Why You Should Invest in Stocks

Lesson 101: Stocks Versus Other Investments

"Some regard private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful see it for what it really is—the strong horse that pulls the whole cart."—Winston Churchill

We all have financial goals in life: to pay for college for our children, to be able to retire by a reasonable age, to buy the things we want. Unfortunately, spending less than we earn is typically not enough for us to reach our goals. We have to do more; we have to invest our savings and put our money to work. Stocks are quite simply one of the best ways to make your investment dollars work the hardest.

Investing in stocks is not rocket science. The only real characteristics shared among successful stock investors are basic math skills, a critical eye, patience, and discipline. Combine these with an understanding of how money flows and how businesses compete with one another, along with a dash of accounting knowledge, and you have all the mental tools needed to get started. We will teach you all these in this workbook series.

Although you don't need an advanced college degree to invest in stocks, selecting stocks is nevertheless an intellectual exercise. It requires effort, but it can bear many fruits. After all, investing in stocks not only leads to potentially higher returns on your investment dollars, it also leads to a greater understanding of how the world works.

What Is a Stock?

Perhaps the most common misperception among new investors is that stocks are simply pieces of paper to be traded. This is simply not the case. In stock investing, trading is a means, not an end.

A stock is an ownership interest in a company. A business is started by a person or small group of people who put their money in. How much of the business each founder owns is a function of how much money each invested. At this point, the company is considered “private.” Once a business reaches a certain size, the company may decide to “go public” and sell a chunk of itself to the investing public. This is how stocks are created.

When you buy a stock, you become a business owner. Period. Over the long term, the value of that ownership stake will rise and fall according to the success of the underlying business. The better the business does, the more your ownership stake will be worth.

Picking Stocks

If stocks are ownership interests in businesses, selecting which stocks to own is really an exercise in picking which businesses you want to own.

Why Invest in Stocks?

Stocks are but one of many possible ways to invest your hard-earned money. Why choose stocks instead of other options, such as bonds, rare coins, or antique sports cars? Quite simply, the reason that savvy investors invest in stocks is that they provide the highest potential returns. And over the long term, no other type of investment tends to perform better. (Lesson 103 will talk all about the historical returns of stocks.)

On the downside, stocks tend to be the most volatile investments. This means that the value of stocks can drop in the short term. Sometimes stock prices may fall for a protracted period. For instance, those who put all their savings in stocks in early 2000 are probably still underwater today. Bad luck or bad timing can easily sink your returns, but you can minimize this by taking a long-term investing approach.

There's also no guarantee you will actually realize any sort of positive return. If you have the misfortune of consistently picking stocks that decline in value, you can lose money, even over the long term!

Of course, we think that by educating yourself and using the knowledge in this workbook series, you can make the risk acceptable relative to your expected reward. We will help you pick the right businesses to own and help you spot the ones to avoid. Again, this effort is well worth it, because over the long haul, your money can work harder for you in equities than in just about any other investment.

Your Investment Choices

Let's see how stocks stack up to some of your other investment options:

Mutual Funds. Stock mutual funds can offer similar returns to investing in stocks on your own, but without all the extra work. When you invest in a fund, your money is pooled with that of other investors, and then it is managed by a group of professionals who try to earn a return by selecting stocks for the pool. (Shameless plug: We at Morningstar have a whole separate set of investing workbooks dedicated to mutual fund investing and finding the best funds.)

Beyond requiring much less effort, one key advantage of funds is that they can be less volatile. Simple statistics says that a portfolio is going to experience less volatility than the individual components of the portfolio. After all, individual stocks can and sometimes do go to zero, but if a mutual fund held 50 stocks, it would be very unlikely that all 50 of those stocks become worthless.

The flipside of this reduced volatility is that fund returns can be muted relative to individual stocks. In investing, risk and return are intimately correlated—reduce one, and odds are you will reduce the other. Another disadvantage to offloading all the effort of picking individual stocks is that you must pay someone else for this service. The professionals running mutual funds do not do so for free. They charge fees, and fees eat into returns.

Plus, the more money you have invested in mutual funds, the larger the absolute value of fees you will pay every year. For instance, paying 1% a year in fees on a $1,000 portfolio is not a big deal, but it's a much larger deal if the portfolio is worth $500,000. In the past, mutual funds often made the most sense for those with relatively small amounts to invest because they were the most cost-efficient. But with the advent of $10 (or less) per-trade commissions on stocks, this is no longer necessarily the case.

Just as picking the wrong stock is a risk, so is picking the wrong fund. What if the group of people you selected to manage your investment does not perform well? Just like stocks, there is no guarantee of a return in mutual funds.

It's also worth noting that investing in a mix of mutual funds and stocks can be a perfectly prudent strategy. Stocks versus funds (or any other investment vehicle) need not be an either/or proposition.

Pros and Cons of Stock Investing

Pros	Potentially higher long-term returns.	**Cons**	Greater volatility.
	Full control of portfolio mix. You choose what you want to own.		Price to entry: the learning curve.
	Greater tax control.		Lots of ongoing work. (No pain, no gain.)
	If done right, lower trading costs & fees.		

Bonds. At their most basic, bonds are loans. When you buy a bond, you become a lender to an institution, and that institution pays you interest. As long as the institution does not go bankrupt, it will also pay back the principal on the bond, but no more than the principal.

There are two basic types of bonds: government bonds and corporate bonds. U.S. government bonds (otherwise known as T-bills or Treasuries) are issued and guaranteed by Uncle Sam. They typically offer a modest return with low risk. Corporate bonds are issued by companies and carry a higher degree of risk (should the company default) as well as return.

Bond investors must also consider interest rate risk. When prevailing interest rates rise, the market value of existing bonds tends to fall. (The opposite is also true.) The only way to alleviate interest rate risk is by holding the bond to maturity. Investing in corporate bonds also tends to require just as much homework as stock investing, yet bonds generally have lower returns.

Given their lower risk, there is certainly a place for bonds or bond mutual funds in most portfolios, but their relative safety comes with the price of lower expected returns compared with stocks over the long term.

Real Estate. Most people's homes are indeed their largest investments. We all have to live somewhere, and a happy side effect is that real estate tends to appreciate in value over time. But if you are going to use real estate as a true investment vehicle by buying a second home, a piece of land, or a rental property, it's important to keep the following in mind.

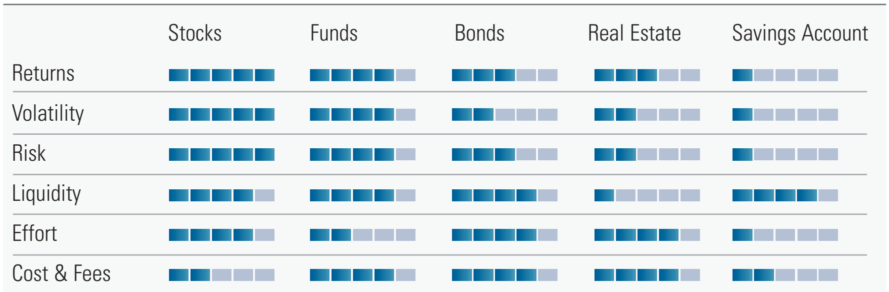
First, despite the exceptionally strong appreciation real estate values have had the past several years, real estate can and does occasionally decline in value. Second, real estate taxes will constantly eat into returns. Third, real estate owners must worry about physically maintaining their properties or must pay someone else to do it. Likewise, they often must deal with tenants and collect rents. Finally, real estate is rather illiquid and takes time to sell—a potential problem if you need your money back quickly.

Some people do nothing but invest their savings in real estate and do quite well. But just as stock investing requires effort, so does real estate investing.

Bank Savings Accounts. The problem with bank savings accounts and certificates of deposit is that they offer very low returns. The upside is that there is essentially zero risk in these investment vehicles, and your principal is protected. These types of accounts are fine as rainy-day funds—a place to park money for short-term spending needs or for an emergency. But they really should not be viewed as long-term investment vehicles.

The low returns of these investments are a problem because of inflation. For instance, if you get a 3% return on a savings account, but inflation is also dropping the buying power of your dollar by 3% a year, you really aren't making any money. Your real return (return adjusted for inflation) is zero, meaning that your money is not really working for you.

How Stocks Stack Up



The Bottom Line

Though investing in stocks may indeed require more work and carry a higher degree of risk compared with other investment opportunities, you cannot ignore the higher potential return that stocks provide. And as we will show in the next lesson, given enough time, a slightly higher return on your investments can lead to dramatically larger dollar sums for whatever your financial goals in life may be.

Investor's Checklist

- Investing in stocks is an intellectual exercise that requires effort, but it is an effort that can bear many fruits.
- Among the potential investments one can make, stocks provide the largest long-term returns, but they also have the largest volatility.
- Stocks are ownership interests in companies. They are not simply pieces of paper to be traded.

Quiz

Answers to this quiz can be found on page 165

1 Which of the following types of investments provide the largest long-term returns?

- a Stocks.
- b Bonds.
- c Savings accounts.

2 Which of the following types of investments are the most volatile in their pricing?

- a Stocks.
- b Bonds.
- c Savings accounts.

3 Which of the following skills sets is NOT needed to be a successful investor?

- a Discipline.
- b A critical eye.
- c Advanced statistics.

4 Over the long term, which type of investment provides the lowest real (inflation adjusted) returns?

- a Stocks.
- b Mutual funds.
- c Savings accounts.

5 When you buy a stock, you are:

- a Making a loan to a company.
- b Buying an ownership interest in a company.
- c Investing in the government.

Worksheet

Answers to this worksheet can be found on page 175

1 Why do you want to invest at all? Write down your financial goals in life in the space below. The effort you put into these workbooks will certainly help you toward these goals.

2 What are some of the things that concern you about stock investing? Write them here. Are you willing to see the value of your investments continuously fluctuate (sometimes significantly) in order to receive a higher long-term return?

3 Can you describe what a stock actually is?

4 Write below some products and brands you like. Figure out which companies make these. Chances are you can become an owner in these businesses.

Product names	Company