



## Understanding The Stock Market

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### Introduction

Imagine the heads of Microsoft, JPMorgan, Alphabet, and Meta at your front door. They tell you they want a partner: you put up some capital, they run the businesses, and you share in the profits for as long as you hold your stake. If you ever want out, you can sell your interest in seconds to someone else who wants in. That, in essence, is what the stock market allows you to do—be a silent partner in thousands of real companies at once.

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### What the Stock Market Is

The stock market is a marketplace where pieces of real companies—shares—are bought and sold. Own a share and you own a small slice of that business: a claim on its assets and a share of its profits after debts and obligations are paid. Prices change because millions of investors are constantly updating their expectations about future earnings, interest rates, and risk.

In the short run, the market behaves like a voting machine, with prices moving on sentiment, stories, and headlines. Over time, it acts more like a weighing machine, and stock returns tend to track one anchor: the growth of corporate earnings. If companies, in aggregate, grow sales, improve productivity, and raise profits, shareholders usually do well over time. Stocks are simply the legal and financial wrappers around that basic relationship.

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### Dow, S&P 500, and Nasdaq: What Those Indexes Really Are

Financial news constantly cites “the Dow,” “the S&P,” and “the Nasdaq,” often as if they were sports scores. They are just different ways of summarizing big chunks of the market.

The Dow Jones Industrial Average tracks 30 large U.S. companies. It is “price-weighted,” which means companies with higher share prices have more influence on the index than lower-priced names, regardless of their actual size by market value. This is an old-fashioned way to build an index, which makes the Dow more of a historical tradition than a precise barometer of the overall market. It is still widely quoted because it has been around since 1896, but for most investors today it is not the most informative guide to the equity market compared with broader, market-cap-weighted indexes.

The S&P 500 tracks roughly 500 of the largest U.S. companies, weighted by their total market value. When analysts talk about “the U.S. stock market” in a serious context, this is usually what they mean. It covers most major industries and represents a very large share of total U.S. corporate equity value. For most purposes, the S&P 500 is the main scoreboard.

The Nasdaq Composite covers thousands of companies listed on the Nasdaq exchange, with a heavy tilt toward technology, communications, and biotech. It is more growth-oriented, more volatile, and more sensitive to changing stories about innovation and future earnings. When the Nasdaq is swinging, markets are repricing growth and the changing fortunes of large technology companies.

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### Why Invest at All?

If you work for a living and leave your savings in cash, you are quietly running backward. Prices rise over time; that is inflation. A bank account or mattress keeps your dollars safe in nominal terms, but those dollars buy less in the future.

You invest to shift from being only a worker to also being an owner of productive assets. Stocks give you a claim on growing business earnings. Bonds give you interest payments in exchange for lending money. Real estate can provide rent and potential appreciation. Over long periods, diversified portfolios of these assets have historically outpaced inflation and grown wealth in a way that wage income alone rarely can.

The goal is straightforward: build a pool of capital that gives you options in the future—about work, about where you live, about how you handle setbacks—without having to guess short-term market moves.

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### Understanding the Different Types of Investments

Different assets do different jobs. Understanding their role in your investment portfolio is very important.

Stocks represent ownership. If businesses grow, innovate, and raise profits, stockholders can earn rising dividends and capital gains. Over long periods, broad U.S. stock markets have delivered the highest returns among major asset classes, in exchange for significant short-term volatility. Historical data compiled by NYU Stern for 1928–2025 show U.S. stocks (S&P 500 including dividends) returning about 9.8% per year on average, while long-term U.S. Treasury bonds returned about 4.7% and 3-month Treasury bills about 3.0%.

International stocks are simply ownership in companies based outside the U.S.—Nestlé, Toyota, ASML, Novo Nordisk, and thousands of others that earn money in different currencies and economic systems. They matter because the U.S. is large, but not the whole world; a global portfolio that includes developed and emerging markets abroad taps additional sectors, demographics, and policy regimes that don't always move in lockstep with the S&P 500. Over long periods, foreign markets have delivered returns broadly comparable to U.S. stocks but with different cycles, which can improve diversification by smoothing out the returns of your portfolio.

Bonds are loans. You lend money to governments or companies; they promise interest and repayment at maturity. Returns are lower than stocks over long periods, but the

path is smoother. Bonds are the ballast in a portfolio, especially as you approach goals where capital preservation matters more than maximum growth. Over the longest period of time for which we have data, the NYU Stern series shows that from 1928–2025, long-term Treasuries earned less than half the annual return of stocks but with lower volatility.

Real estate can be owned directly (a rental property) or indirectly (real estate investment trusts). It can provide rental income and some protection against inflation, but direct property ownership is local, illiquid, and requires active management. Public REITs trade like stocks and share some of their volatility. There is no need to own REITs separately because they are included in many stock funds and are part of the S&P 500.

Crypto assets, in most cases, do not produce cash flows. Their value depends largely on what others will pay in the future, rather than on earnings or rent. That does not make them worthless, but it places them closer to speculative bets than to core building blocks for funding retirement, college, or long-term financial independence.

In simple terms: stocks and bonds, properly diversified, form the spine of a long-term plan. Real estate can play an important supporting role. Crypto, if used at all, belongs in a small, speculative bucket you could afford to see go to zero.

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### How Stocks Have Actually Performed vs Bonds and T-Bills

NYU Stern’s long-running dataset tracks annual returns on U.S. stocks, long-term Treasury bonds, and 3-month T-bills back to 1928. Using those data through 2025, the pattern is consistent: stocks higher, bonds lower but steadier, bills lowest and safest.

#### Long-Term Annualized Returns by Asset Class (NYU Stern, 1928–2025)

Period	S&P 500 (incl. dividends)	S&P 500 (incl. dividends)	10-yr U.S. Treasury Bonds	3-mo U.S. T-Bills
1 year	17.8%	7.8	7.8	4.2
3 years	22.5%	6.4	6.4	4.3
5 years	15.3%	15.6%	5.6	2.9
20 years	12.4%	5.4%	4.4	2.3
1928–2025	9.8	4.7%	4.7	3.0

Source: Historical Returns on Stocks, Bonds and Bills, NYU Stern (1928–2025)

Remember, there is no certainty in the stock market, and past performance never guarantees future results.

Bonds and T-bills have delivered lower long-term returns than stocks, but they are generally safer because they are built on contractual promises: regular interest

payments and a stated amount of principal due at maturity, assuming the issuer does not default.

Risk and return are linked. Assets with higher risk tend to offer higher expected returns to compensate investors for bearing that risk, while safer assets usually come with lower expected returns.

The return figures discussed are geometric averages, which account for compounding. They do not mean you will earn those returns every single year—far from it. They show that over long periods, stocks have historically rewarded patient owners far more than bonds or T-bills, at the cost of much larger ups and downs along the way.

This is why the basic guidance—own stocks for long-term growth, hold bonds for stability, and keep cash for short-term needs is a sensible strategy. It reflects nearly a century of market history and how different assets have behaved over time.

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### Why Picking Individual Stocks Is So Difficult

Most people's first instinct is to pick stocks and to build a portfolio one stock at a time. You know the brands. You watch the news. You feel you have an edge. The problem is that stock prices already embed the expectations of all other market participants, including professionals armed with research teams, data feeds, and risk models.

Several stubborn facts get in the way of the casual stock picker:

- A small minority of stocks drive a large share of long-term market returns; if you miss them, your results suffer badly. Those big winners are extremely hard to identify in advance: today's stars are often so popular and expensive that they are unlikely to deliver above-average future returns, while tomorrow's stars are often small, obscure companies that don't show up on the average investor's radar.
- Hendrik Bessembinder, a professor of finance at Arizona State University, studied the roughly 28,600 public companies that have been listed in the U.S. from 1926 to 2024. Key to his definition of wealth creation is that a stock produces returns in excess of one-month Treasury bills. His data show that just 2 percent of the companies produced 90 percent of the aggregate wealth creation of \$79.4 trillion, and the top 6 alone added \$17.1 trillion.
- Stocks are much more volatile than most people realize. Michael J. Mauboussin with Morgan Stanley studied the maximum drawdowns (declines) and recoveries of more than 6,500 stocks from 1985 to 2024. He found that the median (average) drawdown was 85 percent, and roughly 54 percent of stocks never returned to their prior peak after hitting bottom. Many individual stocks simply do not recover from large declines; indices quietly remove these companies, but stock pickers must decide when to cut losses. Most investors do not have the patience, temperament, or analytical depth to distinguish between stocks that will recover from the more common permanent impairment after an 85 percent collapse.

- Over long horizons, most active managers underperform simple index funds after fees and taxes, even though they have far more resources than the typical individual investor. That isn't an abstract claim for me; it was my day job for years. I was responsible for the Focus List of recommended stocks whose results were published in the Wall Street Journal alongside the lists from all the other major investment firms. I worked with an army of smart, dedicated analysts who spent nearly their entire day talking to management teams, building and updating earnings models, and weighing each company's prospects against its competitors. The incentives were sharp, the scrutiny constant, and the effort level very high. In spite of all that, consistently outperforming a simple index fund was extraordinarily difficult—not just for us, but for the firms we were competing against.
- When a fully staffed research platform, with access to management, data, and tools, struggles to beat a low-cost index over time, it should make individual investors cautious about how much edge they really have picking stocks on their own. This is not an argument that no one should ever pick stocks. It is a reminder that picking winners is a demanding full-time craft, not a weekend hobby. For someone with a job, a family, and other priorities, trying to beat professionals at their own game is usually a poor risk-reward trade.

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### Why Mutual Funds and ETFs Are Usually Smarter

Mutual funds and exchange-traded funds (ETFs) exist so you do not have to decide which 20 or 30 companies to own. In a single fund, you can own hundreds or thousands of stocks at once, across many industries and sometimes many countries.

Index funds are the cleanest version. An S&P 500 index fund owns the companies in the S&P 500, in roughly the same proportions as the index. No manager is trying to guess the next winner. The fund simply delivers the market return, minus a very small fee.

This structure has three practical advantages for individual investors:

1. **Diversification.** One company can fail; a whole economy cannot disappear in the same way. Owning a broad basket sharply reduces the damage any single mistake can do.
2. **Cost.** Index funds and ETFs from major providers often charge fees measured in a few hundredths of a percent per year. Active funds charge more, and using a financial advisor can cost an additional 1%-1.5% or more. Over decades, that cost difference compounds heavily.
3. **Discipline.** With broad index funds, you do not need to constantly decide what to buy or sell. You own the market and let the underlying businesses work on your behalf.

When the long-run data say the market has delivered around 9–10% annually over nearly a century, while most stock pickers and many active managers lag that, the

burden of proof shifts. The default should be broad, low-cost funds. Stock picking becomes an optional side project, not the base plan.

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### Vanguard: The Low-Cost Leader

Vanguard is one of the largest investment managers in the world with assets under management around \$11 trillion.

Costs are one of the few levers investors fully control, and Vanguard's structure is the main reason those costs can be pushed so low.

Vanguard runs its funds at scale and with minimal frills, which helps, but the core difference is ownership. In the U.S., Vanguard is organized so that its funds effectively own the company, and the fund shareholders, in turn, own the funds. That means there is no outside corporate owner demanding a profit margin on top of what it costs to run the products. After paying operating expenses, the benefit of growth and efficiency is returned to investors in the form of lower expense ratios rather than higher corporate profits.

Because most of Vanguard's flagship products are straightforward, rules-based index funds, they are also inherently cheaper to run. An S&P 500 or total-market ETF does not need star managers, large research teams, or constant trading. The job is to track an index accurately, keep trading costs low, and pass the results through. When you combine that simple design with an at-cost ownership model and enormous scale, you end up with expense ratios like 0.03% on a broad U.S. stock ETF, 0.03% on a core bond ETF, and 0.05% on a total international ETF—numbers that would be uneconomic for a traditional profit-seeking asset manager offering the same products.

The practical implication for a long-term investor is clear: using a low-cost provider with this kind of structure lets you keep almost all of what the underlying asset classes earn. Paying 1%–1.5% a year on comparable exposures hands away a large slice of the expected equity premium to intermediaries, year after year. Over decades, that structural difference in cost compounds into a very large difference in outcomes.

With mutual funds and Exchange Traded Funds (ETFs) expense ratios are expressed as a percentage of assets invested:

- Vanguard S&P 500 ETF (VOO): 0.03%
- Vanguard Total Bond Market ETF (BND): 0.03%
- Vanguard Total International Stock ETF (VXUS): 0.05%

Suppose you build a simple 60/20/20 mix:

The **weighted expense ratio** is:

- $0.60 \times 0.03\% + 0.20 \times 0.05\% + 0.20 \times 0.03\% = 0.034\%$ , which rounds to **0.03–0.04%** per year.

Compare that with paying 1.00%, 1.25%, or 1.50% all-in through higher-cost funds or wrap fees. Assuming you invest \$100,000 over 30 years and your portfolio earned a 7% annual return. The net annual return and ending value would be considerably higher by keeping costs low:

#### The Long-Term Cost of Investment Fees

<b>Fee Level</b>	<b>Net Annual Return</b>	<b>Value After 30 Years</b>	<b>Difference vs 0.034% Fee</b>
0.034% (VOO/VXUS/BND mix)	6.97%	\$727,900	—
1.00%	6.00%	\$574,300	\$153,600 less
1.25%	5.75%	\$538,100	\$189,800 less
1.50%	5.50%	\$503,100	\$224,800 less

Assumes \$100,000 initial investment, 7% gross annual return, 30-year horizon

#### How to Invest in Practice: Accounts and Providers

To invest, you need an account. For most individuals, that means a tax-advantaged retirement account (traditional IRA or Roth IRA) and a taxable brokerage account for general long-term investing beyond retirement contributions. Many large providers now let you open these accounts with very low or even no stated minimums, and you can often start with a few hundred dollars and add money over time through automatic contributions rather than waiting to accumulate a big lump sum.

You do not need enough money to “build a portfolio” on day one. You need enough to buy a single broadly diversified fund and a plan to keep adding to it. Index mutual funds and ETFs that cover U.S. stocks, international stocks, and bonds are widely available at low cost from firms like Vanguard and Charles Schwab, which have transparent fee structures and long histories of being investor-focused rather than product-sales-focused.

The process for opening an account is straightforward:

1. Visit the firm’s website and select “Open an account.” Choose IRA, Roth IRA, or brokerage as appropriate.
2. Provide basic information and link your bank account.
3. Transfer money into the new account.
4. Choose one or two broad index funds—for example, a total U.S. stock market fund or an S&P 500 index fund, and a bond fund if you want added stability—and make your first purchase.

You do not need to trade frequently. You do not need complex products. The discipline is in keeping costs low, staying diversified, and staying invested.

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### Dollar-Cost Averaging: A Simple, Robust Habit

Dollar-cost averaging means investing a fixed dollar amount at regular intervals, regardless of what markets are doing that week. For example, you invest \$200 on the first business day of every month into an S&P 500 index fund in your account.

When prices are high, your \$200 buys fewer shares. When prices are low, the same \$200 buys more. Over time, this smooths your entry price and lets volatility work for you instead of against you. You avoid the all-too-human pattern of buying big after markets have risen and freezing when they are temporarily down.

This approach does not guarantee profits or prevent losses. Markets can fall for extended periods. But for most people without a reliable way to time cycles—meaning almost everyone—regular investing into a diversified fund is more realistic and more repeatable than trying to wait for the perfect moment.

The recipe is simple:

- Pick a low-cost, diversified fund as your core holding.
- Decide on an amount you can truly sustain, even in a rough year.
- Automate the monthly contribution.
- Keep going.

Investors who can do this consistently have the greatest likelihood of building wealth over time.

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## Major Asset Types: Roles and Risks

Asset Type	What You Get	Main Risks	Role in a Plan
Stocks	Ownership, growth, dividends	Volatility, business/market cycles	Long-term growth engine
Bonds	Interest, principal at maturity	Rate moves, credit risk	Stability, income, dampen volatility
Real estate	Rent, potential appreciation	Illiquidity, local market risk	Diversifier, inflation hedge
T-bills / cash	Stability, liquidity	Losing to inflation over long term	Short-term needs, emergency reserves
Crypto	Speculative upside if widely adopted	Extreme volatility, no cash flows	At most a small, speculative side bet

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## Key Takeaways:

1. Understand that a stock is a piece of a business, not a lottery ticket.
2. Learn that the S&P 500 is the main scoreboard for large U.S. companies.
3. Open a simple account at a reputable low-cost firm like Vanguard or Schwab.
4. Pick one broad stock index fund (such as a total U.S. market or S&P 500 fund) and, if desired, one broad bond fund.
5. Set up an automatic monthly investment for an amount you can commit to for years.
6. Ignore most short-term market noise and let time and compounding do the heavy lifting.

If you remember nothing else from this piece, remember this: stocks are slices of real businesses, markets reward patient owners more than traders, and costs and behavior matter more than clever forecasts. You do not have to outsmart Wall Street to reach your goals. You do have to pick a simple, low-cost structure, automate your saving, and leave it alone long enough for compounding to work.

If you have not started yet, open a basic account at a low-cost firm, choose one broad stock fund and, if appropriate, one bond fund, and set up a monthly contribution you can live with. If you are already investing, use what you have read here to simplify, lower your costs, and make sure your portfolio matches your real time horizon. The stock market can look mysterious from the outside, but for disciplined investors it is mainly a tool—a way to turn working income into ownership in the world's productive assets and, over time, into freedom of choice.

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