Investing Basics

By Ryan Watkins, Chief Content Creator at TraderTactics.com

Every trader needs to start somewhere, so why not start with the basics?

Investing has thousands of words, terms, theories, methods, and intense mathematical formulas. I will spare you the lesson in advanced mathematical investment models and get to the point of what matters the most from a fundamental understanding.

First, we need to understand the two types of investing out there, Passive & Active.

Passive Investing:

This is buying a stock or ETF, putting it in a box, locking it and throwing away the key. You are in this stock position for an exceptionally long time, years, decades in fact and you hope you picked the right stock so that when you retire and need the money that there is enough to last your full retirement. You likely will not just pick one stock or ETF, but several or many, and stay invested in them for the duration of your investment horizon. This is commonly known as, "Buy & Hold" Investing.

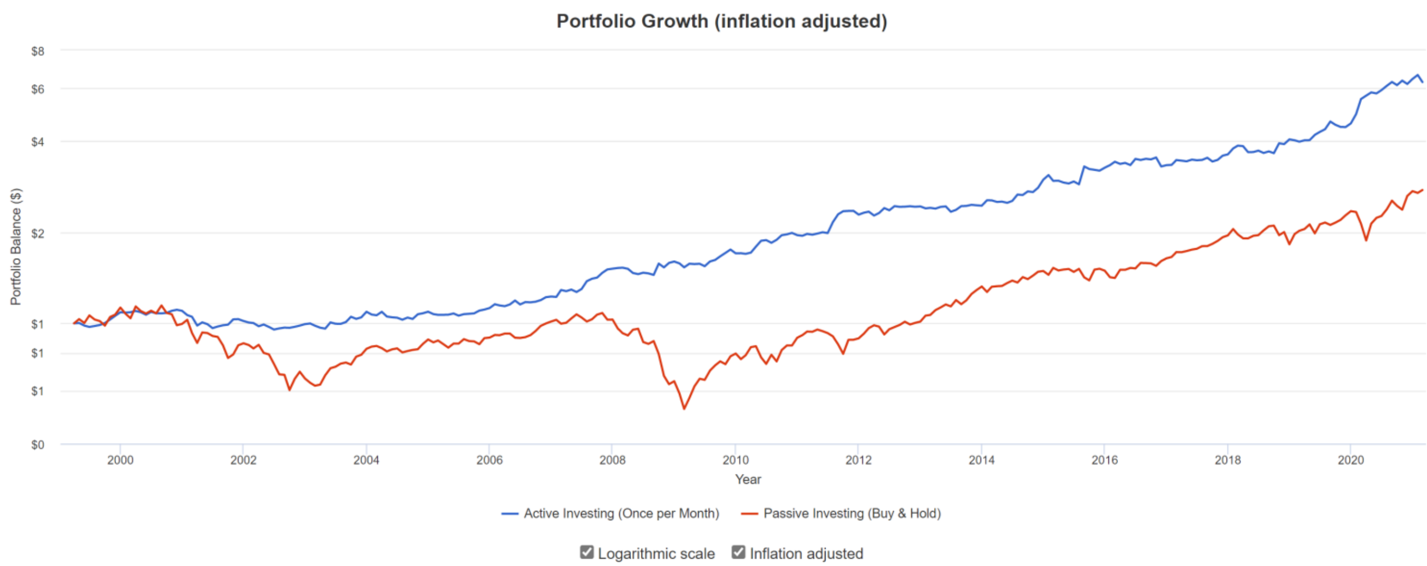
The other main point in Passive Investing is you the investor are Passive. Meaning, you do truly little work, maybe no work at all if you hire an investment manager and financial advisor to do it for you. This type is not for everyone and has its pros and cons and should be well thought out if this is the right path for you or not.

Active Investing:

This type of investing takes a more active role in your investments. The definition can have a broad range, for example, some Active Investors can, add, or remove investments from their portfolio every month, other Active Investors may change investment allocations each Quarter (3 months), and others may change each year. The main point here is they are Active and looking for good investment opportunities to better their lives and enhance their returns each year.

This can be a big advantage over a Passive Investor, but it does take some education first in what to look for. I will show you an example comparison of a Passive Allocation vs an Active Allocation and you be the judge.

Below is a chart of a Passive Allocation of the S&P 500 (Red Line), a major benchmark for investment comparison, and an Active Allocation updated once per month (Blue Line).



The range of time that was used was starting at April 1st, 1999 to Feb 28th, 2021.

There are several key differences in this chart that are especially important to investors. Let us look at the results under a microscope and discover a few more especially important terms.

First, look at how much smoother the blue line is compared to the "jumpier" red line. If the blue line were a movie, it would be a long, slow, documentary based on facts and if the red line was a movie it would be an action-packed thriller that will keep you on the edge of your seat.

That may sound fun and exciting, but please trust me when I tell you, the more "action-packed" your investment allocation is the scarier the ride. You do not want that in investing? The exciting part in the movie is called "**Standard Deviation" (Stdev)** in investing. It is the ups and downs that investors experience just like an emotional high or low in a movie.

The higher the **Stdev** the more exciting the movie, or in this case the more your investments "jump around". The Passive Investment Model has a Stdev of 15.07%, which is high compared to the Active Investing "documentary" of 8.98%. This simply means the Active Investing Model is not nearly as Jumpy, volatile, explosive, exciting, or unstable. In investing, this is a good thing to have, a low Stdev.

Portfolio Returns

Portfolio	Initial Balance	Final Balance	CAGR	Stdev	Best Year	Worst Year	Max. Drawdown
Active Investing (Once per Month)	$1.00	$10.01	11.08%	8.98%	42.20%	-5.67%	-10.94%
Passive Investing (Buy & Hold)	$1.00	$4.40	6.99%	15.07%	32.18%	-37.02%	-50.97%

Compare the same two investment models from Jan 1st, 2007 to Jan 1st, 2010. Notice the **Stdev** for the Passive Investment (Buy & Hold) was an extremely high 19.72% compared to the Active Investment Model of 9.12%. Investors that are trying to hold through this difficult and volatile period will not likely stay invested. Most will panic, sell, and not return to investing until they feel confident enough to do so and by that time, they have missed most of the best investments.

Portfolio Returns

Portfolio	Initial Balance	Final Balance	CAGR	Stdev	Best Year	Worst Year	Max. Drawdown
Active Investing (Once per Month)	$1.00	$1.50	14.04%	9.12%	29.04%	0.54%	-5.74%
Passive Investing (Buy & Hold)	$1.00	$0.81	-6.63%	19.72%	26.49%	-37.02%	-50.97%

Another term, "**Maximum Drawdown" (MDD)** is the lowest emotional low in a movie. It is the part when you think the hero has no hope left or when you are crying in a movie because your favorite character died, that is the Maximum Drawdown. Trust me, you do not want a big drawdown, nor do you want them often either. Every investment will have drawdowns, it is part of investing, but read this carefully and remember these next words…

The lower your drawdown is and the fewer the drawdowns you have, the better your performance will likely be.

It is the number one factor I look at. Of course, you do not want to just sit in cash and have no drawdown, we do need to invest our money to grow it, but we need to be very mindful of decreasing our drawdowns when we are able.

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Just look at the difference in drawdowns between the Active and Passive Investment Models, -10.9% vs -50.9%. That is a huge difference. Just imagine you have $100,000 invested in each allocation. The Active has a drawdown of 11%, so that means your investment is down to $89,000 (-$11,000). Now that same $100,000 invested in the

Passive Allocation is down -51% (-$51,000). That means your $100,000 is now down to only $49,000. You have just lost half of your account, ouch!

You might be thinking, yeah but I have not actually "lost" that money because I have not sold it yet. Please understand, whether you sell it or not, your account is down 51%, period! To add to that, it takes a 100% return on your account just to get it back to break even. Yes, you read that right, a 100% return just to get it back to breakeven when your account has a drawdown of 50%!

Compare the same two investment models from Jan 1st, 2007 to Jan 1st, 2010. What a difference!

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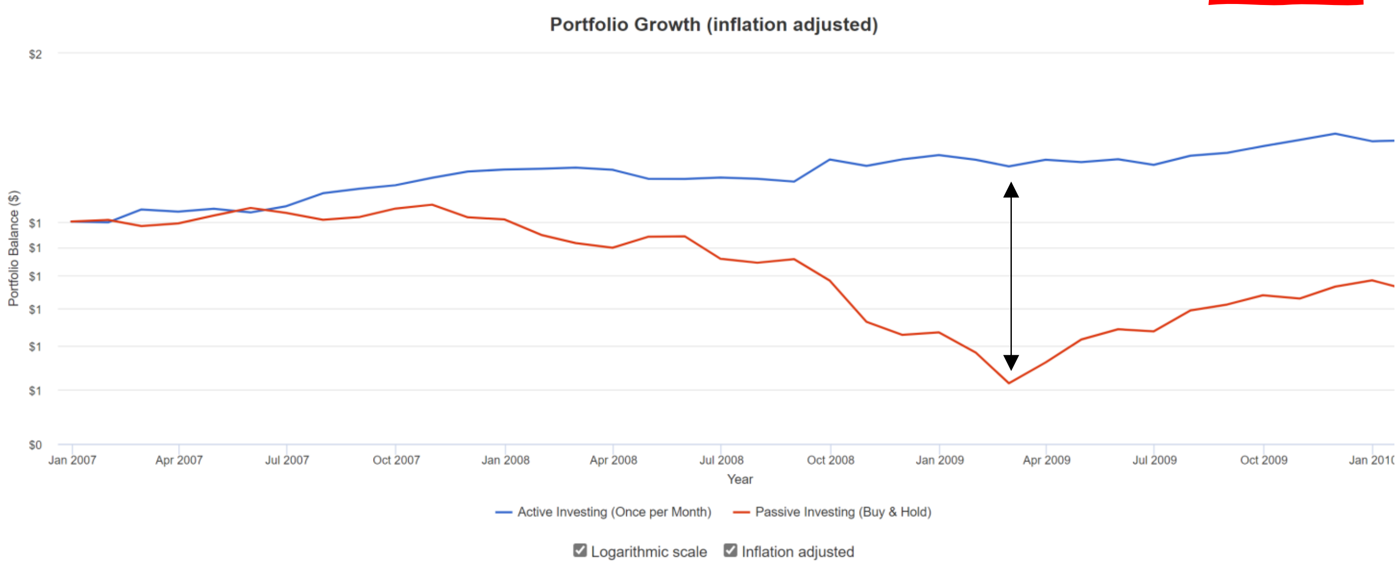

Back to our original study, look at the Active Investing **Worst Year**, -5.67% vs passive at -37.02%. This is a big difference. Just imagine telling your spouse, friends, or co-workers, your portfolio only lost 5.67% last year and will recover much faster than the rest of the investing world that is stuck with a 37.02% loss on the year, and may take several years just to get back to breakeven.

% Losses	% Gain Required to Breakeven
5%	5.3%
10%	11.1%
15%	17.6%
20%	25.0%
25%	33.3%
30%	42.9%
35%	53.8%
40%	66.7%
45%	81.8%
50%	100.0%

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Now to the fun part, the **CAGR**. **CAGR** stands for **Compounded Annual Growth Rate (CAGR)**. It is the most accurate way to identify what the most realistic historical performance has been. CAGR is different from an Average Return that is so often quoted by Investment Companies.

They quote the average because it is always a higher number, so it makes their investment fund look better than it is. So always go with the CAGR not the Average. In other words, CAGR is a Geometric Mean, and the average return is an Arithmetic Mean.

Metric	Active Investing (Once per Month)	Passive Investing (Buy & Hold)
Arithmetic Mean (monthly)	1.13%	-0.41%
Arithmetic Mean (annualized)	14.49%	-4.78%
Geometric Mean (monthly)	1.10%	-0.57%
Geometric Mean (annualized)	14.04%	-6.63%

The CAGR factors in all the ups and downs that an investment has. Remember that a 50% drawdown needs a 100% return just to get back to breakeven? CAGR factors that in.

Now for the cherry on top! Look at the CAGR for **Active Investing, 11.08**% compared to **Passive Investing at 6.99%.** let's call it 11% vs 7%, that's **4% more CAGR** year after year.

Trust me, that compounded 4% will make a big difference over time as you can see, for every $1.00, Active Investing made $10.00. The Passive only made $4.00 for every $1.00 invested over the same period of time.

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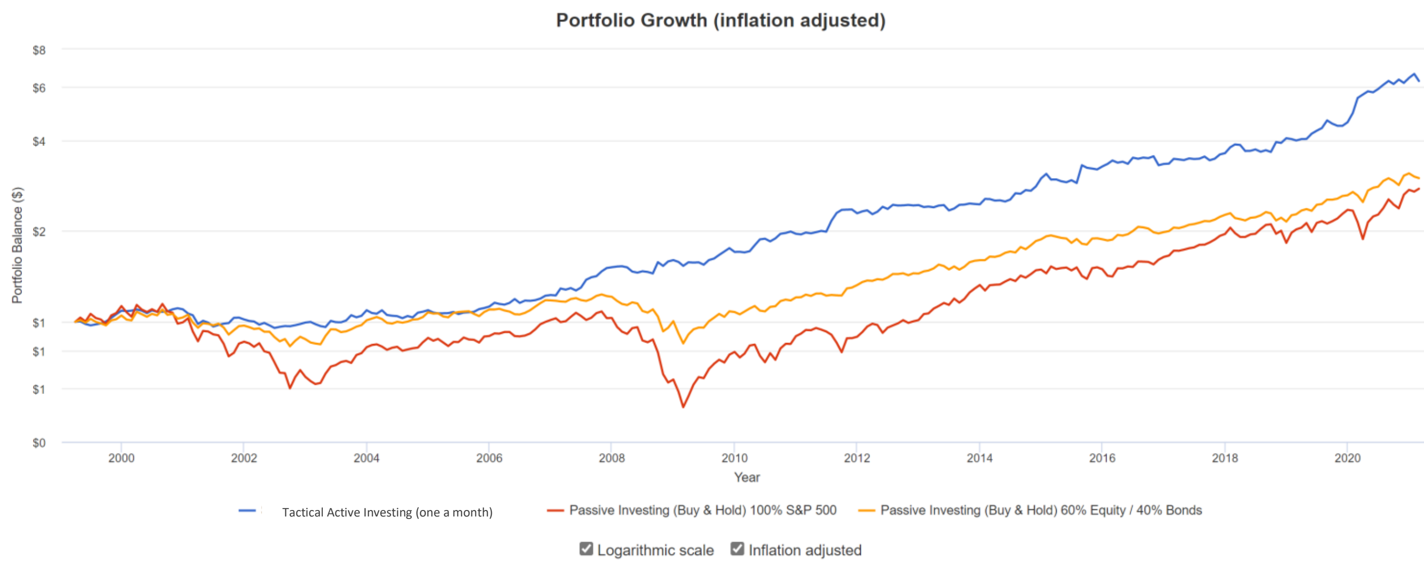
Investing is never just one factor, it is a combination of factors. It is like a good meal; it takes more than one ingredient to make it really good. Using **CAGR, Stdev,** and **Max. Drawdowns** are three of the most important. Finding the right combination of those is what should be the focus when creating either a robust Passive or Active Investment Model.

Here is one last example of an Active Investment Model compared to the S&P 500 and a 60% Equity/40%Bonds (60/40) split, both quite common industry benchmarks.

Portfolio Returns

Portfolio	Initial Balance	Final Balance	CAGR	Stdev	Best Year	Worst Year	Max. Drawdown
Tactical Active Investing (one a month)	$1.00	$10.01	11.08%	8.98%	42.20%	-5.67%	-10.94%
Passive Investing (Buy & Hold) 100% S&P 500	$1.00	$4.40	6.99%	15.07%	32.18%	-37.02%	-50.97%
Passive Investing (Buy & Hold) 60% Equity / 40% Bonds	$1.00	$4.77	7.39%	8.80%	24.97%	-16.83%	-29.94%



The best advice I have for you in investing is simple, **know what you do and how you do it!**

If you would like to know more about active investing, this company has the **best investing software** I have seen to do it. I personally use Allocate Smartly and think they have an excellent product. Another good one is Portfolio Visualizer, but it is more complex to learn and seems to cater to passive investing more than active. Either is a good solution.

God Bless & Good Trading,

Ryan

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You may learn more about Trading & Investing at www.TraderTactics.com