Investment Accounts

There are several types of investment accounts that are designed to meet a variety of investing objectives and life stages.

As earnings increase and responsibilities grow, there are a number of investment accounts that can help investors save for retirement, maximize investment flexibility, and even save for education.

Cash investments such as certificates of deposit and interest-bearing savings accounts typically require no more than a bank or credit union account, but other investments are typically held in a brokerage account. A brokerage account allows you to buy stocks, bonds, mutual funds, as well as cash investments. These accounts may include the services of a stockbroker or they may be self-managed (such as an Internet-based discount firm). Advanced investors may also use their account to purchase even riskier investments such as commodities and stock options. Some investors even take out loans and use the money to invest, a practice known as "buying on margin."

Brokerage accounts are established as either tax advantaged retirement accounts, meaning that taxes are either deferred or eliminated, or as taxable accounts, meaning that taxes are paid each year on gains.

There are many other types of brokerage accounts that we will not cover here, including college savings accounts (such as 529s), trusts, and custodial accounts.

Tax Advantaged Retirement Accounts

Tax advantaged retirement accounts are intended to encourage people to save for retirement, but there are significant restrictions on how much money can be deposited and when it can be withdrawn. The main advantage of these accounts is the ability to grow money year after year without paying income tax on the gains, thus maximizing the benefits of compounding. Some accounts give you a tax deduction for contributing to the account (lowering your income tax bill), while others allow you to withdraw the money tax free at retirement time.

Examples of tax advantaged retirement accounts would include Individual Retirement Accounts (IRAs), 401(k) and 403(b) plans, and Simplified Employee Pension (SEP) plans.

For the specific benefits, restrictions, and types of tax advantaged accounts, please see our material on Retirement Savings Accounts.

Taxable Brokerage Accounts

Any adult can open a taxable brokerage account. You can invest as little or as much as you want and the money can be withdrawn at any time. With standard brokerage accounts, you must pay yearly taxes on the money you earn.

Taxable brokerage accounts are a good choice for those who need the most flexibility in managing their money since there are no restrictions on deposits or withdrawals. These accounts are also a good option for those who have maxed out their allowable contribution to retirement accounts.

For investments bought and sold within the same year, your tax rate on the gain is equal to your ordinary income tax rate. Investments owned a year or longer before sale are taxed at the "capital gains" tax rate, which will likely be lower than your ordinary income (less than half the ordinary tax rate of those in the highest tax brackets). When Warren Buffet says he pays a smaller percentage of his income in taxes than his secretary, it is because most of his income is in the form of capital gains.

Before Opening an Investment Account

Investing in anything other than cash investments (such as certificates of deposit) always involves the risk of loss. Before making any investment, most experts recommend maintaining savings equal to six months of salary or more in a risk-free account. Unexpected events such as a job loss, illness, or accident can affect your income.

A responsible strategy is to save an emergency fund before opening an investment account.