The Basic Pillars of Investing

1. What Is Investing

Investing is a way to put your money to work and let it grow over time. One of the tools for this is **ETFs (exchange-traded funds)** . An ETF is a fund that trades on an exchange much like a stock, but internally it holds tens to thousands of different securities at once. By buying an ETF you can invest in a broad basket of real companies and their products, revenues and profits. Stock markets are therefore not just charts and percentages, but a share in the economy and in the companies whose goods and services we use every day. Besides equity ETFs, there are also bond ETFs. Bonds usually deliver a lower but more stable return and act within a portfolio as a cushion against the swings of the equity component.

The main reason to invest is **inflation**. Money sitting in a current account or held as cash gradually loses purchasing power, meaning that in a few years the same amount will buy you less. Long-term investing is a tool for softening this effect and protecting the purchasing power of your savings over time. The value of an investment can, however, also fall in individual periods, which is a natural part of investing. In such moments it is important not to give in to panic (more in the chapters on risk and the psychology of investing).

The key factors of success are **time** and **regularity**. Thanks to **compound interest**, it is not only your contributions that grow, but also the returns that have already been achieved. Compound interest means that it is not only your original invested amount that grows, but gradually also all the returns that this amount has produced in the meantime. Put another way, one year's return becomes part of the base from which the next year's return is calculated, so the money earns not only on the original contribution but also on itself. The longer you let your money work, the stronger this effect becomes. Regularly investing smaller amounts also leads to a meaningful result.

The sheer volume of savings matters too: the final value of your assets is often influenced more by how much you can set aside regularly than by any attempt to achieve a slightly higher return.

Before you start investing, it is useful to clarify your goal and time horizon. More conservative solutions are better suited to short-term goals, while long-term goals (for example, retirement) leave room for riskier but historically more profitable equity investments. The composition of your portfolio should match your goal, your horizon and your ability to bear risk.

2. Diversification: Your Insurance Against Volatility

Diversification means spreading your assets across a number of smaller investments: different companies, sectors, regions and asset classes. This helps you avoid a heavy concentration of money in a single investment and softens the impact of a sudden drop, because your other assets hold you up.

Diversification serves two basic purposes:

1. Limiting risk - crises hit different regions and types of assets with different force. When one falls, another may rise, softening the overall decline of the portfolio.

2. Capturing growth - it is hard to predict in advance which market segment will grow. With broad diversification you can be sure that part of your money is always invested in the part of the market that is currently rising.

Diversification works best when you combine assets that do not move in the same way (that have a low or opposite correlation). When one falls, another can balance it out, so the value of the portfolio fluctuates less. This reduces risk and at the same time makes the long-term return more stable.

A practical tool for broad diversification are **ETFs (exchange-traded funds)** . With a single purchase, even with a small amount, you gain exposure across dozens to hundreds of companies, sectors and regions.

3. Risk as a Natural Part of Investing

Investment risk can be divided into two basic types. **Specific risk** is tied to a particular company or borrower, for example poor management decisions, weak demand for products or an inability to repay debt. With bonds this appears as credit risk, i.e. the risk that the borrower (a state or a company) will not repay its obligation in full or at all. This risk can be eliminated through broad diversification across a large number of companies, sectors and regions (more in Chapter 2).

Market (systemic) risk , by contrast, stems from the overall development of the economy and market sentiment and affects all investments at once. Market risk is the possibility that the value of an investment will (temporarily) fall. It is entirely natural and cannot be fully removed, yet it is not a reason for fear. It cannot be eliminated through diversification, but it can be mitigated with a sufficiently long time horizon.

There is a relationship between risk and return: the higher the risk you are willing to take, the higher the return you can achieve, but also the larger the potential losses. This level of risk is expressed by the standard SRI scale with values from 1 to 7, where a higher number means greater volatility.

The most effective tool for managing risk is **time**. Stocks fluctuate over the short term, but over a sufficiently long horizon they have historically risen. The longer you invest, the statistically smaller the risk of loss. Investing is not about timing the market, but about time spent in it.

The risk of concentration in a single company is dampened by the principle of index investing, on which index ETFs are built. The composition of indexes changes continuously according to how individual companies perform. Successful companies gradually gain a larger weight, while declining ones drop out. By investing in a broad index through an ETF, you therefore invest in a cross-section of the various assets of a given period without having to guess the specific winners.

That is why it is important not to panic during downturns. A period when the market falls by more than 20% from its peak is called a bear market; for a long-term investor it is more an opportunity to buy assets at lower prices than a reason to sell.

A steady level of risk is also maintained through rebalancing, i.e. regularly adjusting the portfolio so that the ratio of riskier and safer assets matches the investor's goal and horizon. In practice this means that when an asset class (for example, equity ETFs) exceeds its planned weight due to growth, part of it is sold and the proceeds are moved into underweighted asset classes, returning the portfolio to its originally chosen level of risk.

4. Costs and Fees

Costs are among the few variables in investing that you can know precisely in advance and directly influence.

With investment products (including ETFs) you will most often encounter the total expense ratio (TER), which covers the fund's management fees. Beyond it, there may also be entry fees, transaction fees for buying and selling, or an account-maintenance fee charged by the investment company. Even a seemingly small difference, for example one percentage point per year in fees, can, thanks to the compounding effect, amount to a difference of tens of percent in the final value of the portfolio over twenty to thirty years.

That is why, when choosing an investment, it pays to look not only at the expected return, but also at how much of it actually remains for the investor after all fees are deducted.

5. Taxes and Investing

Investment returns may be subject to income tax, and the exact rules differ by country and by type of investment instrument and change over time. Because the conditions can vary depending on the specific situation and individual circumstances of the investor, and because legislation can change, it is advisable to verify the current rules or consult a tax adviser.

There is also a difference between accumulating and distributing funds. Accumulating funds continuously reinvest received dividends and interest back into the fund, making full use of the compound interest effect. Distributing funds, by contrast, pay the returns directly to the investor, which can have an impact on income tax.

6. The Psychology of Investing

The greatest risk in investing is often not the market itself, but the investor's reaction to it. The most common mistakes include:

- Panic during downturns: Selling during a sell-off turns a temporary loss into a permanent one.
- Chasing performance: Buying whatever has risen the most recently, even though this says nothing about future returns. Buying speculative assets.
- Timing the market: Trying to guess the best moment to buy or sell.
- Overconfidence: The belief that you can systematically beat the market through your own judgment.

The solution is to define a clear strategy in advance, for example in the form of a regular investment plan, and to stick to it even in times of uncertainty. Automating your investing helps remove some of the emotion from decision-making.

7. Investment Horizon and Investor Profile

Before you start investing, it is useful to clarify three things: your goal, your time horizon and the level of risk you are willing and able to take.

The goal determines what you are setting the money aside for. It could be a retirement reserve, a future property purchase, or simply growing your spare savings.

The time horizon indicates how long the money can stay invested. Over a short horizon (up to two or three years) it is better to choose more conservative instruments with lower value fluctuation, since there may not be enough time to recover from a possible decline. Over a long horizon (ten years or more) the portfolio can tolerate a higher share of stocks, since short-term swings have enough room to even out.

The risk profile takes into account not only what loss you could psychologically bear, but also your financial situation, for example whether you have built a financial reserve for unexpected expenses before starting long-term investing. Together these factors determine the appropriate composition of the portfolio between equity and bond components and cash instruments.

You can find more information on these topics in the articles on the Finax blog:

- 10 Myths About Investing
- How to Earn More with Lower Risk: The Art of Diversification
- There Is No Need to Fear The Markets
- What Risks Are Involved in Investing

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