Step 7: Buy Your First Stock

Description

You've paid off your credit cards. You've saved up an emergency fund. You've opened a brokerage account. You've done your research and found the stock of your dreams. Let the guns blaze!

Whoa there, cowboy!

Hey, we're just as excited as you are that you're ready to be a stock owner. But before you go knocking on Mr. Market's door, bearing cash and gusto, let's keep some perspective.

First, this is just one of *many* investments you'll end up owning. That's to say, you want to invest in sips, not gulps. Your first purchase should be as petite in size as it is bold in spirit. Second, don't forget that your first investment is also a learning experience. As any craftsman will tell you, there's no better way to learn than by doing.

A journey of a thousand miles begins with a single step. And that's what we recommend to you: Buy a single share of your favourite stock. Just one. This *one* share will teach you more about life as an investor than we could ever hope to teach you here. Follow it. Get to know it. Read the quarterly earnings releases, listen to or read the transcript of the conference calls, and see how the stock's daily fluctuations affect you. For future stock purchases, you should keep trading costs and commissions to less than 2% of your total purchase amount, but we'll let that slide on your first buy.

There is something else we would like for you to pick up while you're making a stop at your friendly online broker: A stake in an index fund.

The passive investor's best friend

How many times have you heard someone ask, "How'd the market do today?" But what is "The Market?" And how do we know how it did? Usually, the answer reflects the performance of an index — such as the S&P/TSX Composite Index, the Dow Jones Industrial Average (U.S.) or the Standard & Poor's 500 (U.S.) — rather than the market as a whole.

What all indexes have in common is that the value of the index changes proportionally to the value of the stocks in the index. So when the index goes up, the aggregate value of the stocks in the index has grown by a proportional amount, and vice versa.

And you can invest in those indexes — through index funds. These funds don't look to beat the market — they look to match it as closely as possible. That might not sound enticing at first blush, but consider that index funds offer:

1. Instant diversification: When you invest in an index fund, in one fell swoop you've spread your dollars across industries, markets, currencies, and countries, substantially lowering your risk in the process.

2. Low costs: Index funds have *much* lower expenses than actively managed mutual funds. If we lean a bit on U.S. data to make this point, the average actively managed U.S. mutual fund charges its investors 1.4% for the privilege of owning units. The Vanguard 500 Index fund which tracks the S&P 500, carries an expense ratio of only 0.16%. A spread of 1.24% which over the long term can amount to a serious difference in your portfolio's return, especially given the impact of…..here's that term again….compounding!
3. Superior returns: According to the Fool's own U.S. based research, only 42% of actively managed mutual funds beat the S&P 500 through the 15 years ending January 2009. We're not the only ones to have studied this dynamic; numerous others have shown that you're likely to underperform by investing in a typical "actively managed" fund. And as we just pointed out, you'll pay a lot more for that privilege.

Although we firmly believe that an index fund should serve as the foundation for your portfolio, we Canadians need to be careful in selecting *which* index we want to own. For Canadians looking for diversification, our beloved domestic index—the S&P/TSX Composite—may actually not be the best option. That's because the S&P/TSX Composite is dominated by three sectors: Financials (think banks and insurance companies), Energy (think oil and natural gas), and Materials (think base metal and gold miners).

These three sectors amount to about 75% of the entire index, which means a whopping $0.75 of every $1 you invest in a Canadian index fund is allocated to a measly three sectors—and three that are often pretty darn volatile.

That's not smart, Foolish diversification. Instead, we believe it makes much more sense for Foolish Canadian investors to invest in a U.S. based index fund, and specifically one that mimics the S&P 500. The big 3 Canadian sectors, Financials, Energy and Materials, only amount to about 25% of the S&P 500, meaning the success of the index is not nearly as influenced by the traditionally volatile stocks that reside in these sectors.

It doesn't end there. We would also recommend that you purchase a currency hedged version of an S&P 500 index fund. That sounds fancy, but it's simply a U.S. index fund that takes currency out of the equation, so you don't have to worry about exchange rate changes.. One of the best known ETFs that provides this currency neutral exposure is the S&P 500 Index Fund (CAD Hedged) offered by iShares from Blackrock. This product trades on the TSX under the symbol XSP.

In terms of allocation, we simply recommend that for every dollar you put into individual stocks, you roll the same amount into an index fund.

Owning a single share in a single business is very, very unlikely to achieve the long term goals that we have in mind for you, and therefore at some point, once you have gained a satisfactory level of comfort with your one share, it will be time to either round out that position, in three stages of course, or dump it and move on. To improve your odds of success and reduce your risk, your portfolio building journey should lead you to at least 15 holdings plus the same dollar amount allocated to an index fund. This will ensure the proper amount of diversification, but still ensure that each of your holdings will have an impact (hopefully positive) on the overall performance of the portfolio.

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