

Beginning Investor

A series providing guidance for new investors on how to become successful investors. See AAII.com for the other articles in this series.

How Much Is Needed to Start Investing?

What is the minimum dollar amount needed to start investing? It is a question some members ask us and likely one that many others have, especially those who are new to investing.

Technically, you are only limited by the minimum amount required by a brokerage firm or mutual fund company to open an account. ShareBuilder, an online broker, has no required minimum account balance. More than 50 mutual funds included in our annual mutual fund guide have minimum purchase requirements of \$100 or less, including funds offered by Fidelity, AssetMark, USAA and Oakmark.

Pragmatically, you should weigh the dollar amount you have available to invest against the actual costs of creating a diversified portfolio. Brokerage commissions for buying and selling stocks and exchange-traded funds (ETFs) increase significantly on a percentage basis as the dollar amount invested decreases. Mutual funds, conversely, charge a flat percentage fee. Commission-free ETFs, which are offered by some brokerage firms (including Charles Schwab, Fidelity and TD Ameritrade) are even more advantageous from a cost standpoint.

Stocks and Brokerage Commissions

Most online brokerage firms charge between \$7 and \$10 per trade. Though this does not sound like much, commissions can have a big impact on small accounts. For example, say you have \$1,000 to invest in a single stock. Your buy and sell orders will each cost you \$10, resulting in a transaction cost of \$20. This equates to a 2% reduction in your actual returns. Once you start factoring in the costs, your profit may very well not justify the risk of trying to pick an individual stock, if you are investing a small amount in a taxable account.

If you have a larger sum of money, brokerage commissions quickly decline as a percentage of your investments. For instance, \$10 to buy and sell equates to only 0.1% of a \$10,000 investment. This “economy of scale” boosts your realized returns.

Beyond the costs of buying a single stock, you need to

consider how many stocks you can actually buy. Studies suggest a minimum of 15 to 20 securities are required to build a diversified portfolio. Buying fewer, especially less than 10, increases the risk that a sharp decline in a single stock will significantly hurt your returns.

Mutual Fund Advantages

An alternative to buying individual stocks is to invest in a mutual fund. A no-load mutual fund does not charge you any money for buying or selling your shares from an account held with the mutual fund family. Rather, it charges a flat expense ratio. The amount charged varies, but the average domestic large-cap fund charges 1% annually.

The bigger advantage a mutual fund gives you is instant diversification. Rather than spending a lot of money on commissions for 15 or 20 stocks, you could get exposure to several hundred stocks for a flat fee.

ETFs Are Even Cheaper

The cheapest option is use a commission-free ETF. If you use a brokerage firm that waives the commission, you will incur no transaction costs. (Taxes may still be owed on realized capital gains or distributions, however.) The expense ratios are also lower than mutual funds, with some ETFs charging 0.1% or less.

There are three caveats, however. The first is that you will have to meet the minimum account balance required to open a brokerage account. The second is that the selection of commission-free ETFs is limited and, from a performance and strategy standpoint, you may be better off paying commissions to get the ETF you want. Three, both ETF and mutual fund capital gains and distributions can be subject to taxes, which hurts your realized returns. (You will not incur taxes on capital gains or for funds and stocks held in a tax-deferred account, such as an IRA.)

—Charles Rotblut, CFA, Editor, AAI Journal