How to Get Started Investing in Stocks and Mutual Funds

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- Where do I begin?
- How do I get started investing?
- How do I pick good mutual funds?
- How do I find good stocks?

These questions likely sound familiar. People often feel they don't know where to begin in their search for stock and fund investments.

Helping people make thoughtful and sound investing decisions is our mission at Morningstar. And part of that mission is educating people on the basics—as well as advanced aspects—of investing.

If you explore what we have published over the past 20 years, you'll find plenty of editorial for beginning, intermediate, and experienced investors.

In response to librarians' requests for help to get their patrons started, we've gathered what we consider some of our best introductory material into this booklet.

You can share this with staff. And you can make copies for patrons. In fact, we encourage you to copy this booklet and give it to patrons who ask you, "How do I start?"

Start here.

How to Get Started Investing in Mutual Funds

Intimidated by the task of picking a mutual fund? You're not alone. With more than 20,000 funds to choose from, it's tempting to let others do the picking for you.

Actually, selecting the best funds for you is easier than it appears. Like almost everything else in life the best way to start is by asking the right questions.

Selecting the best funds is easier than it appears.

And here are the five questions you should ask about a mutual fund—all questions you can easily answer by consulting our database created exclusively for libraries and their patrons, Morningstar Investment Research Center. They are questions that form the very foundation of Morningstar's approach to fund selection.

- How has a mutual fund performed?
- How risky has it been?
- What does it own?
- Who runs it?
- What does it cost?

1 How Has a Fund Performed?

Many would say that a fund that produced returns of 22% per year for the past five years performed better than a fund that returned 20% per year over the same period.

That's sometimes the case, but not always. The fund that gained 20% may have beaten competing funds that follow the same investment style by 6 percentage points, while the 22% gainer may have lagged its competitors by a mile.

To really know how well a fund is doing, you can't look at returns in isolation. Instead, put a fund's returns into context. Compare the fund's returns with those of appropriate benchmarks—with indexes and with other funds that invest in the same types of securities.

This is easy to do on Morningstar Investment Research Center.

Just click on the Total Returns link found in the left column of every fund report. You'll see a fund's performance compared with its category average and a benchmark, such as the S&P 500.

2 How Risky Has a Fund Been?

The very act of investing involves an element of risk. But some funds are more volatile than others. Generally, the greater the return of an investment, the greater the risk—and therefore the greater potential for loss.

Investors who take on a lot of risk expect a greater return from their investments, but they don't always get it. Other investors are willing to give up the potential for large gains in return for a less bumpy ride.

Consider a fund's volatility in conjunction with the returns it produces. Two funds with equal returns might not be equally attractive investments; one could be far more volatile than the other.

Consider a fund's volatility in conjunction with the returns it produces.

Here are four measures of risk you'll find in every fund report in Morningstar Investment Research Center.

Standard Deviation

A high number could indicate a fund is volatile. Most investors equate risk with volatility.

Beta

It measures a fund's sensitivity to market movements. For instance, a fund with a beta of 1.10 performed 10% better than its benchmark index in up markets and 10% worse in down markets.

Morningstar Risk

Our measure looks at the downside risk of funds each month. We categorize 10% as low risk, 22.5% as below-average risk, the middle 35% as average, the next 22.5% as above-average, and the top 10% as high risk.

Morningstar Bear Rank

Bear markets are down markets (such as the biggest bear of all, The Great Depression). Our bear rank tells how a fund has performed in a down market.

Find these risk measures on Morningstar Investment Research Center.

Click the Morningstar Rating and Risk Measures links in the left column.

3 What Does a Fund Own?

To set realistic expectations for what a fund can do for you, it's important to know what types of securities a fund's manager buys. You shouldn't expect a bond fund to gain 10% per year, but that's not an unrealistic expectation for a stock fund.

Don't rely on a fund's name to tell you what it owns. Fidelity Magellan FMAGX is a giant in the fund industry, but does the fund's name give you any idea of the types of securities its manager buys?

Refer to financial reports to learn how.

The portfolio sections of the financial reports on Morningstar Investment Research Center provide a wealth of portfolio information, including top holdings, sector breakdowns, and the Morningstar style box.

Don't rely on a fund's name to tell you what it owns.

Fund managers can buy just stocks, just bonds, or a mix of the two. They can stick with U.S. companies or venture abroad. They can hold big companies, like Coca-Cola KO or Gillette G, or focus on small companies most of us have never heard of. They can load up on high-priced companies that are growing quickly, or they can favor value stocks with lower earnings prospects but cheap prices. Finally, managers can own 20 or 200 stocks.

How a manager chooses to invest your money is one of the most important factors that will drive performance. To get a feel for how a manager invests, examine a fund's portfolio.

4 Who Runs the Fund?

Mutual funds are only as good as the people behind them: the fund managers who make the investments.

Knowing who's calling the shots is essential to smart mutual fund investing.

Because the fund manager is the person most responsible for a fund's performance, knowing who's calling the shots—as well as how long he or she has been doing it—is essential to smart mutual fund investing.

Make sure that the manager who built the majority of the fund's record is still the one in charge. Otherwise, you may be in for an unpleasant surprise.

Morningstar Investment Research Center is your source for valuable insights into managers.

Click the Management link in the left column and you'll have access to manager biographies and can learn how long the manager has been with the fund.

Click on the Stewardship Grade link and you'll get a detailed rundown on fund management that helps you assess whether managers are working for investors or just for themselves. Information you'll find here includes corporate culture, the quality of the board of directors, manager incentives, and more.

5 What Does a Fund Cost?

Mutual funds aren't free. However, the way funds get paid leaves lots of investors with the impression they are nearly free. That's hardly the case; in fact, some funds extract quite dear prices.

Paying enormous expenses to invest is like giving money away. That's because every penny that you give to fund management or to brokerage commissions is a penny you take away from your own return.

Further, costs are one of the few constants in investing: They'll remain pretty stable year in and year out while the returns of stocks and bonds will fluctuate. You can't control the whims of the market, but you can control how much you pay for your mutual funds.

Unfortunately, fund costs are somewhat invisible, buried in shareholder reports and taken right off the top of your return.

Morningstar Investment Research Center surfaces these expenses.

You'll find a detailed breakdown of a fund's costs in every fund report. Just click the Fees & Expenses link in the left column.

19 Ways to Become a Smarter Stock Investor

Here at Morningstar, our stock analyst staff has nearly a thousand years of collective investing experience. They've learned a lot about successful stock investing. We've boiled down some of their most helpful observations into 19 suggestions we think will make you a better stock investor.

1 Keep It Simple.
Seventeenth-century philosopher Blaise Pascal once said, "All man's miseries derive from not being able to sit quietly in a room alone."

By keeping it simple you can greatly enhance your odds of success.

This aptly describes the investing process. Those who trade too often, focus on irrelevant data points, or try to predict the unpredictable are likely to encounter some unpleasant surprises when investing. By keeping it simple—focusing on companies with economic moats (that is, strong competitive advantages), requiring a margin of safety when buying, and investing with a long-term horizon—you can greatly enhance your odds of success.

2 Have the Proper Expectations.
Are you getting into stocks with the expectation that quick riches await? We hate to be a wet blanket, but unless you are extremely lucky, you will not double your money in the next year investing in stocks. Such returns generally cannot be achieved unless you take on a great deal of risk by, for instance, buying extensively on margin or taking a flier on a chancy security. And that is crossing the line from investing into speculating.

Though stocks have historically been the highest-return asset class, this still means returns in the 10%-12% range. These returns have also come with a great deal of volatility. If you don't have the proper expectations for the returns and volatility you will experience when investing in stocks, irrational behavior—taking on exorbitant risk in get-rich-quick strategies, trading too much, swearing off stocks forever because of a short-term loss—may ensue.

3 Be Prepared to Hold for a Long Time.
In the short term, stocks tend to be volatile, bouncing around every which way on the back of Mr. Market's knee-jerk reactions to news as it hits. Trying to predict the market's short-term movements is not only impossible, it's maddening.

It is helpful to remember what Benjamin Graham said: In the short run, the market is like a voting machine—tallying up which firms are popular and unpopular. But in the long run, the market is like a weighing machine—assessing the substance of a company.

Yet all too many investors are still focused on the popularity contests that happen every day, and then grow frustrated as the stocks of their companies—which may have sound and growing businesses—do not move. Be patient, and keep your focus on a company's fundamental performance. In time, the market will recognize and properly value the cash flows that your businesses produce.

4 Tune Out the Noise.
There are many media outlets competing for investors' attention, and most of them center on presenting and justifying daily price movements of various markets. This means lots of prices—stock prices, oil prices, money prices, frozen orange juice concentrate prices—accompanied by lots of guesses about why prices changed.

Unfortunately, the price changes rarely represent any real change in value. Rather, they merely represent volatility, which is inherent to any open market. Tuning out this noise will not only give you more time, it will help you focus on what's important to your investing success—the performance of the companies you own.

Just as you won't become a better baseball player by staring at statistical sheets, your investing skills will not improve by only looking at stock prices or charts. Athletes improve by practicing and hitting the gym; investors improve by getting to know more about their companies and the world around them.

When stocks have fallen, they are low, and that is generally the time to buy!

5 Behave Like an Owner.
We'll say it again—stocks are not merely things to trade. They represent ownership interests in companies. If you are buying businesses, it makes sense to act like a business owner. This means reading and analyzing financial statements on a regular basis, weighing the competitive strengths of businesses (economic moats), making predictions about future trends, as well as having conviction and not acting impulsively.

6 Buy Low, Sell High.
If you let stock prices alone guide your buy and sell decisions, you are letting the tail wag the dog. It's frightening how many people will buy stocks just because they've recently risen, and those same people will sell when stocks have recently performed poorly.

Wakeup call: When stocks have fallen, they are low, and that is generally the time to buy! Similarly, when they have skyrocketed, they are high, and that is generally the time to sell!

Don't let fear (when stocks have fallen) or greed (when stocks have risen) take over your decision-making.

7 Watch Where You Anchor.
Anchoring is mentally clinging to a specific reference point. Unfortunately, many people anchor on the price they paid for a stock, and gauge their own performance (and that of their companies) relative to this number.

Remember, stocks are priced and eventually weighed on the estimated value of future cash flows businesses will produce. Focus on this. If you focus on what you paid for a stock, you are focused on an irrelevant data point from the past. Be careful where you place your anchors.

8 Remember that Economics Usually Trumps Management Competence.

You can be a great racecar driver, but if your car has only half the horsepower as the rest of the field, you are not going to win.

Likewise, the best skipper in the world cannot effectively guide a ship across the ocean if the hull has a hole and the rudder is broken.

Also keep in mind that management can (for better or for worse) change quickly, while the economics of a business are usually much more static. Given the choice between a wide-moat, cash-cow business with mediocre management and a no-moat, terrible-return businesses with bright management, take the former.

9 Be Careful of Snakes.

Though the economics of a business is key, the stewards of a company's capital are still important. Even wide-moat businesses can be poor investments if snakes are in control. If you find a company that has management practices or compensation that makes your stomach turn, watch out.

Great managers often find new business opportunities in unexpected places.

10 Bear in Mind that Past Trends Often Continue.

One of the most often heard disclaimers in the financial world is, "Past performance is no guarantee of future results." While this is indeed true, past performance is still a pretty darn good indicator of how people will perform again in the future. This applies not just to investment managers, but company managers as well. Great managers often find new business opportunities in unexpected places. If a company has a strong record of entering and profitably expanding new lines of business, make sure to consider this when valuing the firm. Don't be afraid to stick with winning managers.

11 Prepare for the Situation to Proceed Faster than You Think.

Most deteriorating businesses will do so faster than you anticipate. Be very wary of value traps, or companies that look cheap but are generating little or no economic value.

On the other hand, strong businesses with solid competitive advantages will often exceed your expectations. Have a very wide margin of safety with a troubled business, but do not be afraid to have a much smaller margin of safety for a wonderful business with a shareholder-friendly management team.

12 Expect Surprises to Repeat.

The first big positive surprise from a company is unlikely to be the last. Ditto the first big negative surprise. Remember the "cockroach theory." Namely, the first cockroach you see is probably not the only one around; there are likely scores more you can't see.

13 Don't Be Stubborn.
David St. Hubbins memorably said in the movie *This is Spinal Tap*: "It's such a fine line between stupid and clever." In investing, the line between being patient and being stubborn is even finer, unfortunately.

Any time a crowd has unanimously agreed that a certain investment is a "can't lose" opportunity, you are probably best off to avoid that investment.

Patience comes from watching companies rather than stock prices. If a stock you recently bought has fallen, but nothing has changed with the company, patience will likely pay off.

However, if you find yourself constantly discounting bad news or downplaying the importance of deteriorating financials, you might be crossing that fine line into stubborn territory. Being stubborn in investing can be expensive.

Always ask yourself, "What is this business worth now? If I didn't already own it, would I buy it today?" Honestly and correctly answering these questions will not only help you be patient when patience is needed, but it will also greatly help you with your selling decisions.

14 Know Your Friends and Your Enemies.
What's the short interest in a stock you are interested in? What mutual funds own the company, and what is the record of those fund managers? Does company management have "skin in the game" via a meaningful ownership stake? Have company insiders been selling or buying? At the margin, these are valuable pieces of collateral evidence for your investment thesis on a company.

15 Recognize the Signs of a Top.
Whether it is tulip bulbs in 17th century Holland, gold in 1849, or Beanie Babies and Internet stocks in the 1990s, any time a crowd has unanimously agreed that a certain investment is a "can't lose" opportunity, you are probably best off to avoid that investment.

Also, when you see people making investments that they have no business making (think bellboys giving tips on bonds, auto mechanics day-trading stocks in their shops, or successful doctors giving up medicine to "flip" real estate), that's also a sign to search for the exits.

16 Look for Quality.
If you focus your attention on companies that have wide economic moats, you will find firms that are virtually certain to have higher earnings five or 10 years from now.

You want to make sure that you focus your attention on companies that increase the intrinsic value of their shares over time. These afford you the luxury of being patient and holding for a long time. Otherwise, you are just playing a game of chicken with the stock market.

17 Don't Buy Without Value.
The difference between a great company and a great investment is the price you pay. There were many fantastic businesses around in 2000, but very few of them were attractively priced at the time.

Finding great companies is only half the equation in picking stocks; figuring out an appropriate price to pay is just as important to your investment success.

Great investors are willing to go against the grain.

18 Always Have a Margin of Safety.
Unless you unlock the secret to time-travel, you will never escape the inherent unpredictability of the future. This is why it is key to always have a margin of safety built in to any stock purchase you may make—you will be partially protected if your projections about the future don't exactly pan out the way you expected.

19 Think Independently.
Great investors are willing to go against the grain. You should find zero comfort in relying on the advice of others and putting your money where everyone else is investing. Quite simply, it pays to go against the crowd, because the crowd is often wrong.

Also remember that successful investing is more about having the proper temperament than it is about having exceptional intelligence. If you can keep your head while everyone else is losing theirs, you will be well ahead of the game—able to buy at the bottom, and sell at the top.

The Bottom Line

We've included a lot of information and collective wisdom into these pages on fund and stock investing. We firmly believe that if you heed the advice contained here, you will make better decisions when buying and selling funds and stocks.

And here's another piece of sound advice: Gain as much knowledge of investing concepts, techniques, methods, and investments as you can. Knowledge, after all, truly is power.

Here are three suggestions for greatly increasing your investing knowledge.

Morningstar Investment Research Center Investing Classroom
You'll find Investing Classroom in the Help & Education section of Morningstar Investment Research Center. It offers self-paced courses on stock and fund investing, and portfolio building. Investing Classroom breaks learning down into manageable chunks. You can cover a topic in around 10 minutes. We think it is the easiest and quickest way to sharpen all your investing skills.

The Five Rules for Successful Stock Investing: Morningstar's Guide to Building Wealth and Winning in the Market
We refer often to the value of a company in this booklet. So, exactly how do you establish value? Read this book authored by our director of stock analysis. In the simplest possible terms, it explains how to establish the intrinsic value of a company. Along the way, it dispenses tons of invaluable stock investing insights.

Morningstar Guide to Mutual Funds: 5-Star Strategies for Success, 2nd Ed.
You probably first heard about Morningstar in association with fund investing. Yes, we are the authority. And this is the standard reference on how to pick funds, assemble them in a successful portfolio, and monitor the portfolio to ensure it always produces at its peak.

For more information about Morningstar Investment Research Center and our other library products, please contact Morningstar Library Services.

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