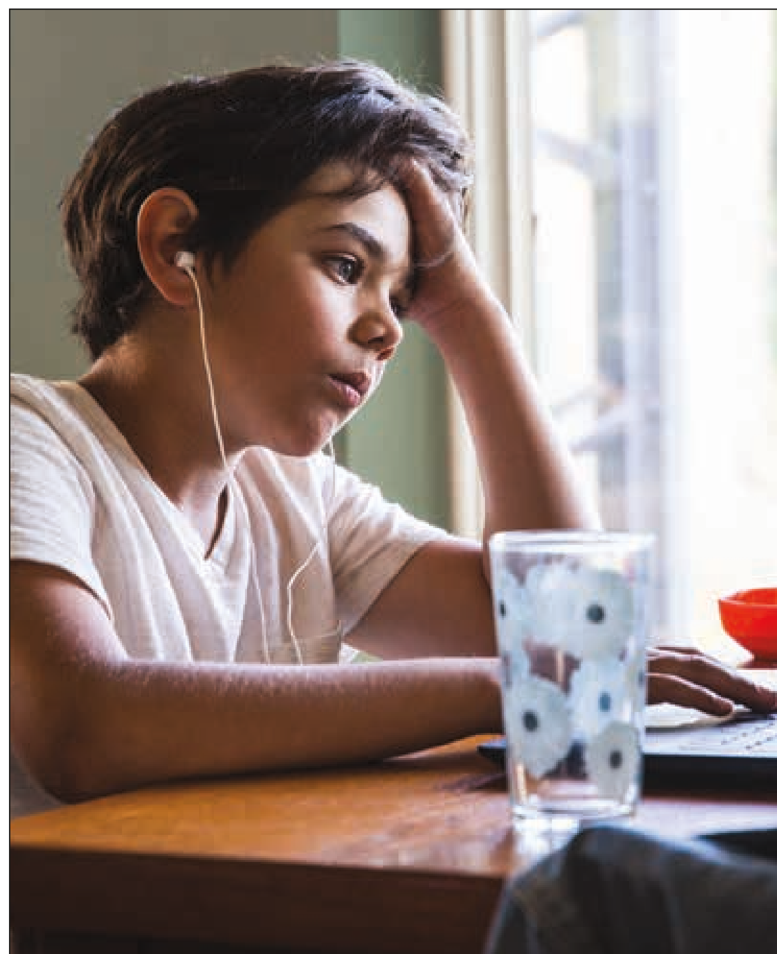

financial fitness

By Erik Ford

Giving Them A GOOD START

In the wake of everything else we experienced in 2020, there was a surge of new individual investors entering the financial markets. Despite the volatility and uncertainty of the markets and life in general, the combination of being stuck at home and the ability for small investors to enter the markets due to lower account minimums and lower transaction costs prompted younger and smaller investors to put their money to work.

Research conducted by FINRA and the University of Chicago found that new investors were more likely to be younger, more diverse, and have lower incomes than existing investors. Of new investors, two-thirds were under 45 and one-quarter had incomes under $35,000. The reason cited most frequently for investing was saving for retirement, but also ranking high was the ability to invest small amounts. Obviously, those are both good things: starting early in order to save for retirement and realizing the benefit of being able to start small.

The disconnect with new investors is how they perceive risk, in particular, the risk they may actually be taking and the risk they think they are taking. The majority report that they are taking an average risk and expect average returns, while 40% report a willingness to take above average risks and expect above-average returns. This in and of itself is not a bad thing for younger investors who have the benefit of time, but we question how they perceive the risk they are actually taking. Being 100% invested in equities is vastly different than being 100% invested in one equity. Of new investors, 61% report making at least one trade a month. Further, two-thirds of new investors report that they trade in individual stocks. As small investors who may be taking a high level of risk by focusing on equities, compounding that risk by being invested in a few individual stocks, while perhaps exciting, presents much more risk than new investors realize. While most new investors reported taking average risk, many actually engaged in above-average risk-taking by being in a very few positions.

According to an article in the AAII Journal (April 2021), "Many don't know a lot and don't seem to realize it." This conclusion is partly based on a quiz given to new investors where they scored very low even though they expressed a high level of confidence. It should be noted that these results are not that different from investors with some level of experience.

To properly reduce their risk, of course, new and small investors should look to mutual funds or exchange-traded funds to get diversified exposure to the markets. Young investors can afford to take more risk via higher equity exposure but concentrating that in one or a few individual positions is likely unwise, let alone relying on social media as a "research" source.

One suggestion to address this is to provide a good base of knowledge and a good start for new investors. Make a point of discussing finance and investment basics in family discussions. Introduce discussions of goals, the risk/return trade-off, diversification, compounding, and the value of time for starters. Perhaps assist with a virtual investment account for practice or set up an account with oversight to start. We certainly encourage investing and starting early. However, having a solid grounding in investment basics at the start can provide the guidance that serves beginning investors for a lifetime, a lifetime that can result in a successful savings and investment experience. They may even thank you for it.

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