Smart Investing on a Small Budget

BY REBECCA LAKE

A common myth about investing is that a big fat bank account is required just to get started. In reality, the process of building a solid portfolio can begin with a few thousand—or even a few hundred—dollars.

This story offers specific advice, organized by the amount you may have available to begin your investments. But it first covers some smart moves low-rollers can make to kickstart a savings and investment program.

Strategies to Start

Whether you're planning to invest a little or a quite a lot, in safe bets or high-risk gambles, these steps should help get your plans off on the right track.

Automate Savings

The diligence to dependably set aside a certain amount in savings every month will reap rewards in the long run. If you lack the willpower or organization to do that alone, technological help is available via various smartphone/computer applications.

The apps that make saving the least painless are those that simply round up your purchases and other transactions, and put aside the "savings." Acorns, Qapital, and Chime all round up transactions from your credit and/or debit cards and return the money to you in savings-friendly vehicles.

KEY TAKEAWAYS

- Set aside a certain amount to save regularly
- Look into savings apps that round up your purchases and save the small change.
- First, pay off high-interest debts.
- Take advantage of retirement plans.
- Focus on low-fee options, at every investment level.
- Think about the level of risk you are comfortable with, and how that changes over time.
- Trade up to better choices as your investment pot grows.

Acorns puts the money into one of several low-cost ETF portfolios; these are good vehicles for small savers, as we cover below. Qapital adds the option to automatically transfer money, based on rules you choose, to an FDIC-insured Wells Fargo account. Chime, which is an online bank as well as an app, offers a savings account that automatically sets aside 10% of every paycheck you deposit, among other features.

Short of using these apps, check with your bank about their own apps, and other ways you might automatically transfer funds from non-savings accounts to those better suited to savings and investment.

DEAL WITH YOUR DEBTS

Before you begin to save, analyze what it's costing you to carry debts you already have and consider how rapidly you might discharge those. After all, high-interest credit cards can carry rates of 20% or more and some student loans have interest rates over 10%. Those rates far eclipse the average annual earnings of 7% or so that the U.S. stock market has returned over time.

If you’re carrying a lot of high-interest debt, then, it makes more sense to pay off at least some of it before you make investments. While you can’t predict the exact return on most of your investments, you can be certain that retiring debt with a 20% interest rate one year early is as good as earning a 20% return on your money.

Consider Your Retirement

A key goal of saving and investing, even at an early age, should be to help ensure you have enough money after you stop working. One priority in your planning, then, should be to take full advantage of the inducements dangled by governments and employers to encourage retirement security.

If your company offers a 401(k) retirement plan, don't overlook it. That's doubly the case if your company matches part or all of your contribution to the plan.

For example, if you have an income of $50,000 and contribute $3,000, or 6% of your income, to your 401(k) plan, your employer might match that by contributing an additional $3,000. A less generous employer might contribute up to only 3%, adding $1,500 to your $3,000 contribution.

You'll *always* want to invest enough to get the full amount of your employer’s match. Not to do so is essentially to throw money away.

401(k)s and some other retirement vehicles are also powerful investments because of their favorable tax treatment. Many allow you to contribute with pre-tax dollars, which reduces your tax burden in the year you contribute. With others, such as Roth 401(k)s and IRAs, you contribute with after-tax income but withdraw the funds without tax, which can reduce your tax hit on the year of withdrawal. And remember, if your money has grown for many years, there will be much more than you originally contributed so those tax-free withdrawals will truly be worth it.

In both scenarios, the earnings on what you invest accumulate tax-free within the account. Even if your employer doesn't offer any match on your 401(k) contributions, a plan is still a good deal..

INVEST YOUR TAX REFUND

If you find it hard to save money throughout the year, consider setting aside part or all of your tax refund as a way to get started with investing. It’s one of the few moments in the year where you're likely to get a windfall that you weren't already counting on.

RECOMMENDATIONS BY INVESTMENT AMOUNT

Before the specifics, a few general points are worth underlining. No matter your net worth, it’s important to minimize your investment fees, whether it’s on a checking account, a mutual fund, or any other financial product.

That's especially the case when you’re investing on a budget because fixed fees will take a bigger chunk of your savings. A $100 annual fee on a $1 million account is trivial, but a $100 fee on a $5,000 account is a hefty financial hit. If you’re investing on a budget, carefully choose the costs associated with where you put your money.

You'll also need to weigh likely returns on your investments against the level of risk you're comfortable with taking and that's appropriate to your age. In general, your portfolio should become steadily less risky as you approach retirement.

HOW TO INVEST $500

It may seem like a small amount to work with, but $500 can go farther than you might think in starting an investment portfolio

If you prefer to play it safe, park your sum in a certificate of deposit from a bank or other lender or use it to purchase short-term Treasury bills, which can be purchased through an online broker. The growth potential with both options is limited but the risks are virtually zero. It's a way to earn a little on your money until your nest egg grows to the point where other options are available.

For those who are comfortable with a little more risk, a range of choices are available, even for small investors, that promise greater returns than CDs or T-bills. One is a dividend reinvestment plan (DRIP). You buy shares of stock, and your dividends are automatically used to purchase additional shares or even fractional shares.

This is a great choice for small investors because the shares are purchased at a discount and without paying a sales commission to a broker. Buying a single share of a company's stock will get you started.

Another option for starting small is an exchange-traded fund (ETF), most of which require no minimum investment. Unlike most mutual funds, ETFs typically feature a passive management structure, which translates to lower ongoing costs. However, among other drawbacks to ETFs, you must pay fees on their transactions, To lessen these charges, consider using a discount broker that does not charge a commission or plan to invest less often, perhaps investing larger amounts quarterly rather than making small monthly purchases.

Towards the top of the risk continuum, there's investing in peer-to-peer lending. Crowdfunders connect investors with money to lend and entrepreneurs trying to fund new ventures. As the loans are repaid, each investor receives a share of the interest in proportion to the amount they have invested. Some crowdfunding platforms have high minimums to open an account, such as the $1,000 one for Lending Club, but you can get started with others, such as Prosper, for as little as $25.

Crowdfunding offers high risk, since many new ventures fail, but also the prospect of higher earnings. Generally, annual returns fall in the 5% to 8% range but can climb to 30% or more for investors who are willing to take a big risk, or are simply lucky enough to back an especially profitable newcomer.

How to Invest $1,000

If you’re saving for retirement or a home purchase that's some years away, you might look for a low-fee target-date fund with a relatively low minimum investment, typically of $1,000 or so.

With this type of fund, you choose the target date. The investments in the fund are automatically adjusted over time, with the overall mix moving from riskier to safer as your target date becomes closer.

Why is this important? When you’re just starting out, you have time. You can make riskier investments that might earn higher returns. But as you near your target date, especially if that's your retirement date, you want to protect yourself from sudden losses that can derail your plans.

With that $1,000, you also could consider purchasing individual stock shares, which come with higher risk but can generate higher returns. Investing in individual stocks that pay dividends is a smart strategy. You will have the option of receiving the dividends as cash payouts or reinvesting them in additional shares.

How to Invest $3,000

This investment level allows access to additional options, including more mutual funds. While some funds require a minimum investment of $1,000 or less, a larger sum is more common, such as the $3,000 required by Vanguard for most of its funds.

Among the many fund types, consider looking first to an index fund, a type of mutual fund that tracks a specific market index, such as the Standard & Poor 500 or the Dow Jones Industrials and offers relatively low fees. Like ETFs, index funds are passively managed, which means a lower expense ratio, which in turn moderates fees.

The goal of an index fund is to at least match the performance of the index. It also gives you broad exposure to a number of asset classes.

How to Invest $5,000

The possibilities become broader at the $5,000 level, including more options for investing in real estate. While $5,000 isn't enough to purchase property, or even to make a down payment, it's enough to get a stake in real estate in several other ways.

The first is to invest in a real estate investment trust (REIT). This is a corporation that owns a group of properties or mortgages that produce a continuous stream of income. As a REIT investor, you're entitled to a share of the income generated by the underlying properties. REITs are required by law to pay out 90% of their income to investors as dividends annually. REITs can be traded or non-traded, with the latter carrying much higher upfront fees.

Real estate crowdfunding is a second option. Real estate crowdfunding platforms are now permitted to accept investments from both accredited and non-accredited investors. Many platforms set the minimum investment for gaining entry to private real estate deals at $5,000.

Investors can also choose between debt and equity investments in commercial and residential properties, depending on the platform. Returns for debt investments range from 8% to 12% a year. Equity investments can see higher yields if the value of the property increases. Keep in mind, this type of investment can carry more risks than more traditional investments.

The Bottom Line

Investing can get complicated, but the basics are simple. Maximize the amount you save and your employer's contributions. Minimize taxes and fees. Make smart choices with your limited resources.

That said, building a portfolio can also raise such complexities as how best to balance the risk of some investments against their potential returns. Consider getting help. Given technology and the fierce competition for your investments, more resources than ever are available. Those options include robo-advisors, virtual assistants that can help you create a balanced portfolio at a low price, and fee-only financial advisors, who do not depend on income from commissions on the products they sell you.

The hardest part of investing is getting started. And the sooner you do so, the more you should make, by odds. It's as simple as that.