stock index funds is 0.75 percent, according to Morningstar.

ETFs. Mutual funds and ETFs are very similar. "When you buy one share of an ETF or one share of a mutual fund, you're buying a small piece of a lot of different investments that make up that fund," Granucci explains. "The difference is how they are managed."

There's no active management with ETFs, so if you're thinking about investing in a handful, be prepared to rebalance your portfolio at least once a year (mutual fund portfolios should be rebalanced, too). Advantages include costs that are a lot lower than those of mutual funds (Morningstar reports ETFs have an average annual fee of 0.57 percent) and no minimum investment requirements. While mutual funds may demand initial investments of $1,000 or $3,000, ETFs – which are traded on exchanges and fluctuate in price during the day – cost only their current trading price, like stocks.

ETFs offer exposure to asset classes ranging from bonds to domestic and international stocks, and even alternative investments like commodities. "Instead of trying to do one fund that's going to do it all, you might need to find three or four ETFs that are going to fill all the different buckets that you want to hit," Granucci says.

[Read: How to Avoid Getting Ripped Off By ETFs.]

Before diving in. You might be ready to put that $5,000 to work, but before you settle on one of the above investments, McBride points out three places where your money would be better spent:

1. Paying down high-interest debt.

2. Saving for retirement in a tax-advantaged account, such as a 401(k) or individual retirement account.

3. Starting an emergency savings fund that covers six months of living expenses.

"For the vast majority of Americans, tackling those three priorities is going to more than chew up that $5,000," he says.
And there's a reason why paying debt is at the top of the list: You'll get a higher risk-free rate of return by paying down credit card debt than you will investing in financial securities. As McBride says, "Paying off a 15 percent credit card balance is like earning 15 percent risk-free."

But let's assume you've paid off your debt, contribute to a 401(k) or IRA and have enough savings for a rainy day. Now you're ready to sit down at the table. The experts might have different tastes, but they all agree on one thing: *You* have to know what you're ordering.

In other words, if you don't understand what you're investing in, you might make some mistakes.

"The power of investing comes from compounded returns and time, and if you don't understand what you're doing and you're afraid to ask questions, when the inevitable hiccup comes in the market," Thakor says, "you will be more likely to change your course."

Updated on July 6, 2015: *This story was originally published on April 10, 2014 and has updated to include more current returns data.*

TAGS: investing, retirement, Morningstar, interest rates, savings, stock market, mutual funds, index funds, FDIC

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