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What is a Fool?

"The main purpose of the stock market is to make fools of as many men as possible." -- Bernard Baruch

While we certainly appreciate the plug, somehow we don't think that Mr. Baruch had our kind of Fool in mind. We feel that the main purpose of the stock market is to help enrich those who methodically save and invest, employing a buy-and-hold philosophy. What's more, at The Motley Fool we make a big distinction between a "fool" and a "Fool." Be a Fool! Buy 'n' hold! The others, the fools, may well be made idiotic by trying to predict the daily swings of the market.

Why invest?

Welcome to Investing Basics! If you've found your way here, chances are you've either got some money socked away or you're planning to do so. What are you saving for? Retirement? College for the kids? A new speaker system complete with woofers and tweeters? An exotic animal menagerie complete with Chihuahuas (woofers) and canaries (tweeters)? A retirement villa in the sun-baked hills of Tuscany?

Say you take $2000 of your savings and put it into the stock market. If your money returned 11% a year (the S&P 500's historical average), two grand would be worth $53,416.19 after 30 years. You could buy that Tuscan retirement villa (or at least come up with the down payment) with that kind of money.

Maybe you don't have $2000 burning a hole in your bank account, but perhaps you can afford to invest your lunch money. Brown-bag your lunch and sock away just $4 a day, 250 days a year. It's not a lot, but if you're in your early 20s, you've got the investor's best ally on your side -- time. If you invest $1,000 once a year in an investment that averages an 11% annual return -- the annual stock market return since 1926 -- it'll grow to more than $1 million after 46 years, which is right around the time you'll be ready to retire.

Of course, as you get older and more financially stable, you should be able to put away more to invest. Upping the ante to just $166 a month (lunch money plus about what you pay for basic cable TV and a movie channel), would put you at the million-dollar mark in just 39 years.

Simply put, you want to invest in order to create wealth. It's relatively painless, and the rewards are plentiful. By investing in the stock market, you'll have a lot more money for things like retirement, education, recreation -- or you could pass on your riches to the next generation so that you become your family's Most Cherished Ancestor. Whether you're starting from scratch or have a few thousand dollars saved, Investing Basics will help get you going on the road to financial (and Foolish!) well-being.

The power of compounding

The table below shows you how a single investment of $100 will grow at various rates of return. Five percent is what you might get from a certificate of deposit (CD) or with a government bond, 10% is a little less than the historical average stock market return, and 15% is what you might get if you decide to learn how to pick your own stocks and take advantage of some of our lessons inadvanced investing techniques.

Growing At

Year	5%	10%	15%	20%
1	$100	$100	$100	$100
5	$128	$161	$201	$249
10	$163	$259	$405	$619
15	$208	$418	$814	$1541
25	$339	$1083	$3292	$9540

Why is the difference between a few percentage points of return so massive after long periods of time? You are witnessing the miracle of compounding. When your investment gains (returns) begin to earn money, too, and those returns start to earn... small amounts of money can mushroom very quickly. Extend the time period or raise the rate of return, and your results increase exponentially. For instance, if you start young, say at 15 years of age, note how quickly a single $100 investment grows, especially in the later years.

Growing At

Age	5%	10%	15%	20%
15	$100	$100	$100	$100
20	$128	$161	$201	$249
25	$163	$259	$405	$619
30	$208	$418	$814	$1541
40	$339	$1083	$3292	$9540
50	$552	$2810	$13,318	$59,067
60	$899	$7298	$53,877	$365,726
65	$1147	$11,739	$108,366	$910,044

Looking at it another way, let's compare two teenagers and their lifetime savings habits. Bianca baby-sits a lot and spends most of her spare time reading. She saves $1000 a year starting when she's 15 and invests it in the stock market for 10 years earning 12% per year on average. After 10 years, she comes out of her shell, stops adding money to her nest egg, and spends every penny she earns club hopping and on trips to Cancun. But she keeps her nest egg in the market.

Compare her account to that of her friend Patrice, who squandered her early paychecks on youthful indiscretions. At age 40 Patrice gets a wake-up call when her parents retire on nothing but Social Security. She starts vigorously socking away $10,000 every year for the next 25 years. Guess who has more at age 65? That's right, Bianca. (You figured it was a setup, didn't you?) Her 10 years of saving $1000 per year (just $10,000 total -- the same amount Patrice put away in just one year) netted her $1.6 million by age 65. Patrice, on the other hand, scrimped for 25 years to invest a quarter million dollars out of her own pocket and ended up with just under a million. Neither will be going to the poorhouse, but you see our point: Bianca's baby-sitting money grew for 50 years, twice as long as Patrice's, and Bianca barely missed it.

(It's almost not fair to mention this, but Bianca's money was in a Roth IRA. Patrice could only put 20% of her money in the Roth ($2000 per year). So Bianca's $1.6 million is tax-free, but Patrice will be paying capital gains taxes on most of her money.)

We will revisit the subject of compounding in Step 2, but for now suffice it to say that the power of compounding is the single most important reason for you to start investing right now. Every day you are invested is a day that your money is working for you, helping to ensure a financially secure and stable future.

Getting ready to invest

After seeing all those impressive numbers, you're probably itching to take the next step. You want to drop everything and start investing right now. But ho-o-o-ld on! Would you start running a marathon without first stretching? Would you pour syrup on the plate before the pancakes are done? Having dazzled you with the power of compounded returns, we want to make sure it's not working against you. This means that you've got to get rid of your high-interest debt.

Why? Because, by the very same principle discussed above, a dollar of debt can quickly compound into a few *hundred* dollars of debt. Does it make sense to try to save money at the same time your debts are multiplying like bunnies? The first thing you should do to prepare for investing is to pay down all of your high-interest debt, such as credit card debt. Although some kinds of debt may be low-interest or tax-advantageous (such as your mortgage), the rule of thumb is: Be free of high-interest debt when you begin to invest.

Every dollar you can put toward investing is a dollar that can work for you. And, Fool, every dollar you avoid putting in the pocket of a financial professional, a full-service broker, or a mutual fund manager, is also a dollar that is creating value for you. (We'll get back to this point later.)

Pay yourself first

How can you become a successful investor? By making investing a part of your daily life. It's not such a stretch -- money is already part of your daily routine. Think about each decision that affects your finances, whether it is ordering a $4 glass of wine with dinner or getting a home equity loan to pay down credit card debt.

We're not suggesting that you obsess over every penny you throw into a wishing well. (Please don't embarrass your mother by diving in after it.) If you pay yourself first, you won't have to. What do we mean? When you pay your bills -- the credit cards, the gas, water, electric, cable, and phone bills, and the kid who mows your lawn and the one who throws the newspaper onto your neighbor's porch instead of yours every other morning -- add one more item to that list. In fact, we think it should be the first item. Put yourself at the top of that list: Pay yourself first. Then you don't have to think about it again until next month.

The Motley Fool recommends that you put away as much as possible, with the goal being to save 10% of your annual income (total, not take-home). Depending on your obligations, you may be able to save more or less. The more you save, the more wealth you create -- but anything is better than nothing. Remember, even a few dollars saved now will be worth more than lots of dollars saved later. So take advantage of services that automatically withdraw money from your checking account and transfer it to some savings or investing vehicle. You'll be surprised how easy it is to live on a few less dollars each month. You probably won't even notice the difference.

You can be flexible about this. If you find yourself eating beans and rice every night for a month (and you don't like beans and rice), then maybe you're paying yourself too much, or perhaps you're not in a position to start paying yourself at all. But as soon as it's feasible, jump in. Remember Patrice and Bianca!

Savings and investment vehicles

As you can see from the above numbers, the single greatest factor, by far, in growing your long-term wealth is the rate of return you get on your investment. There are times, though, when you may need to park your money someplace for a short time. Here is a summary of the most common short-term savings vehicles:

Short-Term Savings Vehicles

- **Savings account:** Often the first banking product people use, savings accounts earn a small amount in interest (anywhere from 2.0% to 4.0%, often less), making them a little better than that dusty piggy bank on the dresser.
- **Money market funds:** Money market funds are a specialized type of mutual fund that invests in extremely short-term bonds. Unlike most mutual funds, shares in a money market fund are designed to be worth $1 at all times. Money market funds usually pay better interest rates than a conventional savings account, but below what you could get in certificates of deposit.
- **Certificate of deposit (CD):** This is a specialized deposit you make at a bank or other financial institution. The interest rate on CDs is usually about the same as that of short- or intermediate-term bonds, depending on the duration of the CD. Interest is paid at regular intervals until the CD matures, at which point you get the money you originally deposited plus the accumulated interest payments. CDs offered by banks are usually insured.

As you'll see later, Fools are partial to investing in stocks, as opposed to other long-term investing vehicles, simply because stocks have historically given the highest return on your money. Here are the most common long-term investing vehicles:

Long-Term Investing Vehicles

- **Bonds:** Bonds come in various forms that you will learn about in Step 5. They're known as "fixed-income" securities because the amount of income the bond generates each year is "fixed," or set, when the bond is sold. From an investor's point of view, bonds are very similar to CDs, except that they are issued by the government or by corporations instead of banks.
- **Stock:** Stocks are a way for individuals to own parts of businesses. A share of stock represents a proportional share of ownership in a company. As the value of the company changes, the value of the share in that company rises and falls. Stocks are discussed in detail in Step 3 of Investing Basics.
- **Mutual funds:** Mutual funds are a way for investors to pool their money to buy stocks, bonds, or anything else the fund manager decides is worthwhile. Instead of managing your money yourself, you turn over the responsibility of managing that money to a "professional." Unfortunately, 9 of 10 "professionals" tend to underperform the market indexes, a fact that we'll look at in Step 4.

Retirement plans

There are a number of special plans designed to create retirement savings, and many of these plans allow you to deposit money directly from your paycheck before taxes are taken out. Employers occasionally will match the amount (or a percentage of that amount) you have withheld from your paycheck up to a certain percentage of your salary. (Pssssst. That's what we affectionately call "free money.") Some of these plans permit you to withdraw money early without a penalty in order to buy a home or to pay for education. If early withdrawals are not permitted, you may be able to borrow money from the account, or take out low-interest secured loans with your retirement savings as collateral. Rates of return vary on these plans depending on what you invest in, since you can invest in stocks, bonds, mutual funds, CDs, or any combination.

- **Individual Retirement Account (IRA):** One of a group of plans that allow you to put some of your income into a tax-deferred retirement fund -- you won't pay taxes until you withdraw your funds. Withdrawals are taxed at regular income tax rates, not at the lower capital gains rates. All IRAs are specialized accounts (not investments) that allow the account holder to invest the money however she likes. If you qualify, some or all of your IRA contribution may be tax deductible.
- **Roth IRA:** A new type of retirement account that differs from the conventional IRA in that it provides no tax deduction up front on contributions. Instead, it offers total exemption from federal taxes when you cash out to pay for retirement or a first home. A Roth can also be used for certain other expenses such as education or unreimbursed medical expenses without paying a penalty (but any earnings that are withdrawn are subject to income taxes unless you are over 59 1/2). Roth IRAs have tighter income restrictions ($95,000 for a individual or $150,000 for married couples) than traditional IRAs, and taxpayers who participate in corporate retirement plans and don't qualify for deductible contributions to the conventional IRA often can take advantage of the Roth IRA.
- **401(k):** A retirement savings vehicle offered by employers that is named after the Internal Revenue Code section in which it is covered. Given the tax advantages and the possibility of corporate matching (when your employer matches part of your contribution - that free money we were referring to above), the 401(k) is well worth considering.
- **403(b):** The nonprofit version of a 401(k) plan. Local and state governments offer the 457 plan.
- **Keogh:** A special type of IRA that doubles as a pension plan for a self-employed person. The self-employed person can put aside significantly more than the $2,000 allowed for a IRA.
- **Simplified Employee Pension (SEP) Plan:** A special kind of Keogh-individual retirement account. SEPs were created so that small businesses could set up retirement plans that were a little easier to administer than normal pension plans. Both employees and the employer can contribute to a SEP.

Common Pitfalls to Avoid

Before you race off through the rest of Investing Basics, there are some cautionary points to consider before you proceed. These are common mistakes many people make when considering what to do about investing.

1. **Doing Nothing.** There is no guarantee that the market will go up the first day, month, or even year that you invest in it. But there is one guarantee: Doing nothing at all will not provide for a comfortable retirement.

2. **Starting Late.** Postponing your investing career is second only to not investing at all on the list of investment sins. You already know that the earlier you start the better off you are. (Take another look at the compound return example we gave above.) If you're already past those formative twenties (you don't look a day over 32 to us), we'll reword this first pitfall to read: "Not starting now."
3. **Investing Before Paying Down Credit Card Debt.** If you have money in your savings account and you have revolving debt on your credit card, pay it off. Many credit cards have an annual interest rate of 16% to 21%. Let's say you have $5000 to invest, but you also have $5000 debt on your credit cards with an average annual interest rate of 18%. It doesn't take an astrophysicist to figure out that you're going to have to get an 18% return after you pay taxes just to break even on that $5000. Pay the debt off first, then think about investing.
4. **Investing for the Short Term.** Only invest money for the short term that you're actually going to need in the short term. Invest money in the stock market that you won't need for at least three years, and preferably five years or longer. If you'll need your cash next year for a down payment on a house or for the family Caribbean cruise, use one of the shorter term and safer havens for your cash, such as money market funds or CDs.
5. **Turning Down Free Money.** You'd never turn down a dollar if it was offered with no strings attached. That's what you're doing if your company offers a 401(k) or similar retirement savings plan with an employer match and you're not participating. Take advantage of all tax-advantaged, employer-matched savings programs.
6. **Playing It Safe.** If you're young, most of your investing dollars should be in the stock market. You have enough time to weather any dips in the market and to reap the rewards of long-term gains. Although you may want to transition into bonds later in life as you depend on your investments for income, stocks should make up a large portion of the portfolio of every investor.
7. **Playing It Scary.** Not every investment is for everyone. We'll help you determine your psychological investing profile in Step 2. Investing Concepts. Even if you're a daredevil, you shouldn't pour all of your money into something that could end up going down the drain.
8. **Viewing Collectibles or Lottery Tickets as Investments.** If old comic books, Barbie dolls, and abandoned exercise equipment could be used to fund retirements, do you think the stock market would exist? Probably not. Don't make the mistake of thinking your jewelry, those Beanie Babies, or the lottery will provide for you in your latter years.
9. **Trading In and Out of the Market.** We believe the best approach to investing is the long-term one. Pick your investments well and you'll reap rewards over the long term that you had ever dreamed possible. Trade in and out of the market and you'll be saddled with fees that chip away at your returns, and you'll potentially miss out on gains that long-term investors enjoy with much less effort.

Summary and Next Steps

Congratulations! You've made it through Step One of Investing Basics. (Bet you didn't even break a sweat.) You've witnessed the power of compounding and you understand how debt (and other common pitfalls) can ruin even the healthiest investing plan. Empowered with a general sense of the various savings and investing vehicles, you are now prepared to look at the basic investment concepts. See you in Step 2. Investing Concepts.

For further reading about how to get started in investing, try our bookshelf where we have some suggested titles for fledgling Fools.

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