Getting Started with Investing

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Getting Started with Investing

1. The building blocks (asset classes, types of accounts)

2. Constructing a portfolio

3. Staying out of trouble
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2. Constructing a portfolio
3. Staying out of trouble
The Building Blocks

Stocks

- A stock is a share of ownership of a business.
- Make money through dividends (distribution of profits) and through price appreciation.
- Sometimes referred to as “equities.”
Bonds

• Loan to a borrower (government or business).
• Make money via interest paid by the borrower.
• In the category known as “fixed-income.”
The Building Blocks

Mutual Funds

• Pool of money, run by a fund manager.

• Own a collection of other investments (stocks, bonds, or both).

• Can be “actively managed” or “passively managed.”
The Building Blocks

Actively Managed Mutual Funds

• Fund manager tries to pick investments that will have above-average performance.
The Building Blocks

Passively Managed Mutual Funds

• Fund simply tries to track the performance of a given index (e.g., S&P 500, which reflects the performance of 500 large companies in the US).

• A common use for passive funds is to track the total US stock market or total international stock market.

• Index funds and exchange-traded funds (ETFs) are the most common types of passively managed funds.
Risk and Reward

With a bond, the borrower promises to pay you a certain amount of interest each year, and they promise to repay principal at maturity.

With stocks, there are no guarantees. You simply expect (hope) to get returns.

Because stocks have uncertain returns, they also have higher expected returns. (People wouldn’t buy shares in companies unless they thought they’d earn more than they would via bonds.)
Portfolio Growth

- Vanguard Total Stock Market: $5,002
- Vanguard Total Bond Market: $10,708

Feb 28, 2009
Types of Accounts

• Taxable accounts
• Traditional IRA ("individual retirement account")
• Roth IRA
• 401(k), 403(b)
• Roth 401(k), Roth 403(b)
Taxable Accounts

Interest is taxable.

Dividends are taxable, but at a reduced rate.

Short-term capital gains (from selling an asset held for 1 year or less) are taxable as ordinary income.

Long-term capital gains (from selling an asset held for longer than 1 year) are taxable at a reduced rate.
Traditional IRAs

Can contribute up to lesser of earned income or $6,000 per year ($7,000 if age 50+).

Contribution is deductible. However, if you have a workplace retirement plan, depending on income level you may not get a deduction.

No tax on growth while money stays in the account.

Withdrawals ("distributions") are taxable as income.

10% penalty for early distributions (pre-59.5)
Roth IRA

Contribution limit shared with traditional IRA. ($6,000 for 2021)

No deduction for contribution.

Account grows tax-free.

Distributions of earnings are tax-free if taken out after age 59.5 and you have had a Roth IRA for 5 years. (10% penalty if early)

Contributions can come back out, at any time tax-free, penalty-free.

Ability to contribute “phases out” based on MAGI:

• $125,000 - $140,000 for singles and heads of household
• $198,000 - $208,000 if married filing jointly
401(k) Plans

Akin to a traditional IRA through your employer. (Deductible contributions, account grows tax-free, taxable distributions.)

$19,500 contribution limit ($26,000 if age 50+).

Some employers offer a “matching” contribution.

403(b) plans are very similar.
Roth 401(k) or Roth 403(b)

Contribution limit shared with traditional 401(k) or 403(b) ($19,500 for 2021).

No deduction for contribution.

Account grows tax-free.

Distributions are tax-free if you are at least age 59.5 and your first Roth contribution to the plan was at least 5 years ago.
Constructing a Portfolio

1. Individual stocks/bonds or mutual funds?

2. Actively managed funds or passively managed funds?

3. What asset allocation to use? (How much in stocks and how much in bonds?)
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Constructing a Portfolio

Don’t bother picking individual stocks.

Expectations for a company are already “priced into” the company’s stock price.

To pick above-average stocks, you don’t just have to identify profitable companies. You have to identify companies that turn out to be more profitable than the market expected them to be.
Constructing a Portfolio

When you pick stocks, you’re competing against professional investors.

When you use individual stocks, you increase your risk (less diversified) without increasing your expected return.
Constructing a Portfolio

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Constructing a Portfolio

Most actively managed funds perform worse than passively managed funds.

Active fund success rate for the 20-year period ending 12/31/2020:

• 12.8% for US large-cap blend funds
• 16.8% for US large-cap value fund
• 11.3% for US large-cap growth funds
• 8.7% for US mid-cap blend funds
• 29.6% for US small-cap blend funds
• 14.6% for foreign large-cap blend funds
• 9.7% for intermediate-term core bond funds
Constructing a Portfolio

“The expense ratio is the most proven predictor of future fund returns. We find that it is a dependable predictor when we run the data. That's also what academics, fund companies, and, of course, Jack Bogle, find when they run the data.”

-Russel Kinnel of Morningstar
Constructing a Portfolio

“Using expense ratios to choose funds helped in every asset class and in every quintile from 2010 to 2015. For example, in U.S. equity funds, the cheapest quintile had a total-return success rate of 62% compared with 48% for the second-cheapest quintile, then 39% for the middle quintile, 30% for the second-priciest quintile, and 20% for the priciest quintile. So, the cheaper the quintile, the better your chances.”

-Russel Kinnel of Morningstar
Constructing a Portfolio

Low-cost funds tend to outperform higher-cost funds. And index funds (or ETFs) are the most reliable options for low costs.

But don’t worry about very small differences (e.g., 0.05% vs. 0.07%). That will often change from one year to the next anyway.
Constructing a Portfolio

Index Funds or ETFs?

• For most people, there are 100+ other financial planning decisions that are more important than this one.
• ETFs let you use orders other than market orders. And you can have trades executed during the day. And costs are ever-so-slightly lower (sometimes).
• Index funds let you place round-dollar-amount orders.
• Seriously, this is not important.
Constructing a Portfolio

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Constructing a Portfolio

The big asset allocation question: How much in stocks and how much in bonds?

Your asset allocation should be based on your risk tolerance.

Risk tolerance has two components:

• Economic: how much risk can you afford?
• Mental: how much risk can you psychologically tolerate?
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<td>100% bonds</td>
<td>6.0%</td>
<td>-8.1% (1969)</td>
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<td>80% bonds, 20% stocks</td>
<td>7.1%</td>
<td>-10.1% (1931)</td>
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<td>70% bonds, 30% stocks</td>
<td>7.7%</td>
<td>-14.2% (1931)</td>
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<td>60% bonds, 40% stocks</td>
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<td>100% stocks</td>
<td>10.2%</td>
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The Three-Fund Portfolio

Total Stock Market Index Fund (or ETF)
Total International Stock Index Fund (or ETF)
Total Bond Market Index Fund (or ETF)

Includes everything you need. (Super diversified.)
Low-cost.
Simple. (Easy to understand, easy to maintain.)
The Two-Fund Portfolio

Vanguard Total World Stock Index Fund (or ETF)
Total Bond Market Index Fund (or ETF)
Target-Date Funds

General idea is that they start aggressive and become more conservative as the named retirement date approaches.

Significant variation in underlying allocation from one fund company to another.

Ignore the date in the name. Pick based on allocation.
Staying Out of Trouble

Keep a long-term focus.

• You don’t have to check your portfolio everyday — or even every month.

• Watch out for recency bias. Just because the market has been going up doesn’t mean it will keep going up. Ditto for down markets.
Staying Out of Trouble

Automate your investing.

• Automating your retirement account contributions is the safest way to make sure you’re actually saving and investing.

• Target-date funds automate rebalancing.

• The more you have automated, the less often you have to check your portfolio.
Ignore the financial news.

- The financial media’s goal is just to get your attention.
- The flood of information about Tesla/Bitcoin is not there for any altruistic purpose. It’s not because this is critical information for personal financial planning. It’s just to get your attention.
Staying Out of Trouble

There’s no perfect portfolio.

• There is no perfect asset allocation, except in hindsight.
• There are plenty of “good enough” allocations.
• There is no best fund, except in hindsight.
• There are plenty of “good enough” funds.