Join or Start an Investment Club For Fun and Profit

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Could joining or starting an investment club jump-start your finances? Nearly half of American households have no exposure to the stock market, and lacking the money to invest isn't the only reason why. Many Americans find investing in the stock market scary—even more intimidating than doing their taxes, applying for a mortgage or paying off credit card debt, according to a 2020 JP Morgan Chase survey.

In an investment club, members pool money and select investments by voting during monthly meetings. It's a social way to learn about the stock market and can help overcome investing fears.

But starting or joining an investment club has its own challenges. Clubs must file tax returns, establish rules and bear the pressure of trying to select profitable investments—and if you've ever been part of a committee, you probably already know that acting as a group does not always guarantee intelligent decisions. Here's how to do it right...

JOINING AN INVESTMENT CLUB

Joining an investment club isn't like joining a bridge club or a gym. It's important to choose one that matches your investment approach and has members you can trust and feel comfortable interacting with.

BetterInvesting, the nonprofit organization formerly known as the National Association of Investment Clubs, has a "Visit-A-Club" program (https://bit.ly/3mKKzvi) that points prospects to clubs in their areas that let outsiders visit and potentially join. Or ask friends who belong to investment clubs whether their clubs are accepting new members and whether they would recommend joining.

Warning: Clubs that openly solicit new members often are not true member-operated clubs, but instead investment funds run by a money manager.

Before agreeing to join an existing investment club...

Attend a few meetings to get a sense of the personalities. If you won't enjoy socializing with the other members, the experience isn't likely to be positive. Or if one or two members dominate, your investment ideas might not be considered. Most investment clubs are close-knit groups of friends, family members, church members or coworkers. It can be difficult for outsiders to fit in and find a voice if you're not in this "clique."

Ask to see the club's current portfolio. Does it seek blue-chip stocks? Aggressive small-company stocks? A mix of the two? Does it hold stocks for multiple years or trade frequently? Is its investing in line with your goals and risk tolerance? Also ask to see the club's "Investment Policy Statement," and confirm that its investments and recent performance are in line with its investment philosophy.

Ask about contributions. How much would you have to invest if you joined? Are penalties assessed for late payments? Also ask to see the club's "operating >>

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>> documents"—that is, its partnership agreement and bylaws—to learn other potentially important rules, such as the procedure for withdrawing money.

Ask to see the club's recent tax filings. The IRS requires all investment club partnerships to file an annual return, and many states do as well—more on this below. Confirm that the club files its taxes by the deadline each year. Fines for late or missed filings can be severe and would be paid by members—including members who had not yet joined at the time of the infraction.

LAUNCHING A CLUB

If you launch your own investment club, the choices you make at the outset could shape the club's long-term financial results—and have tax and legal complications.

Form a general partnership. You don't have to pay a lawyer to set this up—free forms are available at my website, ICLUB.com, or at BetterInvesting.org. There might be a state filing fee, but it usually does not exceed $100.

General partnership arrangements are the most common investment club structure. Lawyers sometimes voice concerns that general partnerships do not provide liability protection—in theory, one partner could be held legally responsible for another partner's debts. But in practice, tens of thousands of investment clubs have been structured this way without any known liability issues arising. Still, if liability risk is a major concern, you could structure your club as a limited liability company (LLC).

Once the partnership or LLC is established, it can request a tax ID number by filing Form SS-4, *Application for Employer Identification Number*, with the IRS...open a checking account in the partnership's name...and open a brokerage account with a discount broker.

Create a checks-and-balances system, and monitor the club's books. One member of the club should be elected treasurer and take primary control of its checking and investment accounts. A different club member should be named secretary and receive and review the club's bank and brokerage account statements. This makes it much harder for any one person to embezzle the group's money. Arrange things this way even if the club treasurer is a close friend—the next person elected treasurer might be someone you don't know well. Clubs also should elect a president to preside over meetings and a vice president to step in when the president is not available.

Transparency: During one monthly meeting each year, all the members of the club should scan the account transaction histories together in search of any unexplained withdrawals or missing deposits.

Allow different members to invest different amounts. Many investment clubs insist that every member contribute the same amount—often $50 to $100 per month. That's a mistake. Some members might be forced to drop out when they can't afford to make contributions...while other members who wish to invest more will be prohibited from doing so. *Result:* The club has fewer members and less money than it could, which hurts its performance by increasing the impact of fixed costs, such as tax-reporting expenses. Instead, let club members invest different amounts and weight each member's voting power accordingly.

Draft a club investment policy statement. It should summarize the types of investments the club will or won't consider—a club might restrict itself to investing in domestic stocks, for example...the specific types of stocks it will favor, such as dividend-producing stocks or stocks over a certain market capitalization...risk levels, time horizons and turnover rates it is targeting...and/or its annual return goal. Having this policy statement in place will help focus club members on the sorts of investment ideas they should be bringing to club meetings. It also could prevent an overly aggressive club member from talking the group into an inappropriate investment.

File Form 1065 with the IRS each year—*US Return of Partnership Income.* General partnerships are "pass-through tax entities"—rather than pay taxes themselves, they simply divide up those taxes for partners to report on their own returns. Also provide a Schedule K-1 to partners and the IRS.

MAKING INVESTMENTS

The goals are largely the same whether you're selecting investments for a club or for your own portfolio, but there are some nuances worth noting when it comes to investment club investing.

Use a slow-and-steady approach to portfolio construction with a new investment club. It's tempting to ask club members to make a big initial contribution so that the club has a sizable pot of money available from day one to build a diversified portfolio. But demanding a significant up-front investment will prevent many potential members from joining...and investing in multiple stocks right at the start forces club members who might be totally new to investing to make multiple stock picks. Instead, ask for monthly investments of $50 to $100...put off making any investments until the club has been meeting for three to five months...and then invest all the money that has accumulated in the club's coffers in a single stock. The portfolio won't be diversified at first, but you also won't have very much money on the line at this point. Choose a second stock three to five months later when the club's account balance has built up again, and continue this pattern.

Don't blame members for poor investments. Once the club votes on a stock, the responsibility is shared equally, no matter who proposed a struggling stock.

Resist the urge to hold emergency or weekly meetings. Monthly club meetings reduce the odds of emotion-driven panic selling when the markets have a very bad day. This advantage can be lost when clubs hold emergency meetings following market routs.

Avoid the temptation to lock in winners and hang onto losers. When investors sell a stock that has increased in value, they feel like they've made a smart financial move because they've earned a profit. When they sell one that has lost money, they feel exactly the opposite—and if they don't sell these struggling investments, they don't have to admit they've made a mistake. Deciding to sell off winners and hang onto losers results in portfolios full of the worst ideas. BLP