



STARTING AN INVESTMENT CLUB

Jason Johnson, Bill Thompson and Wade Polk*



An investment club is a group of individuals who pool their money to invest as a group. They meet regularly to learn the basics of stock investing and research possible investments. Historically, investment clubs outperform the broad market indices (Dow Jones Industrial Average, Standard & Poor's 500 Stock Index, etc.) about 60 percent of the time, whereas professionally managed mutual funds outperform these indices only 35 percent of the time. This is because investment clubs, as well as individual investors, can hold on to a long-term investment perspective while professional fund managers are often held accountable for performance on a quarterly basis. By pooling their time, talent and money, investment club members increase their stock market know-how and learn valuable lessons that can be transferred to their individual financial management decisions.

Forming an Investment Club

Group dynamics is a very important consideration when organizing an investment club. When prospecting for members,

remember that each member will be both a social and business partner. Therefore, it is preferable to find people who have different perspectives but who all agree on a basic approach to investing. Most investment clubs have two stated goals: first, to learn about investing in stocks; and second, to make a return on their investments. This should be the order of their priority and all prospective members should agree on this. All decisions made by the club, whether they result in profit or loss, will lead to educational experiences.

Experience suggests that there is no ideal number of participants for a successful investment club. However, a club with 15 to 30 members has both a manageable size (to facilitate constructive discussions regarding stock evaluations) and enough members to generate sufficient funds (through regular dues) to make stock purchases. The group will need to find a convenient meeting place, one with computer and Internet access. The most likely meeting places are members' homes, libraries, community meeting facilities, or places of business where one (or several) members work and have permission to host activities.

Establishing a Club Partnership Agreement

An investment club is typically organized as a general partnership. The partnership agreement should outline the operating practices and serve as the bylaws, addressing all issues that will confront members from formation through a specified ending date. The first item should be a declaration of a club name. This effectively becomes the partnership name (or in IRS terminology the "doing business as" name). Second, the partnership agreement should outline the organizational structure, including names and responsibilities of officers; dues or contribution requirements; and club meeting times, dates and locations.

Bylaws also should address more controversial topics such as procedures for admitting new members, procedures for withdrawing from the partnership, meeting attendance requirements, the schedule of fines for delinquent dues, and a list of prohibited activities. An important decision to make is which partner(s) will be on the signature card at the bank and have access to the trading account and passwords at the brokerage. Usually the treasurer and one other member are given these

* Assistant Professor and Extension Economist-Management, Assistant Professor and Extension Economist, and Extension Program Specialist-Risk Management, The Texas A&M University System.

responsibilities. After careful deliberation and discussion, all of these issues should be written into the general partnership agreement, which should then be signed and dated by each general partner.

One particularly useful resource for investment clubs is the National Association of Investors Corporation (NAIC), a non-profit, tax-exempt organization whose membership consists of investment clubs and individual investors. NAIC was founded in 1951 with a mission to provide sound investment information, education and support that helps create successful, lifetime investors. Many resources can be found at the NAIC Web site: www.better-investing.org.

NAIC's official guide, "Starting and Running a Profitable Investment Club," provides all the information needed to establish and operate an investment club. This guide addresses a broad range of topics, from selecting members and keeping interest high to tips on conducting monthly meetings, working with a broker, and researching stocks. Investment club members can modify specific recommendations to fit the unique personality and goals of their club.

Obtaining an Employer Identification Number

Clubs must have employer identification numbers (EIN) in order to establish the necessary bank and brokerage accounts, as well as for tax reporting purposes. Because the investment club operates as a partnership, it should have its own identification number. Obtain this number from an IRS office or the IRS Web site (www.irs.gov). Download Form SS-4 (Application for Employer Identification Number). After completing this one-page form, you can either fax it to the designated IRS number or call the toll free assistance line and give the information to an assistant. The EIN

number is assigned over the phone and is available immediately for conducting investment club business activities.

Establishing a Bank Account and Discount Brokerage Account

In selecting financial institutions to handle the club's banking and brokerage activities, find convenient, low-cost providers. The club should establish a checking account in the club's name to serve as a holding place for dues until this money can be transferred to a brokerage account. Clubs can often arrange for free checking privileges. Compare various discount brokerages and choose one that is easy to use and charges low commissions.

The rationale for selecting a discount brokerage is that the club requires only stock trade execution, not investment guidance. The evaluation process is the responsibility of club members. Full service brokers typically charge \$50 to 60 per trade. A discount broker will charge only a third or a fourth as much. The less money spent on commissions the more the club has to invest. Keep in mind that the greater the amount of regular dues collected and available for investment, the less the commission charges will reduce the club's return.

Preparing for Tax Reporting Requirements

Generally, an investment club is treated as a partnership for federal tax purposes unless it chooses otherwise. Financial events generated by the investment club partnership (in the form of capital gains/losses or dividends) are taxable in the year they are realized. If an investment club only purchases stocks (and does not sell any of them), then the only taxable event is the receipt of dividends and/or interest. The club will receive a Form 1099 from the brokerage showing

the dividend and interest payments. If the investment club is organized as a general partnership, all financial ramifications pass through the partnership to individual members on a proportional basis. However, this does not absolve the club from filing the appropriate tax reports.

An investment club must file Form 1065 (U.S. Return of Partnership Income), which shows the total of dividends and interest received during the year as well as any capital gains or losses that have resulted from selling stocks. The club also must file a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) for each of the partnership's members; this form shows each member's proportional ownership in the club's portfolio. Each member should receive a copy of the Schedule K-1 to include with his or her individual tax return. Thus, a general partner of an investment club with 20 members would be responsible for claiming 5 percent of the club's taxable income on his or her individual tax return. Until the investment club begins liquidating stocks, this taxable income is confined to interest and dividends. These items must be reported whether or not any distribution from the partnership was actually received. However, the tax ramifications are usually negligible unless the club has accumulated a significant amount of dividend-producing stocks over a number of years.

Beginning the Education Process

Most investment clubs are focused according to tenets prescribed by the NAIC. The four basic principles include: investing regularly; reinvesting all earnings; evaluating growth stocks; and diversifying the portfolio. Investing regularly reinforces the concept of taking a long-term perspective and creates a genuine purpose for each meeting. Reinvesting all earnings

allows the power of compounded growth to work for the club. By focusing on growth stocks, members can see that the value of their investment changes with the sales and earnings growth (profitability) of the companies. Finally, the value of diversification is stressed so that portfolios will be cushioned against industry or sector-wide downturns. These lessons are meant to strengthen members' individual investment plans.

Threats to a Successful Investment Club

One of the biggest pitfalls for an investment club is the challenge of maintaining unity of purpose. If some partners develop interest in timing short-term aspects of the market rather than in investing with a long-term approach, the club loses its perspective. Another problem comes from not setting minimum attendance requirements for members. Active participation from all members ensures a successful educational experience and improves the quality of investment decisions. Sometimes clubs are too eager to accept a new member. This can create problems if the new member doesn't share the club's overall approach to investing, or is not clear on what is

expected of club members. Prospective members should be encouraged to visit the club for a couple of months before being invited to join. Finally, accounting issues often cause problems, even if clubs initially use the "every member has an equal share" system. The equal share system does not accommodate a member withdrawing some of his money in the event of a personal emergency; it can also make new member buy-in prohibitively expensive as the club account grows in value over time. NAIC suggests using a percentage ownership, or unit value, method of accounting from the beginning.

What You Can Expect to Learn

Investment club members gain the confidence to begin or extend their individual portfolios, armed with the knowledge and skills they gain from belonging to the club. The lessons learned from a properly structured and organized investment club are identical to those that must be embraced when making sound individual investment decisions. The first thing to learn is investment terminology (e.g., dollar cost averaging, company sponsored dividend reinvestment plans, etc.). This could be part of

the regular educational discussion. Second, investment club members should learn about the different sectors of the economy and, more precisely, where companies fit within these various sectors. Third, investment club members should identify some preferred weighting of their collective portfolio (across economic sectors) to guide them in evaluating stocks that are appropriate. Finally, the specifics of evaluating and selecting stocks, and regularly reviewing the portfolio's performance, should absorb most of the club's discussion time. There are many methods and perspectives to consider when evaluating individual stocks. Investment clubs can use several of them to identify and select individual stocks so that they become familiar with different perspectives and feel comfortable about the methods they prefer.

For further information:

National Association of Investors Corporation website
www.better-investing.org

O'Hara Thomas E. and Kenneth S. Janke, Sr. *Starting and Running a Profitable Investment Club*. Three Rivers Press, New York:: 1998.

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