Begin Investing

A Guide To Getting Started

Saving

Budgeting By Investing

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Begin Investing
A Guide To Getting Started

By Matt Hylland - BegintoInvest.com

Find out more about me and why I started BegintoInvest.com Here.

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I am not your financial advisor. Before any investments are made you should carefully consider the risks associated with the investment and your financial situation with a professional.

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Why We are Here

"Investors do not understand the most elementary financial concepts, such as compound interest and inflation. Studies have also found that many investors do not understand key financial concepts such as diversification or the difference between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns"
- 2012 study

"Studies reviewed by the Library of Congress indicate that U.S. retail investors lack basic financial literacy. The Studies demonstrate that investors have a weak grasp of elementary financial concepts and lack critical knowledge of ways to avoid investment fraud." - 2012 study

"The Library of Congress Report concludes that 'low levels of investor literacy have serious implications for the ability of broad segments of the population to retire comfortably, particularly in an age dominated by defined-contribution retirement plans"
- 2012 study

The average score for the 2008 Jump$tart Coalition survey of high school seniors and college students for financial literacy was 48.3 percent - the lowest ever recorded.

Young adults, ages 18 to 24 are consistently the worst performing age group in financial literacy surveys.

Poor financial literacy scores mean much more than just being a statistic on a survey

- It means paying more for a car loan or mortgage:

The average person in their 20's has a credit score of under 660.

Consider a $150,000 30 year mortgage:

Credit Score	Interest Rate	Monthly Payment	Total Interest Paid
760-850	3.29%	$656	$86,228
700-759	3.53%	$675	$92,876
680-699	3.69%	$690	$98,274
660-679	3.95%	$708	$104,825
640-659	4.33%	$745	$118,310
620-639	4.88%	$794	$135,936

The average person in their 20's could save:

- **$32,082** if their credit score was raised to 760-880
- **$25,434** if their credit score was raised to 700-759
- **$20,062** if their credit score was raised to 680-699
- **$13,485** if their credit score was raised to 660-679

Consider a $20,000 new car loan:

Credit Score	Interest Rate	Monthly Payment	Total Interest Paid
720-850	3.55%	$448	$1,483
690-719	4.93%	$460	$2,077
660-689	7.07%	$480	$3,018
620-659	10.8%	$515	$4,722

The average person in their 20's could save:

- **$3,239** if their score was raised to 720-850
- **$2,645** if their score was raised to 690-719
- **$1,704** if their score was raised to 660-689

Results found using the Loan Savings Calculator on myFICO.com
Try it yourself and see how much you could save.

Poor financial literacy scores mean much more than just being a statistic on a survey

- It means earning less from your savings and investments:

Average Mutual Fund Expense Ratio: 0.79%

The average Mutual Fund charges 0.79% per year. Today funds exist with expense ratios as low as 0.05%!

Paying the industry average of 0.79% instead of 0.05% costs a $100,000 portfolio over **$75,000** in lost earnings over 25 years!

Expense Ratio is the annual fee a fund charges.

Per $100,000 in your portfolio, 0.79% means you pay $790 a year.

Money saving tip:

Begin To Invest has an "Fund Spotlight Series" to help you find the cheapest funds available.

This is one of the primary reasons that the average investor underperforms the market. This means your savings does not grow as much as it could.

According to a 20 year study done between 1990 and 2010 the average annual return for an investor in equities was 3.27%. Compare that to the average annual return of the S&P 500 Index of 9.14%.

What is the difference between a 3.27% annual return and a 9.14% annual return over the course of 30 years?

Consider $10,000 invested today:

A one time investment of $10,000, after 30 years:

3.27% - $26,255

9.14% - $137,885

This is the consequence of investor's poor financial literacy.

At Begin To Invest we teach you how to **BE** the market, not be beat by the market.

“This Book Can Change Your Life”

I started Begin To Invest because my generation needs help.

We are the most financial illiterate generation ever surveyed, we spend more money than we make, and don’t save or invest.

Now we need to get started.

I have made the same mistakes many investors do when starting out:

- I tried listening to the “experts” for investment ideas.
- I tried the expensive subscription services.
- I tried the day trading courses.

Now I want to make sure you don’t.

The basis for a successful investment portfolio does not lay in expensive stock trading courses, flashy computer programs or high priced Wall Street money managers.

The basis for solid investment returns lies in keeping costs low, diversifying risk and starting early.

As you are about to see, knowing just these basics of personal finance and investing can mean the difference between being able to retire comfortably or being forced to work and pinch pennies decades longer than you should have to.

At Begin To Invest we focus on educating you in the topics of personal finance and investments so that you can confidently manage your own finances and invest for your future.

At Begin To Invest we don’t charge for a membership or carelessly promote expensive products for the sake of commission. We just aim to providing you with top notch information.

I hope this free eBook is a testament to our commitment to provide new and budding investors access to high quality, educational resources.

Enjoy!

Matt Hylland
BegintoInvest.com

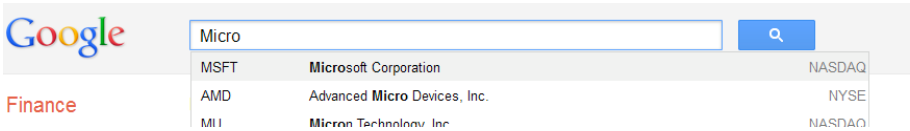
Key Terms

Before getting started, it is important that you understand several key terms:

Stocks - You are the Owner

When you hear of people buying “stocks”, what they are really doing is buying shares of a specific company. A share of a company represents ownership of a small fraction of a company. By purchasing shares of a company you become an owner of a percentage of the company. This ownership entitles you to admittance to shareholder meetings, a share in profits of the company in the form of dividends, voting rights on company affairs, etc. Every public company is made up of shares that are available for investors to buy and sell on a stock exchange.

For example consider the company Microsoft:



To bring up this page shown below, go to www.google.com/finance and search “Microsoft” or “MSFT” which is Microsoft’s “symbol” - which is how Microsoft is identified by investors, brokers and stock exchanges.

Microsoft Corporation (NASDAQ:MSFT)

31.21 +0.27 (0.89%)
Sep 14 - Close
NASDAQ real-time data - Disclaimer
Currency in USD

Range	30.81 - 31.25	Div/yield	0.20/ 56
52 week	24.26 - 32.95		.00
Open	31.01	Shares	8.38B
Vol / Avg.	51.42M/31.90M	Beta	1.00
Mkt cap	261.65B	Inst. own	68%
P/E	15.60		

Eventually we will make sense of everything shown here. For now, look at the **Shares - 8.38B** highlighted above. This indicates that there are 8.38 billion shares of Microsoft outstanding! Each share of Microsoft costs **$31.21**. For $31.21 you can own about 1/8 billionth of Microsoft!

By owning this share of Microsoft you are entitled to attend shareholder meetings and vote on company issues, such as electing board members.

But the primary reason people invest in stocks is to make money. This happens in two ways:

Dividend payments - Some companies offer dividends to shareholders. Microsoft currently pays $.20 per quarter ($0.80 per year) for each share of Microsoft. That $31.21 dollars to buy 1 share of Microsoft gets you 80 cents a year for as long as you own the share. Note that companies can change dividend payments.

Gain in Share Price - This occurs if the price of Microsoft shares goes up. On this day, Microsoft went up 27 cents per share. This is the primary goal of investing - “buy low, sell high”. If we could sell that share of Microsoft that we paid $31.21 for, say $40 in the future - we make money.

Sounds easy right? Picking stocks is a multi billion dollar industry - and most fail

At Begin To Invest we will teach you how to be successful investing in stocks. Our simple, passive investment style outperforms roughly two-thirds of investors every year.

Bonds - You are the Bank

A bond is a security issued by a company where in exchange for you giving a company money today, the company will offer you a small payout over time.

Consider going to the bank for a loan on a new car. The bank agrees to give you a lump sum payment and in exchange you pay the bank every month until the loan is paid off, and of course the bank tacks on a little interest too so they can make money. Bonds are very similar, only investors are acting as the bank. By buying a bond, you are funding the company's debt, and they agree to pay you back over time, with interest.

Consider a hypothetical company that offers a $1,000 bond yielding 5% that matures in 5 years.
This means the company is taking out a $1,000 loan, paying 5% interest and will pay the bond back in 5 years.

If you were to buy this bond, you would give the company $1,000 today. This initial $1,000 is called the **principal investment**. In exchange, the company would give you 5% of $1,000 every year, or $50 a year for 5 years. At the end of the 5 years, you would receive your principal investment of $1,000 back. In total you would have 5 payments of $50 and your principal of $1,000, giving you $1,250. A nice gain of $250!

Notice that corporate bonds work a little differently than the personal loans we are used to dealing with. Generally, corporations do not pay back any principal on the bond until the bond matures, investors only receive interest until the bond matures.

Bonds are considered "Fixed Income" securities because they offer scheduled predetermined payments. In our example above, the investor is always going to receive $50 a year. However what can change is the yield of the bond and its price.

The initial investor in the example above paid $1,000 to get $50 a year. Here the bond is yielding 5%.

However that initial investor may want to sell that bond before its 5 year maturity arrives. The initial investor goes into the "secondary bond market" where other investors look to buy and sell bonds. Investors may be willing to pay more (or less) than $1,000 for that bond based on the economy. If interest rates are low and the economy is weak, like in 2012, investors may be willing to pay more for higher yielding bonds from high quality corporations. Lets say a new investor is willing to pay $1,100. For this new investor, he will still only receive $50 a year and only $1,000 for the bond upon its maturity. Notice that this new investor does not receive a 5% yield on this bond. $50 is only 4.54% of $1,100. Even though the bond is paying out the same amount, it is yielding a lower amount because the new investor paid more for the bond than the initial investor.

This is an important concept in investing.

As a bond's **Price** moves higher, its **Yield** moves lower.
Or vice versa, as a bond's price falls, its yield increases.

In a 2009 survey, only 21% of respondents were able to correctly answer that bond prices fall as yields move higher.

Individual corporate bonds generally have minimum investment requirements of $10,000 or more. Because of this bond funds, as discussed below, generally offer individual investors the best investment path into bonds.

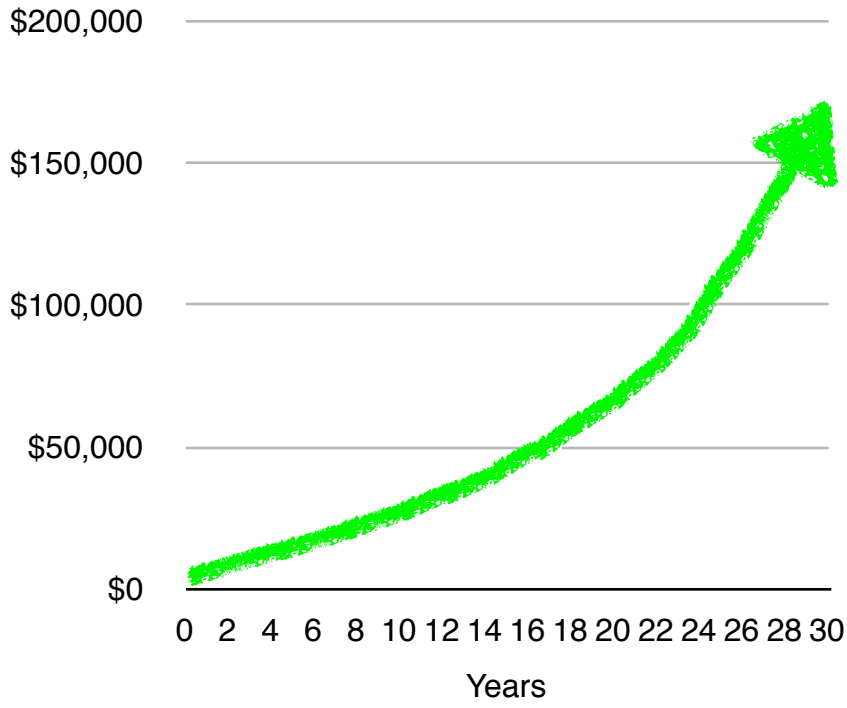
There are other types of bonds for investors to choose from besides corporate bonds. Most popular are U.S. Government treasury bonds. There is also mortgage bonds, savings bonds and inflation protected bonds. We will discuss how the different types of bonds fit into your portfolio in our section on **asset allocation**.

Compounding Interest - Why this works so well

Nothing is a more important part of your investment returns than compounding interest.
The idea behind compounding interest simple - gains today produce more gains tomorrow.
Consider a $10,000 investment today that grows 10% every year:
By the end of year one, the investment is now worth $11,000. An increase of $1,000 - not a bad return in one year.

Next year your investment grows another 10%, but your account value increases more than $1,000 this year. It increases 10% of $11,000 or $1,100! Your $1,000 in gains from year one produced 10% gains as well!

Now $100 extra does not seem significant, but over the course of 30 years, the results are astonishing!



The end total - **$174,494!** - Grown from a $10,000 investment!

Remember the unimpressive $1,100 in gains between year one and two? The gain between year 29 and 30 is over $15,000 - more than your original investment!

This is the power of compounding interest, but in order for compounding interest to work you need to give it time.

This example shows - just waiting one year to invest that $10,000 would result in over $15,000 less in your account.

How important is getting started early so compounding interest can work for you? Consider this example:

Person 1 contributes $1,000 a year to his retirement account starting at age 20 until he turns 34, for a total of $15,000 saved. Person 1 does not contribute another dollar to his account. His investment grows at a rate of 7%, the average return of the S&P 500 index over the last 55 years, until Person 1 reaches 65 years old.

Compare that situation to Person 2, who waits until age 30 to start investing $1,000 a year. Person 2 puts away $1,000 a year into a retirement account for the next 35 years, until he reaches 65 years old. Person 2 has saved a total of $35,000 ($20,000 more than Person 1), and will see that investment grow at the same historical average rate of 7%. How do these situations play out in the long run?

Person 1 saved $15,000, and got started **10 years earlier** - will have **$225,681**.

Person 2 saved $35,000, but got started 10 years later - will have only **$158,590**.

This is the power of compounding interest and saving early!
Save less, Earn more!

Diversification

The idea behind diversification is to limit the risk in your portfolio. Diversifying your portfolio means owning multiple securities instead of just one so that if one security does not perform well, you are protected by the others.

Recently, many investors bought into the IPO of Facebook. An IPO is an “Initial Public Offering” and defines the first day that a company goes public and trades on the stock exchanges so that anyone can purchases shares of the company.

Many investors thought that Facebook was a great investment opportunity, and piled into Facebook, buying as many shares as they could afford.

Consider an investor who had $100,000 in their retirement account. This investor wants to buy Facebook stock and uses every dollar in their retirement account to do so. The first day Facebook traded at about $40 a share, so this investor would have purchased 2500 shares.

The $100,000 invested may represent decades of careful saving by this investor - but now it is all at risk to one specific company.

How would the investor have fared so far?

Above - a chart of Facebook’s share price.
Below - a comparison of Facebook’s performance (in blue) compared to the S&P 500 (in green). Charts from Yahoo Finance

Facebook hit a low around $18, meaning the investor’s retirement account once valued at $100,000, was worth only $45,000!

Not being diversified means having “all your eggs in one basket” If Facebook’s stock fell they would lose years and years worth of savings.

If the investor would have spread out their investments into an S&P 500 index fund, which would have spread their investment out into over 500 companies, they would have made $12,000 over that same amount of time!

(We explain funds such as this on the next page)

With the $100,000 invested in 500 companies, the risk one specific company puts on your portfolio is much smaller.

In a 2007 survey, only 39% of investors could explain the term “Diversification”.

Keep the idea of **diversification** in mind as we move on to discuss mutual funds and exchange traded funds.

Mutual Funds

A Mutual Fund is a professionally managed fund that pools money from many investors and invests that money into a diversified set of securities. Each investor owns a percentage of the assets in the fund based on how much money they invest into the fund.

Investors buy shares of a mutual fund, where each share represents a portion of the assets owned by the fund. Just like a share of a company's stock represents a certain percentage of ownership of the company, a share of a mutual fund represents the ownership of a percentage of the assets of the fund.

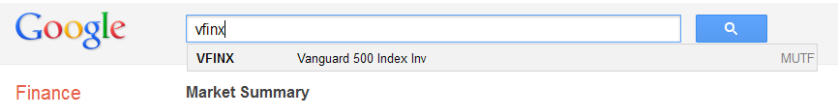
Mutual funds offer investors an easy way to diversify - or hold many securities, which reduces risk for an investor.

In a 2009 survey, only 52% of respondents correctly answered "False" to the statement: "Buying a single companies stock provides safer returns than a stock Mutual Fund"

For a look into mutual funds, lets take a close look at just one of the thousands of funds available to investors; Vanguard's S&P 500 index mutual fund.

To find this fund, return to the Google Finance page - www.google.com/finance

And search for "VFINX"



VFNIX is the fund's "symbol" and is how the fund is identified by investors, brokers and stock exchanges.

On this page you will see information such as the fund's description, historical performance and holdings.

The holdings represent the assets of the fund. For VFINX we see its top 10 holdings are:

Top 10 holdings

Security	Net Assets
Apple, Inc. (AAPL)	4.41%
Exxon Mobil Corporation (XOM)	3.23%
Microsoft Corporation (MSFT)	1.85%
International Business Machines Corp (IBM)	1.82%
General Electric Co (GE)	1.78%
AT&T Inc (T)	1.69%
Chevron Corp (CVX)	1.68%
Johnson & Johnson (JNJ)	1.50%
Wells Fargo & Co (WFC)	1.44%
Coca-Cola Co (KO)	1.42%

At the time of writing, VFINX is trading at $135 a share.

By investing $5,000 into this fund today, an investor would own 37.037 shares (Unlike stock, you can own fractional shares of a mutual fund). Your investment is then spread out into all the fund's holdings. 4.41% of your $5,000 is invested in Apple, 3.32% is invested in Exxon Mobil, etc. (As shown to the left). For most investors, mutual funds or ETF's (discussed next) provide the easiest and most affordable way to diversify their investments into a wide variety of assets.

There are also mutual funds that just own bonds and "hybrid" funds which own both stocks and bonds. The right fund for you will depend on your **asset allocation** (discussed later) and risk tolerance.

The important thing to consider when investing in mutual funds or ETFs is the **expense ratio**, or fee charged to be invested in the fund. Keep fees as low as possible by looking for index funds or passively managed funds. Historically these funds have outperformed "actively managed funds" or other alternative investment styles and charge expense ratios around 0.2% or under, while actively managed funds can charge fees of up to 2% a year!

We help find funds with low fees with our Begin to Invest Fund Spotlight Series

Exchange Traded Funds - ETFs

Exchange traded funds function very similar to mutual funds, and for the ordinary investor the difference is not significant. When an investor puts in an order to buy a mutual fund, the order is processed at the end of the day. When an investor buys shares of an ETF, the order is instantly processed, just as if buying shares of an individual company. ETFs could be bought and sold multiple times a day, unlike a mutual fund.
Besides that difference, ETFs and mutual funds have the same role in an investor's portfolio.

Like a mutual fund, an ETF creates shares and each share represents a percentage of assets owned by the fund. There are ETFs that own stocks, bonds, commodities such as gold or silver, and just about every other type of security in existence. There are ETFs that only own stocks of certain sectors, such as only bank stocks or only technology stocks or ETFs that only own stocks from certain countries. The possibilities for investments in ETFs are nearly limitless. Because of this, ETFs make it very easy for individual investors to diversify their portfolios. In addition, ETFs typically offer lower expense ratios than their mutual fund counterparts. Because of this ETFs are rapidly gaining in popularity for all types of investors.

Lets look at an ETF as an example. ETF with the ticker symbol "SPY". Like the mutual fund VFINX on the previous page, SPY aims to match the S&P 500 index. So their holdings should be similar.

Fund Top Holdings

As of 09/20/2012

NAME	WEIGHT	SHARES HELD
Apple Inc	4.94%	8,236,897
Exxon Mobil Corp	3.24%	41,191,350
General Electric Co	1.80%	93,332,310
International Business Mach	1.80%	10,160,755
Microsoft Corp	1.78%	65,861,720
Chevron Corp New	1.76%	17,381,202
At&T Inc	1.68%	51,646,356
Procter & Gamble Co	1.44%	24,136,904
Johnson & Johnson	1.43%	24,192,492
Wells Fargo & Co New	1.41%	46,809,450

Fund Information

As of 09/22/2012

Ticker Symbol	SPY
Primary Benchmark	S&P 500
CUSIP	78462F103
Short Selling Allowed	Yes
Gross Expense Ratio	*0.10%*
Net Expense Ratio	0.0945%
Inception Date	01/22/1993
Management Team	ETF Management Team
Distributor	ALPS Distributors, Inc.
Distribution Frequency	Quarterly
Exchange	NYSE ARCA EXCHANGE

Like mutual funds, ETFs charge an **Expense Ratio** fee to investors in the fund. The Expense ratio comes out of the ETFs shares price, and is not "billed" to investors like other fees. SPY has an expense ratio of 0.1%, this means investors should expect this ETF to underperform the S&P 500 index by approximately 0.1%.

As we can see below from Google Finance, over the past year SPY has underperformed the S&P 500 index by 0.07%, roughly the expense ratio of the fund.

The information for the fund on the left side of the page is found on the fund's website, found here. Before investing in any fund, be sure to read the fund information that is required to be displayed on the fund's webpage or the fund's prospectus.

The decision on which ETFs to own depends largely on your **asset allocation** (discussed below).

Asset Allocation

Asset allocation describes how an investor's funds are split between various security types. Investor's target a certain percentage of their portfolio be allocated to stocks, a certain percentage to bonds, etc.

The typical "rule of thumb" for investors is the "age in bonds rule", meaning the percentage of assets you own in bonds should be equal to age. If you are 30 years old you should have 30% of your assets in bonds, and therefore 70% in stocks.

Asset allocation is set to control risk in a portfolio. Historically bonds have offered a "safer" investment than stocks and provide a steady "fixed" income to investors where returns from stocks can fluctuate wildly. However, historically bonds have not had as great of returns as stocks over long periods of time.

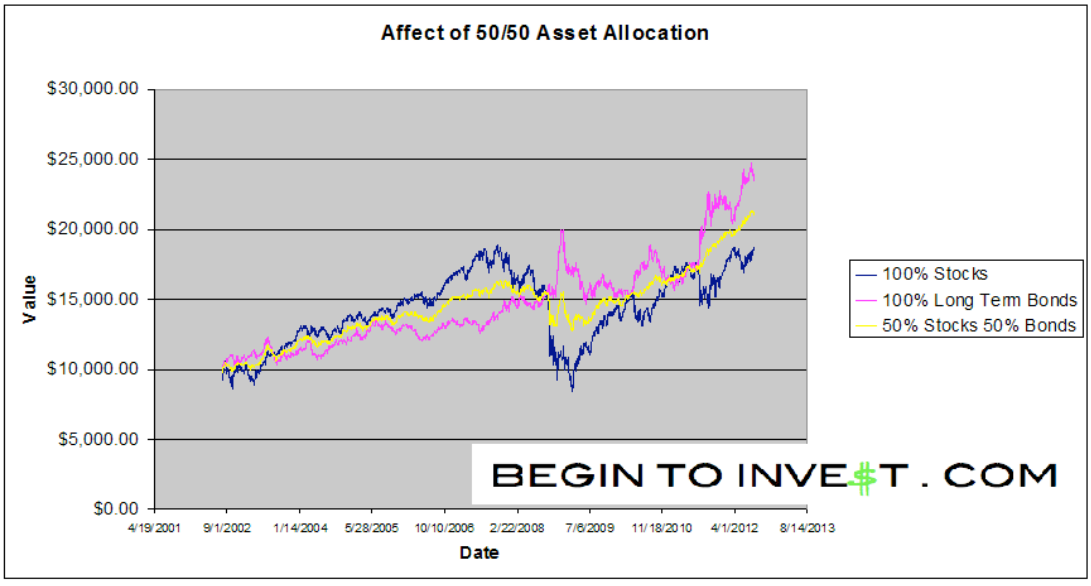
To understand why Asset Allocation is important consider two different investors; A 25 year old with a decent job and steady income, and a 80 year old widow whose only income comes from her retirement accounts.

In times of a bad economy, such as what we saw in 2008, stock prices declined as much as 50% and many stocks cut dividends or eliminated them all together. For an 80 year old widow, if the value of her retirement account dropped by 50% in one year it would be devastating as that is the money she is relying on to pay the bills. However for a 25 year old beginning investor, they have decades to continue to invest and make up for the losses from a bad year and a current income that does not rely on their investments. For this reason, our hypothetical 80 year old widow should have a majority of her assets in bonds, as they provide a steady stream of income and their price is not at risk to wild fluctuations of the stock market.

How does Asset Allocation affect the returns of your portfolio?

Consider $10,000 invested in mid 2001 in the chart below:

The blue line represents the value of the $10,000 if it was invested 100% in stocks (The ETF "SPY")
The pink line represents the value of the $10,000 if it was invested 100% in bonds (The ETF "TLT")
- which is an ETF that invests solely in long term government bonds.
The yellow line represents the value of the $10,000 if it was invested 50% in stocks and 50% in bonds.



Notice the difference in performance of stocks and bonds in the midst of the 2008 market decline. Stocks **lost** nearly 50% while bonds **increased** roughly 25%!

From 2001 to 2008 stocks outperformed bonds, as they have historically. However when stocks declined sharply, bonds did their job by protecting investors capital.

This is why it is important to have a proper mix of stocks and bonds in your investment portfolio.

Before Your First Purchase - Selecting an Account Type

Before making your first investment you need to open an account at a broker. The first question a broker will ask when opening an account is “What type of account would you like to open?”. Your answer to this question can have significant implications in the future, so it is important that you understand your options.
There are several types of retirement accounts to choose from:

401(k)

401(k)’s are investment accounts set up through your employer - not a broker. For government employees, this is your TSP. In a 401(k) money comes out of your paycheck before taxes are taken out and is invested in selected funds offered by your employer. What makes 401(k)s unique is the employer match that many companies offer. Many companies will match the contributions you make into your 401(k) up to a certain percentage. This equates to free money and should be taken advantage of! At a minimum, invest up to the full potential of your employer’s match to get all the free money you can.

401(k) investments grow “tax deferred” meaning that investors do not pay taxes on 401(k) investments until money is withdrawn. It is important that investors take taxes into account when looking at 401(k) balances as 10%,15% or more will be effectively taken out due to taxes.

Typically investment options in 401(k)s will be mutual funds offered by the fund manager of the 401(k). Popular fund managers are Fidelity and Vanguard, but there are many others. Remember when selecting mutual funds to carefully consider the expense ratios. Some 401(k)s are notorious for offering very expensive funds with expense ratios of 2% or higher. If your 401(k) does not offer quality funds to choose from talk with co-workers and your Human Resources office to try and get additional offerings.

For the majority of Americans a 401(k) is your primary savings and investing vehicle. They have produced solid returns historically because it is typically the only account that investors consistently add to and leave alone so compounding interest can work. Don’t treat your 401(k) as just another savings account. It should only be borrowed from in severe circumstances.

If you do have to withdraw before age 55 1/2 (or age 59 1/2 depending on employment status), you will have to pay taxes on the withdrawn amount plus a 10% penalty.

401(k)s have a limit of $17,000 in contributions per year, unless you are over the age of 50, in which you can use “catch up contributions” of an additional $5,000 for a total of $22,000. These limits are set to increase as inflation increases, so if you are in position to be able to max out your 401(k), be sure to check on the latest limits.

When invested into a 401(k), you must also start withdrawing money at a certain time, usually age 70 1/2. This is called a minimum required distribution. The specific amount varies, and typically your 401(k) fund manager or the IRS will notify you of the required withdrawal.

The bottom line for 401(k)s - you are turning down free money by not participating in them. At minimum, invest up to your company’s match.

Of employees under the age of 25, only 44% participated in their companies 401(k) plan in 2011.
- Vanguard

Traditional IRAs

An IRA is an “Individual Retirement Account” and is another tool to help you save for retirement.

When investing in a traditional IRA, you must first open an account with a broker such as Fidelity or Vanguard (More on brokers later in the book). The money you deposit into a IRA has already been taxed, but when you file your taxes you can deduct the IRA contributions from your taxable income.

Gains in your IRA grow tax deferred just like a 401(k), meaning that you pay taxes upon withdrawal from your IRA.

IRAs also have similar rules to early withdrawals as 401(k)s. Withdrawals from your IRA before age 59 1/2 can result in a 10% penalty along with regular income taxes.

IRAs give you more investment options than your 401(k) will. In an IRA you can purchase any stock, any mutual fund or any ETF. You may see advertisements by banks offering IRA accounts to hold CDs (Certificates of Deposit) or companies offering IRA accounts that hold gold or silver. However I believe the best place to have an IRA is through a broker, where all these options and more would be available. Because money invested in an IRA is a long term investment, bonds make more sense over CDs because of their higher interest rate, and gold or silver ETFs offered within your brokerage account offer a cheaper investment into gold, silver or other precious metals than someone else can offer.

Contributions to IRAs are limited to $5,000 per year and you must have income at least equal to your contribution. If you income was only $3,000 in 2012, you can not contribute more than $3,000 into an IRA.

Also like 401(k)s, at age 70 1/2 you must start withdrawing money from your IRA. The amount of your minimum required distribution will vary, and typically the IRS will notify you of required minimums.

Investors will typically “roll over” old 401(k) accounts from previous employers into IRAs. This is not considered a withdrawal from your 401(k) or IRA as long as the money from your old 401(k) is put into a roll over IRA within 60 days. Rolling over old 401(k)s can give you access to better investment alternatives offered in IRAs, and make your investments easier to manage by consolidating them into one place. Most brokers offer rollover IRA accounts and will be happy to guide you through the process.

In 2012 only 15% of Americans were making annual contributions into an IRA, the lowest ever recorded.

In 2012 only 38% of Americans had some form of an IRA account, making 2012 the 4th consecutive year that number has declined.

For many new investors, Traditional IRAs make great investment accounts, however ROTH IRAs have more to offer most investors. Next we discuss the differences between the two account types and explain why ROTH IRAs are superior for most investors.

ROTH IRAs

ROTH IRA is a relatively new addition to the individual investor's set of tools for retirement and investing. ROTH IRAs were created in 1997, and allow investments to **grow completely tax free**. Contributions to ROTH IRAs are not tax deductible like in traditional IRAs, however when withdrawing money from a ROTH IRA, the investor pays no taxes on gains!

This means ROTH IRAs are superior for young investors for several reasons. First, most young investors are in a lower tax bracket because they do not make much money. Remember investing in a ROTH IRA means paying taxes now, instead of later. By paying a relatively small amount now, you get to keep a much larger amount of money later. We have shown in previous examples about just how great of a force compounding interest can be. For a young investor, even small amounts of money can grow into significant sums in 30 years.

Consider our example given when discussing compounding interest. $10,000 growing into $174,000. For a ROTH IRA, you would have to pay taxes on the $10,000, but compare that to the taxes on $174,000 you would pay in a Traditional IRA! By paying a little more now, you guarantee yourself a much greater return in the future.

There are some limitations to ROTH IRAs. In order to be eligible to contribute to a ROTH IRA you must have taxable income under $110,000 if you file your taxes as an individual or $173,000 combined taxable income for married couples.

These limits change with inflation, check with the IRS about the most up to date limits here.

ROTH IRAs have a maximum annual contribution of $5,000 (or $6,000 if over the age of 50). Any contributions made to a Traditional IRA also count toward this limit. For example, as an investor you can put $5,000 in a traditional IRA, $5,000 in a ROTH IRA or $2,500 in each, but the combined contribution into any type of IRA can not exceed $5,000 per year.

ROTH IRAs do have several additional advantages over Traditional IRAs. ROTH IRAs have no required minimum distributions. This makes ROTH IRAs better accounts to have if you have other retirement accounts such as a 401(k) that will require withdrawals and you will not need the money in the ROTH IRA until later in life.

The other advantage ROTH IRAs have over Traditional IRAs is that they can be withdrawn from without penalty. However, only the initial investment may be withdrawn, not any gains in that investment. Consider an example:

Ben invests $5,000 into a ROTH IRA and in 5 years it grows to $7,000. After those 5 years, Ben loses his job and his car breaks down. He now desperately needs money for a new car. Thankfully he can withdrawal that $5,000 from his ROTH IRA without penalty, but he can not withdrawal the total $7,000. The $2,000 of increased value (gains) is the only part that is penalized if withdrawn. All original contributions can be withdrawn without penalty.

Like with Traditional IRAs, investors in ROTH IRAs may start to make penalty free distributions of gains starting at age 59 1/2.

Because of these features a ROTH IRA continues to be one of the best ways for young investors to save. A ROTH IRA is the only account that offers tax free growth and penalty free withdraws.

For most investors, after contributing up to your company's match for your 401(k), contributing $5,000 per year into a ROTH IRA should be your next priority.

Brokers

When deciding on a broker, there are many things to consider:

First and foremost, ensure that they offer a ROTH IRA or IRA instead of solely a regular brokerage account, which offers no tax benefits.

Next, be sure you can meet the account minimums for that broker. If all you can afford is $1,000, you will not be able to open an account at places like Vanguard which has a $3,000 minimum.

Look at the broker's offering of its own funds. Many broker's offer commission free trades on their own mutual funds and ETFs, which can save you a lot of money and make investing small amounts of money worthwhile. Make sure you are happy with their offering of funds. Some brokerages charge as much as $75 to purchase a mutual fund outside of their fund family, so look carefully.

For the long term investor, there are a couple of brokers that stand out that I have had personal experience using and can recommend. Note there are many others such as TD Ameritrade, Charles Schwab and ETrade which consistently receive high reviews. However I believe Fidelity and Vanguard offer a better selection of funds and I have used them personally, so I feel comfortable recommending them.

Fidelity

- $2,500 minimum to open an account
- $7.95 commission for stocks and non-commission free ETFs
- $75 to purchase non-Fidelity Mutual Funds!

Fidelity currently offers 30 Commission Free ETFs, the list can be found here.

Included in those 30 ETFs is a good mix of stock index funds, some good inexpensive bond funds and some foreign stock funds.

Fidelity offers well over 100 mutual funds, with about 50 offering expense ratios below 0.5%. Before opening an account, ensure you are happy with their list of funds, which you can search through here.

Vanguard

- $3,000 minimum to open an account
  Note: accounts with balances under $50,000 are charged a $20 annual fee. Accounts with balances less than $2,500 are charged a $10 monthly fee.

- $7 commission for stocks and non-commission free ETFs
- $35 to purchase non-Vanguard Mutual Funds

Vanguard offers 49 commission free ETFs, which are generally the cheapest in the industry. The full list is found here.

Vanguard also offers some of the cheapest mutual funds in the industry. Offering over 100 funds with expense ratios as low as 0.05%. The complete list can be found here.

Vanguard investors can avoid an additional $20 annual fee on mutual funds for signing up for paperless statements here.

Note: Please be sure to read the fine print carefully when opening an account. These numbers change frequently as the industry evolves. There is no guarantee these numbers are correct.

Brokers - Continued

For those just starting out, account minimums for brokers like Fidelity and Vanguard may be too high. For those with less to invest, I recommend a discount broker such as Scottrade, which has a $500 minimum, or Etrade which has no minimum for ROTH IRAs.

Accounts can always be switched over to another broker later once your account value has been built up. Discount brokerages such as Scottrade or Etrade do not offer their own funds, but will charge a low rate of $7-$10 per trade on any ETF available.

Scottrade

- $500 minimum to open an account
- $7 Trades for stocks and ETFs
- $17 to purchase mutual funds
- Over 500 local branches

- Absolutely no fees with Scottrade. I have had an account with Scottrade since I started investing at age 18, starting with an account of just $500. I have never encountered a fee other than the $7 for commission.

The local branches have come in handy for me on several occasions. Scottade also uses local branches as meeting locations for seminars to educate investors on the basics of investing and research.

Etrade

- $0 minimum for ROTH IRAs, $500 minimum for cash accounts.
- $10 trades for stocks and ETFs
- $20 to purchase mutual funds

- No fees if you use paperless statements

Scottrade and Etrade are two of the largest and most popular discount brokerages in the country. Both offer educational resources and highly rated customer service to help you get started.

Brokers - Opening your Account

The process for opening an account at any brokerage will be about the same. Applications can be completed online and will typically take less than 15 minutes. Within a day or two you can fund you account and start investing!

A ROTH IRA will be the best option for most beginning investors, particularly young investors. However it is impossible to recommend the best account type for each person. Be sure to consider benefits of all account types before opening an account.

A Ray of Hope?

According to Fidelity Investments, ROTH IRA contributions increased 9% from 2010 to 2011.

Your First Trade

First off, **congratulations** for making it this far. You are already far ahead of the average investor by making it here. Now lets set up your account with the right investments to be sure you make the most out of your savings.

For new investors with little money to get started I like to suggest a simple two fund portfolio. 1 bond fund and 1 stock fund. ETFs have no minimum investment, so even if you are starting with a few hundred dollars, you will be able to invest and learn how the market works.

The ETFs listed below have no minimums, as long as you can afford 1 share you will be able to invest. To get started pick 1 stock fund and 1 bond fund. Put 50% of your initial investment into the stock fund and 50% in the bond fund. Some brokers offer free trades on select ETFs, if your broker is listed, you will be charged no commission from purchasing that ETF. If your broker is not listed, any of these funds will do. Just note you will be charged the normal commission (usually $7-$10) to buy.

Stock Funds

VOO - Vanguard customers trade for free

IVV - Fidelity and TD Ameritrade customers trade for free

SPY - The most popular S&P 500 index fund

Bond Funds

BND - Vanguard and TD Ameritrade customers trade for free

AGG - Fidelity customers trade for free

Note, this 50/50 split is most likely not your optimal long term asset allocation. However for those that are brand new to investing, what is more important is that you understand your investments and know how they will perform. Even if you have no money to invest, watch how these funds perform over time by entering the fund's symbols into a website like Yahoo Finance.

This initial investment gets you invested and seeing some returns on your investment. As you read more and learn more about investing, adjust your investments accordingly to match your desired asset allocation.

Chart from Yahoo Finance

How have these funds performed over the last two years?

As stocks have been volatile, bonds have given portfolios balance and protection.

A simple stock fund and bond fund be the core of your portfolio for decades to come.

A Note on Budgeting

As you put your hard earned savings into tax advantaged investment accounts like an IRA or 401(k), be sure you realize one thing. In order to withdrawal from those accounts, under most circumstances you will pay a penalty if you withdrawal before you are retired (ROTH IRAs provide one exception). Although the money can be taken out in an emergency, it is not desirable because of the penalty and loss of potential earnings. For this reason if you are committing money into a retirement account, be sure you have an emergency fund already established.

Emergency Fund

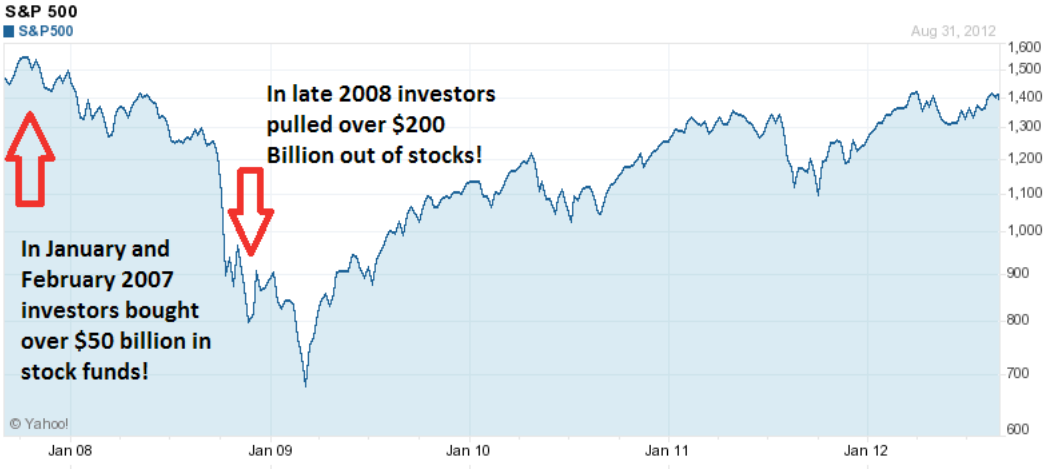
Your investments set aside for your retirement do not serve the same function as money in your savings account. Investments set aside for retirement need to be left alone for as long as possible so compounding interest can work for you and help ensure you have the money you need when it is time to retire.

For this reason, building up an emergency fund should be your first priority. Before you invest or even before aggressively paying down any debt have **at least** 3 months of expenses set aside in a checking, savings, or money market account. Many people will recommend up to 12 months of expenses stashed away - and you should build up to that eventually. Besides serving as a safety net for you and your family, an emergency fund serves another important role.

If you lose your job, more than likely the economy is in decline or already in recession. If the economy is in decline or in recession, more than likely the stock market is down significantly. If the stock market is down significantly you will more than likely take a loss on your investments if you sell (plus take a penalty if from an IRA). And more than likely, if the stock market is down significantly, it is a great buying opportunity, not a time for selling.

We saw the affects of this most recently in the 2008/2009 market decline. During the last half of 2008, investors pulled over $200 billion out of stock funds. The market was near a 10 year low. Anyone who had purchased stocks in the last 10 years more than likely lost money by selling. If investors could have been comfortable keeping money in the stock market, by having a large enough emergency fund, they could have comfortably stayed invested in the stock market.

Only several years later, that $200 billion withdrawn from the market would be worth over $300 billion today if it was just left alone.



Emergency funds can be kept in checking accounts, savings accounts or money market funds. The interest those accounts may offer is not nearly as important as the money being accessible and safe (meaning, not subject to wild price changes).

Budgeting