How to Start Investing: A Simple Guide

These five crucial questions can help you define how to start investing.

There's a certain mystique that accompanies investing, created by images of zig-zagging stock charts and frantic traders. It's as if investing is like a chess match only Wall Street insiders can understand, which may be what's keeping most people on the sidelines: More than 50 percent of Americans don't own any stocks, and of those, 21 percent say they don't know enough about stocks to take the plunge and invest.[1]

Here's the kicker: Successful investing isn't rocket science. You don't need to discover the next Amazon or understand the relationship between the dollar and the yen to watch your money grow. At its core, investing is a matter of understanding a few basic principles about risk, diversification and different investment types, then having the patience and discipline to let your investments grow.

If you're ready to take the plunge into the markets, ask yourself these five questions first so you can begin to learn how to start investing.

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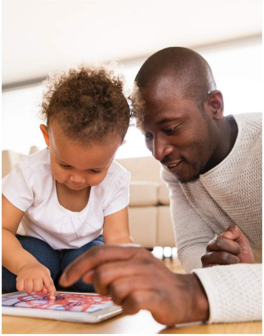
1

WHY ARE YOU INVESTING?



Before you put a dime into an investment, you need to know why you're going to start investing in the first place. Are you saving for a child's college tuition? Your daughter's wedding? A new home? A retirement that involves a lot of globetrotting? Or do you just want some money at the ready in case an opportunity presents itself? This first question is crucial, because the answer will pretty much determine how and what you invest in.

When you've committed to a few goals, estimate the cost and sketch a reasonable time frame for each of them. When will you need the money? Knowing your intended timeline for each goal is very important, as it will greatly influence the types of investments you choose to help you reach your goal (more on that later).

2

WHAT CAN I INVEST IN?

The universe of investments is vast, and you can easily fall down a rabbit hole of unfamiliar terms like derivatives, commodity futures or cryptocurrencies, just to name a few. But when you're getting started, you just need a basic understanding of two primary investment vehicles: stocks and bonds. They're like the yin and yang of a portfolio. Bonds are more predictable, but usually offer less return on your investment over time. Stocks can be more erratic but can offer more return in the long run.

Bonds

A bond is a loan you make to the government or a company. In exchange, you receive interest payments (known as the coupon rate) that are paid throughout the life of the bond. At the end of the bond's term (its maturity date), you'll get back your initial investment and keep all that interest you earned along the way. Bonds, especially those issued by the U.S Treasury and backed by the full faith and credit of the U.S. government, are typically viewed as safe, stable investments.

However, that isn't to say bonds are risk-free. Bond prices can fluctuate, meaning that if you want to sell the bond before it matures, you could lose money (conversely, you could make money, too). Inflation can also be a concern if the bond coupon payments are fixed. For instance, if inflation is 2.8 percent and your bond yields just 2 percent, you're not keeping pace with the rising prices of goods. Lastly, if you invest in bonds issued by a company, there's a risk that the company goes bankrupt and fails to pay back the money it owes you.

Despite these risks, bonds are generally considered a safe place to put your money for predictable returns, and there's a reasonable expectation that you'll earn interest without losing your original investment.

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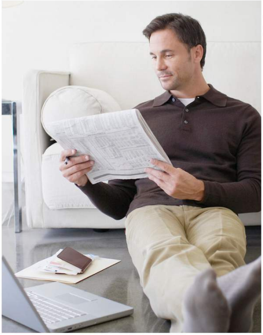
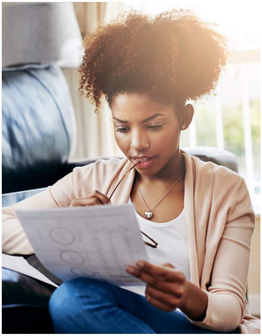


Stocks

A stock is a small ownership stake in a company. If the company does well, its stock price typically rises. If the company does poorly, its stock price may decline. The idea is to hang onto shares of quality companies and sell them at a higher price than what you originally paid. Many companies also reward their shareholders with dividends — typically cash paid for each share owned or additional stock — to provide value beyond just stock price growth. Each company sets its own dividend policy, which means they aren't guaranteed.

Stock prices can be volatile and dramatically rise and fall with breaking news, political policies, disruptions in an industry, or, quite frankly, no apparent reason. Despite the risk, over the long run stocks have historically provided greater returns than lower-risk bonds.

Mutual Funds and ETFs



While you can buy individual stocks and bonds, you don't have to. Mutual funds and ETFs allow you to buy shares of a diversified portfolio that holds various stocks and bonds. Mutual funds and ETFs also allow access to investments that may be otherwise hard for individual investors to buy. They do this by pooling together the money of hundreds, if not thousands, of investors at once.

But when it comes to trading mutual funds and ETFs, there are distinct differences. Mutual funds trade their shares at the end of the trading day, which means they don't go up and down in value throughout the day the way stock prices do. ETFs are traded throughout the day, so their share prices can fluctuate in real time based on market conditions.

Passive versus active management styles

Passively managed funds do not have a dedicated manager. Passive funds might track an index — say, the S&P 500 — and buy and sell stocks based how much a company is worth compared to the total index. For instance, if Apple stock is worth 4 percent of the S&P 500 index's total value, 4 percent of the stock holdings in a passive fund will be in Apple.

On the flip side, actively managed funds are overseen by an individual or team of professionals. Active managers look for value that isn't reflected in a stock's price. So, if a manager believes a stock is trading for more than the company is worth, the manager may sell the stock. Or if the manager believes the company is worth more than its stock price reflects, he or she may buy more.

	PASSIVE	ACTIVE
⊕ PROS	Passive funds tend to have the lowest fees because they don't require much expertise to manage. And, since they reflect an index, you're not likely to underperform the index.	Active managers won't follow the herd. Their experience helps them find opportunities and value that the market might be overlooking.
⊖ CONS	Passive funds basically follow the herd. Regardless of whether you may feel a company is too expensive or too risky, you'll hold it if it's part of the index.	Active funds tend to charge higher fees because there's a person or team in control. And, regardless of their expertise, it's hard to consistently beat the market year after year.

3

WHAT'S MY APPETITE FOR RISK?

If the stock market tanks tomorrow and your portfolio shrinks by 50 percent, how would you feel? Would you lie awake in a cold sweat worrying because you need the money to retire in a few months? Or would you be comfortable knowing you still have time to potentially earn it back, and then some, over several years?

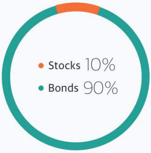
These are all things to consider when determining the asset allocation of your portfolio. If you're the type whose stomach drops when the market does, perhaps you're thinking that it's just safer to keep all your assets in cash. But if you don't need the money soon, being too risk averse is, itself, quite risky. If you don't assume enough risk, you may be forgoing growth that's essential to reaching your financial goals as the price of things goes up over time.

Risk and reward go hand in hand. You just need to manage risk to strike a balance that's appropriate for your situation.

TWO COMMON RISK MANAGEMENT STRATEGIES

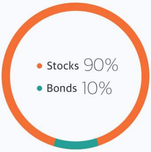
Conservative

A very conservative, low-risk asset allocation could be 90 percent bonds and 10 percent stocks. A portfolio like this would have risen 3.4 percent during the financial crisis in 2008. On the other hand, it would have grown, on average, just 4 percent annually over the 10 years that followed.



Aggressive

A very aggressive, high-risk asset allocation would be 90 percent stocks and 10 percent bonds. This portfolio would have fallen 32 percent in 2008. However, if you had stuck with this allocation, you would have enjoyed an average annual return of over 8 percent in the following decade — double that of the conservative allocation.

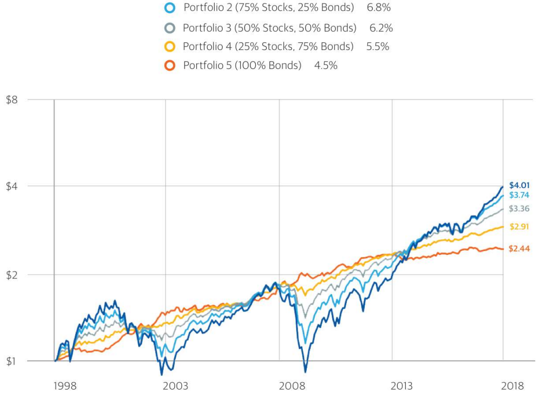


As you can see, the allocation of stocks and bonds in a portfolio can dramatically affect both your upside and downside potential over time.[2]

COMPARING ASSET ALLOCATIONS

Here's another example of how different asset allocations can affect returns. The below chart shows how $1 invested in five hypothetical portfolio allocations would have fared over a 20-year period. Portfolios with a higher allocation to stocks produced greater returns than those more heavily weighted toward bonds, but they experienced more volatility.

○ Portfolio 1 (100% Stocks) 7.2%



Stocks are represented by the Ibbotson® Large Company Stock Index. Bonds are represented by the five-year U.S. government bond. The data assumes reinvestment of income and does not account for taxes or transaction costs. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

Diversification

This goes one step deeper than asset allocation. Let's say you have a portfolio that's 70 percent stocks and 30 percent bonds. You wouldn't want the entire portion of your stock holdings to be in a single company or industry. That would mean that if that company went bust or that industry took a big collective hit, your portfolio could lose 70 percent of its value.

Instead, you can spread out risk by investing your portfolio's stock allocation into many different companies across a range of sectors or even countries. Bonds are no different: That 30 percent bond allocation could consist of corporate bonds, Treasury bonds and international bonds. Quite simply, diversification reduces the chances that a single investment would significantly impact your overall portfolio performance.

4

WHAT IS YOUR TIME HORIZON?

Now that you've set some financial goals, considered your investment options and weighed your appetite for risk, you need to determine when you'll need to access the money you're investing. Keep this guiding principle in mind: The sooner you'll need those funds, the less risky you'll want to be with your investment mix. But the more time you have before you need your money, the more opportunity you have to take advantage of compound growth. Keep the following in mind when it comes to your time horizon.

Short-Term Goals (1 to 2 years)

Mid-Term Goals (2 to 10 years)

Long-Term Goals (10-plus years)

If you're planning a vacation to Europe, you don't want to see the market dip and watch 30 percent of your Euro-trip savings vanish. In the short-term, the goal is to preserve rather than aggressively grow your funds, which means you'll likely want to play it safer and choose something like CDs, money market accounts or Treasury bills to park your savings.

Someday you might want to get married or purchase a new home or car. You won't need this money tomorrow or in a pinch, but you may need it fairly soon. That means safety is still important for mid-term goals; at the same time you want your money to work a little harder to grow. For that reason, you'll likely want to include a larger mix of stocks for mid-term goals.

For the big, far-off things like retirement or college, growth is critical. For goals 10 or more years into the future, it's okay to take more risk because you'll have plenty of time to make up for the occasional market dip. By taking on the additional risk, you have more time to see the benefits of compound interest.

THE POWER OF TIME

When it comes to reaching long-term goals like retirement, time is your greatest ally. That's because the sooner you start investing, the more time you have to benefit from compound growth (when your earnings earn you even more because they are reinvested). To understand what that means, consider the following hypothetical example of Miguel and Anna, two 25-year-olds who start working at the same time.

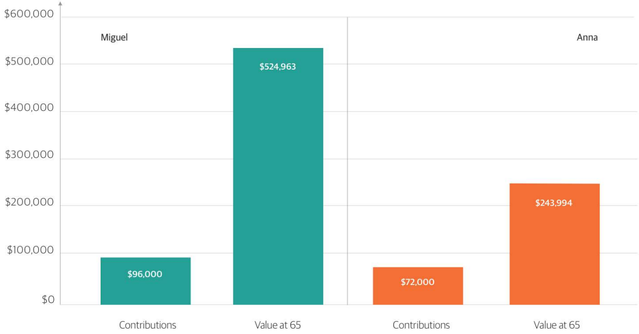
MIGUEL

- Begins investing immediately by putting $200 a month into an Individual Retirement Account (IRA) that earns a 7 percent average annual return.
- At 65, Miguel's total investment is $96,000

ANNA

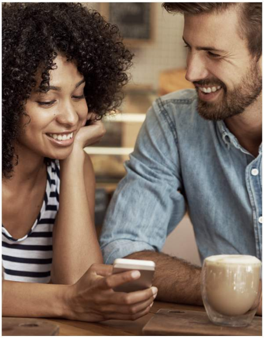
- Waits 10 years to start investing.
- At 35, she starts contributing $200 a month to an IRA that earns a 7 percent average annual return
- At 65, Anna's total investment is $72,000

Investing early and often always wins



Although Miguel contributed only $24K more than Anna, his account is worth nearly double at age 65: $525K vs. $244K.

This is a hypothetical example intended to illustrate the concept of compounding. It is not representative of any specific investment or investment account. Actual investment account value will fluctuate and may be worth more or less than the original investment.*



Nearing the Finish Line:

As you get closer to the end of your time horizon, your portfolio needs to adjust accordingly. A 20-year-old saving for retirement, for instance, may be entirely invested in stocks at first. But as that same investor turns 30, 40 and 50, his or her portfolio mix should gradually shift from an aggressive allocation to a more conservative mix. By taking your risk level down a few gears as your goal approaches, you can shelter decades of gains from an unexpected turn in the market.

One of the easiest ways to do this is in a target-date fund, which automatically adjusts your mix of stocks as you get closer to your target date. If you have a retirement account through your employer, there's a good chance your contributions are landing in a target-date fund.

5

HOW INVOLVED DO YOU WANT TO BE?

Time for one final consideration: How involved do you want to be as an investor? There are options to fit any level of commitment.

Flying Solo

A do-it-yourself approach will give you control over every investment decision and your costs are typically lower, depending on your level of trading activity (you are typically charged a fee through a broker for each trade).

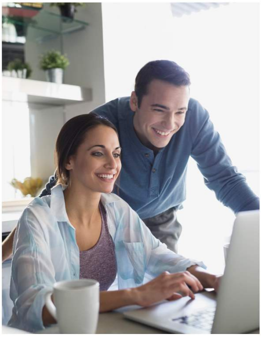
The thing is, you'll need to spend a lot of time researching investments and studying market news to ensure your portfolio is headed in the right direction. You'll also need to remember to rebalance your portfolio to ensure your risk level is appropriate. It'll also require discipline to keep your emotions in check when the markets are volatile — a hard thing to do when all that stands between you and a sell or buy order is the click of a mouse.

The do-it-yourself approach can also become overwhelming if you are managing multiple accounts and your assets grow. However, if you're up to it, managing your own portfolio can be a highly educational and rewarding experience.

Using Robo-Advisors

Nowadays, you can place your money into several automated portfolio management services. After opening an account, you input information about your money, goals, risk tolerance and time horizon, and the service automatically constructs a portfolio for you based on this info. You simply deposit money into your account at your leisure and the algorithm goes to work, rebalancing for you as necessary.

It's typically not very expensive to open a robo-advisor account, and using one can save you hours of research and portfolio maintenance. However, a robo-advisor constructs your portfolio based on a preset algorithm that won't necessarily reflect your whole financial picture or take into consideration key life events. It takes a standardized approach that works for people like you, but not you per se. As such, investing with a robo-advisor may not reflect your needs or an appropriate level of risk for your circumstances.



Using Professionals

Working with a financial professional can help you build a comprehensive investing approach that's customized to your goals. He or she can help you adjust your financial plan as your needs evolve, and help you see the big picture so that how you invest fits into your bigger financial plan. Of course, we're all human, including financial pros, so some will be a better fit for you than others. You'll want to carefully consider a financial pro's credentials, experience, fee structure and planning style before committing to working with one.

PUTTING IT ALL TOGETHER

If you're still feeling apprehensive about dipping your toes in the markets, just remember that investing is one piece of a larger pie that is your financial plan. Yes, it can feel complicated, but there are ways to invest without overwhelming yourself. And given the power of compound interest over time, the sooner you get started, the better. A financial professional can help you identify your goals and understand how to start investing, as well as how your investing strategy can fit into your bigger money picture.

[1] Bankrate.com, April 2015

[2] Source: PortfolioVisualizer.com

No investment strategy can guarantee a profit or protect against loss. All investing carries some risk, including loss of principal invested.

Past performance is no guarantee of future results. Examples are for illustrative purposes only and not indicative of any investment.

With fixed income securities, such as bonds, interest rates and bond prices tend to move in opposite directions. When interest rates fall, bond prices typically rise; and, conversely, when interest rates rise, bond prices typically fall. Bond and bond fund investors should carefully consider risks – such as interest rate risk, credit risk, liquidity risk and inflation risk – before investing in a particular bond or bond fund. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment.

Exchange traded funds (ETFs) are subject to risks similar to those of stocks. Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. ETFs are traded on the secondary market, like stocks. As a result, shares of an exchange traded fund may trade at a premium or discount to the fund's actual net asset value, particularly during periods of market volatility. The performance of an exchange traded fund may vary from the market index it attempts to replicate due to market volatility, transaction costs, valuation differences, differences between the assets held in the exchange traded fund's portfolio relative to the market index, and other factors.

Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

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