Investing Basics

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Investments are transfers made from current income intended to provide future income (for example, in retirement.). Investments take maximum advantage of time and compounding, with gains reinvested to generate gains of their own.

Although investments should be made regularly, starting early in the investor's lifetime, emergency/reserve savings goals should also be pursued and met.

Investment Instruments

The most common investment instruments are stocks, bonds, and mutual funds. The value of investment accounts grows through profit-sharing with stockholders (dividends), growth in the market value of shares of stocks, and/or interest payments on money borrowed from investors (bonds).

Stockholders own small parts of a company, whereas bondholders lend to a company or government entity. Mutual funds are "baskets" of stocks or bonds; each shareholder owns a piece of the basket. Mutual funds provide an easy alternative to selecting individual stocks or bonds by pooling money from many investors to purchase stocks and/or bonds. The holdings of a mutual fund are called a "portfolio."

Return on Investment

Different portfolios project different rates of return. None of them are guaranteed or insured, however, and the highest projected returns are associated with the highest risk.

Stocks have averaged an annual return of 10% to 12% for the past 90 years, but can rise and fall dramatically, especially in the short term.

Bonds can be very safe (guaranteed by the U.S. government), have a high risk of default (if a company is heading toward bankruptcy, etc.) or fall somewhere in between. Investors need to research the "rating" of a bond to ensure they buy only those that match their risk tolerance.

Investment Accounts

Investment accounts include:

Personal investment accounts, for holdings in stock, bonds, and mutual funds. There are no upward limits on amounts that may be invested and no requirement that investments be held for a set length of time. Dividends may incur taxes that have to be paid annually.

401(k) accounts: These are employer-sponsored retirement accounts; TSP is a form of 401(k). In 2018, employees may contribute up to $18,500 per year. Contributions are subject to early-withdrawal penalties and taxes if withdrawn before age 59.5.

Individual retirement accounts (IRAs): These are retirement accounts funded by entirely by individuals rather than employers. In 2018, individuals may contribute up to $5,500, and either defer taxes until retirement (traditional IRA) or pay taxes now and pay no taxes later on earnings (Roth IRA). Early withdrawal penalties apply to either kind of IRA.

Other investment accounts include 529 accounts (for college savings); 403(b) accounts (retirement accounts for employees of non-profit organizations); and 457 accounts (retirement accounts for certain government employees).

Financial Advisers

Most investors use a financial adviser to manage their investments. Advisers may work for a bank or credit union, a brokerage company, or may be in private practice. Investors should ask about a prospective advisor's credentials (such as Certified Financial Planner or attorney-at-law), the length of their experience, and the average returns they have generated on investment accounts they manage.

Some financial advisers charge fees and or commissions for their services. Investors should understand what those are and how they are collected.

Investors should be sure to clarify what their interests are when interviewing prospective financial advisers.