Making informed financial choices

Your Investment Choices

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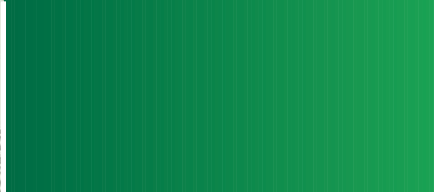
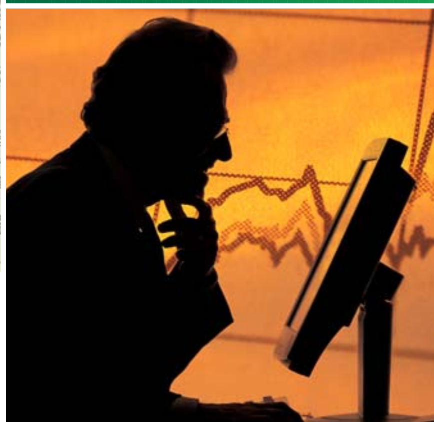
Start With the Investment Basics





Everyone wants to have a strong investment plan. Investing makes your money work for you today, so you'll be financially secure tomorrow.

And while making a quick profit can be an exciting part of investing, understanding the basics is key to building a successful long-term strategy. If you question that insightful advice, check with those people who put all their investment eggs in the dot.com stocks of the go-go '90s. How do their portfolios look now?

For many people there are so many investment options to choose from that it's very challenging to know just how to begin.

"Successful investing requires specific objectives and a plan to get there," says Chad Winklepleck, an investment representative with Edward Jones in Oregon, Wis. Having a plan is very important and too many people go into an investment blindly. A solid plan includes defining what your long-term goals are and coming up with a strategy to achieve those goals with the least amount of risk.

If you don't save and invest intelligently, you could be in for a real surprise.

According to the Office of Investor Education and Assistance, Securities and Exchange Commission (SEC), only 5% of investors believe they know everything they need to know to make good investment decisions.

And while most adults have high expectations for retirement, many will fail to maintain the lifestyle and standard of living to which they have become accustomed because they failed to plan and save. More than half—55%—of all current workers haven't even tried to figure out how much they need to save and accumulate for retirement, according to a recent Employee Benefit Research Institute study.

More disconcerting is the fact that two out of three American households—an estimated 65 million households—probably will fail to realize one or more of their major life goals because they've failed to develop a comprehensive financial plan.

Making a Plan

So you're interested in investing and think you have the means to do so, but with so many different avenues, where do you start?

There isn't any magic answer as to where to start, says Mark Schwartz, managing partner at TriCapital Advisors, North Bethesda, Md. The key is to follow one overall comprehensive plan. Where you start will depend on your particular situation. Start investing in all different areas if you can—saving a little bit for your retirement, a little bit for your children's college funding, and a little bit for whatever other goals you have. "You can't forsake one goal for another until the other is fulfilled—you should be working toward them simultaneously," Schwartz says.

The first step—a plan—will give you a clear sense as to how much money you're going to need to fund these various goals. You can break that down into a percentage basis if you wish. For example, if each month you have $100 to invest, you might put 40% toward a retirement account, 40% toward a college fund, and the difference toward a combination of other goals that you have—like the vacation you have been wanting to take.

The two most critical factors in dealing with risk are your time horizon and discipline. If you have the time—at least five to 10 years—to let your money grow—and the discipline to follow a prudent strategy—common stocks, based on historical returns, offer the highest potential returns vs. other investment categories.

Time horizon

The amount of time you have to reach your goals is just as important as the goals themselves. Everyone has different financial goals and different financial dreams, says Carl Sanger, owner of Serenity Wealth Management, LLC, in Massapequa, N.Y.

Sanger, a registered investment adviser, considers himself to be a bridge builder. Just as he does for his clients, you want to build a bridge from where you are right now to where you want to be in the future. To do this, you must set a certain amount of money aside into each investment area, be it stocks, bonds, or cash—based on a historical perspective of how much you can expect each area to gain. Over time and following a set strategy, you build your investment bridge, piece by piece.

The longer the time you have to ride the ups and downs of the stock market, the more risk you can assume, says Chris Witt, a former MEMBERS Financial Services representative in Madison, Wis. If you have a longer amount of time—eight to 10 years—to meet your goals, you could be more stock-oriented. If you're looking at a shorter time frame—less than two to three years—you could be more stable and safer with your investments, and consider putting more of your money into bonds and money market accounts.

When people are closer to when they're going to start to need their investments to live on—those a few years from retirement or who have already retired—they most likely should fund accounts that are less subject to market volatility, Schwartz says. Investors in this predicament need to be

aware that it's probably time to reallocate the account and make it more conservative—with steady, stable investments. These investments will have less growth over the long term, but over the short term carry less risk of loss.

Portfolio

Your portfolio consists of all the assets you own and represents the choices you've made with your money. It's a collection of investments such as stocks, bonds, mutual funds, cash assets, and real estate.

Your portfolio should be as unique as you are, Sanger says. Everyone has different standards of living and different lifestyles to maintain. Your portfolio should be tailored to accomplish your financial goals—taking into account your age, income needs, portfolio size, life situation, and future needs. Also, your financial plan must be adaptable to change should your life situation change.

Asset allocation

Building a portfolio entails combining different investments—in different percentages—to meet your financial goals. This is called asset allocation. Asset allocation ensures diversification of your investments.

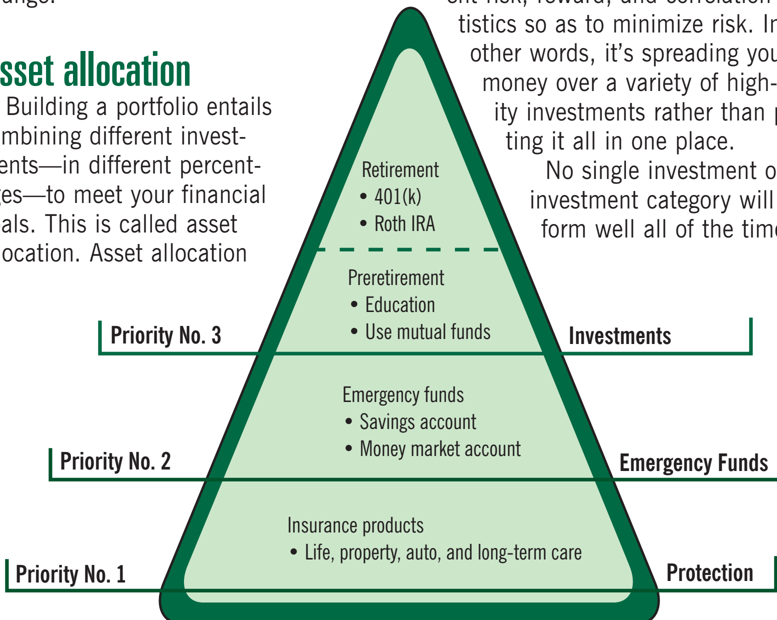
Asset allocation can help an investor control risk, match a portfolio with specific financial goals, and increase the predictability of returns.

Individuals should consider investing in stocks for growth and long-term goals, says Witt, and should consider investing in bonds and cash (money markets) for stability and safety. One can look at different investment needs as to where they fall on a pyramid, illustrated below.

Diversification

You can't control factors that cause investments to fluctuate, but you can diversify your portfolio to smooth out the ups and downs. "Diversification is the No. 1 way people can make money investing," says Winklepleck. It's the process of dividing investment funds among a variety of securities with different risk, reward, and correlation statistics so as to minimize risk. In other words, it's spreading your money over a variety of high-quality investments rather than putting it all in one place.

No single investment or investment category will perform well all of the time,



Source: Members Financial Services

under all market and economic conditions. But, by diversifying your money as far as you can to have exposure to every market, you'll reduce the risk of concentrating too much of your portfolio in the wrong one. "There will be times when your portfolio is up and times when it's down," Winklepleck says, "but diversification takes out those large peaks and spikes and turns your journey into a rolling wave."

An estimated 65 million households probably will fail to realize one or more of their major life goals.

Investors should diversify by spreading their investments around stocks, bonds, and cash. When you're in individual stocks, however, a general rule of thumb is to buy 12 to 15 stocks from different industries—such as the medical field, technology field, and financial services field, Winklepleck says. Many investors do not have the assets to invest in so many individual stocks, so they invest primarily in mutual funds.

Stock mutual funds will offer more diversification because each one is made up of roughly 150 to 300 individual stocks. Mutual funds save investors the costs of buying each stock individually and allow investors to diversify with professional money management.

Rebalancing

By rebalancing your portfolio you'll be able to adapt your plan to fit your needs.

Rebalancing involves periodically reviewing the makeup of your portfolio to keep it in line with your asset allocation plan. Say your portfolio allocation was initiated at 50% in stocks and 50% in bonds, and after a year it has reached 55% stocks: The rebalancing process involves selling 5% of your stocks to bring the portfolio back to the desired mix of 50% stocks and 50% bonds.

Rebalancing has been proven over time to be almost as important as the selection of your investments, says Sanger of Serenity Wealth Management. It can't be overstated how important this is.

When life's circumstances change, let whomever is watching your money know so he or she can review your plan. These circumstances could include buying a house, having a child, sending a child to college, divorce, retirement, a significant other's death, and so forth.

For example, says Edward Jones's Winklepleck, say you inherit $100,000 and want to apply it toward a retirement account. Now you might not need to take as much risk in your portfolio; you might be able to kick it down a notch. You'll readjust your portfolio to fit your same goal, but your ability to reach that goal has changed.

Even if you don't have a change in life circumstances, review your portfolio every 13 months. Look at yourself and your portfolio and examine what it's done over the past year. Sanger says that by rebalancing every 13 months, it allows for 12 months to pass—ensuring that you'll pay a lower capital gains rate. Then you'll be able to take the funds from the sectors that outperform and put your money back into the areas that are the next performers.

You'll essentially be rebalancing so the amount you're investing in stocks is

invested equally in all the different stock sectors and the amount you're investing in bonds is invested equally in all the different bond sectors and maturities.

Capital gains

A capital gain is the amount of money you make on an investment when it is sold. It's the difference between the money you sell it for and the money you paid for it. For example, if you buy a stock for $100 and you sell it for $200, you've made a capital gain of $100.

When you sell the asset, you'll have a long- or short-term capital gain or loss—depending on how long you've held the asset. You'll owe taxes on the gain and perhaps a commission on the sale.

If you've owned the stock for a year or longer, it's a long-term gain—you'll pay the tax at a lower rate than you pay on your earned income or on dividends and other investment income, reports Precision Information, a personal finance software company based in Madison, Wis. Short-term gains are taxed at the same rate as ordinary income. Portions of capital losses of either length are tax-deductible.

Dollar-cost averaging

Dollar-cost averaging is a method of buying stock or mutual fund shares by investing the same amount of money on a regular schedule, regardless of market price. Studies show that investors who use this method may end up paying less per share over time on average than those who purchase shares in a lump sum.

Your fixed investment buys more shares when the market is down, so you'll have more shares that will grow when the market rebounds.

Regular investments play an important role in building your portfolio. Some fund groups even waive initial minimum investments—which could be as much as $10,000 or more—if you make routine investments deposited directly from your paycheck or financial services account.

This type of systematic investing is one of the best ways to invest in the stock market. Using this approach, you may be able to lower the overall cost of your investment. By making regular investments in specific mutual funds every month, or quarter, it'll be easier to handle instead of having to come up with a lump sum all at once.

Buying on margin

Buying on margin means you're buying on a loan; you're borrowing the money from the brokerage house to buy. This is very risky.

Say you want to buy 100 shares of Microsoft that will cost $6,000, but, you only want to pay $4,000. You borrow $2,000 from your investment broker to buy this stock. Investors do this to leverage buying power. You always want your investments to do well, but when you're buying on margin, you had better hope they do. If your investment doesn't do well, it will compound your loss because you will have to pay the broker back for the amount you "borrowed," plus interest.

Risk tolerance

If you ask yourself what your risk tolerance is, you have to ask, "What is the biggest annual portfolio loss I'm willing to tolerate to get the highest return?" says Sanger of Serenity Wealth Management. If you consider how volatile you can see your portfolio being, that's essentially how risk-tolerant you are.

For those with little investing experience, risk usually means: "How likely is it that I will lose some of my money?" A person's tolerance for risk is intertwined with a person's willingness to invest.

But, risk and reward do not necessarily go hand in hand. If you were positive you'd get a reward, you'd take the risk—but when you become too aggressive and take on excessive risk, you then have a greater potential to lose.

For investors who don't want that crushing blow and to see devastating losses, their risk tolerance is different from someone who says, "Look, I have 30 years to go [until retirement] and I don't care if I lose 20% this year—I'm buying all the stocks I can buy," says Sanger. They don't mind the roller-coaster ride that goes along with aggressively seeking big gains.

Having a plan in place and knowing what you're working toward also determines risk tolerance, says Winklepleck. "You can be the riskiest person in the world, but if you're going to be fine, why take the risk and expose yourself to the risk if you don't need it?"

Different investments fall on a risk/reward continuum.

For example, a passbook savings account falls on the low-risk end of the continuum. If you take $1,000 and put it in a savings account at your financial institution, you are guaranteed that you will get your $1,000 back. On top of your original deposit you're also guaranteed to earn interest/dividends at the passbook rate. Right now interest on a regular savings account is about 1.2%. At this rate you'd earn about $11 a year.

On the other end of the spectrum—the high-risk end—you could use that $1,000 investment on a $10,000 property. There are no guarantees, but if later you sell the property for $50,000, your original $1,000 is now worth $41,000.

Ending Value of a Series of Equal Monthly Deposits*

Number of years	Annualized interest rate									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	$1,206	$1,211	$1,217	$1,222	$1,228	$1,234	$1,239	$1,245	$1,251	$1,257
2	2,423	2,447	2,470	2,494	2,519	2,543	2,568	2,593	2,619	2,645
3	3,653	3,707	3,762	3,818	3,875	3,934	3,993	4,054	4,115	4,178
4	4,895	4,993	5,093	5,196	5,301	5,410	5,521	5,635	5,752	5,872
5	6,150	6,305	6,465	6,630	6,801	6,977	7,159	7,348	7,542	7,744
6	7,417	7,643	7,878	8,122	8,376	8,641	8,916	9,203	9,501	9,811
7	8,697	9,008	9,334	9,675	10,033	10,407	10,800	11,211	11,643	12,095
8	9,990	10,401	10,835	11,292	11,774	12,283	12,820	13,387	13,986	14,618
9	11,296	11,822	12,381	12,974	13,604	14,274	14,986	15,743	16,548	17,405
10	12,615	13,272	13,974	14,725	15,528	16,388	17,308	18,295	19,351	20,484
11	13,947	14,751	15,616	16,547	17,551	18,632	19,799	21,058	22,417	23,886
12	15,293	16,260	17,307	18,444	19,676	21,015	22,469	24,051	25,771	27,644
13	16,652	17,799	19,050	20,417	21,911	23,545	25,333	27,292	29,439	31,795
14	18,025	19,369	20,847	22,471	24,260	26,230	28,404	30,802	33,452	36,381
15	$19,411	$20,971	$22,697	$24,609	$26,729	$29,082	$31,696	$34,604	$37,841	$41,447

**Monthly amount deposited is $100.*

Source: CUNA's economics and statistics department

Remember that even though the stock market can be volatile, it's not how the market behaves that's important, but how the investor behaves.

Many investors jump in and out of the market as it goes up and down—if they would stay in they wouldn't have to worry so much about risk tolerance. Investors who are constantly counting their money or looking at the value of their funds in the newspaper have a lower risk tolerance than someone who is content to not worry about day-to-day fluctuations.

Taxes

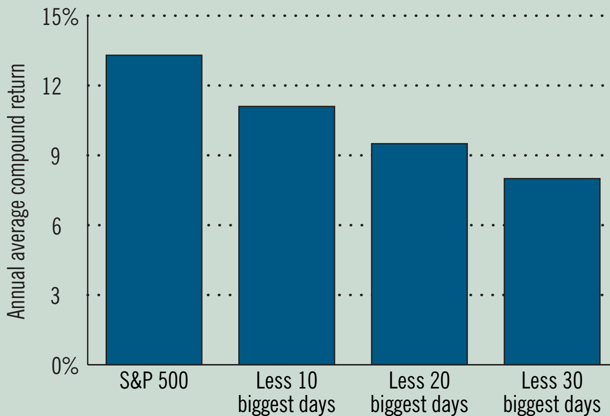
Most of the time, an investment decision based solely on its tax implications is the wrong decision. You're only paying taxes if you've made money, says Winklepleck of Edward Jones, and don't overlook that.

What to buy

Don't get caught up on the gimmicks. Buy companies with well-proven track records. Be careful if you're tempted to buy that new "hot stock" or IPO (initial public offering)—the risk may be more than you bargained for.

An IPO is the first sale of a corporation's stock to outside investors. To do this, the management registers the stock with the Securities & Exchange Commission (SEC) and makes an initial public offering. Becoming an IPO means that a company goes from being a "private" company to a "public" company—the initial time that it hits the stock exchange.

If you're an aggressive investor you'll buy aggressive company stock, but buy something with a proven track record. "Don't try to find the newest IPO that's just coming out because you think it's the next Microsoft—generally you will not find it, and it's luck if you do," Winklepleck says. Many IPOs end up filing for bankruptcy.



Explanation: This chart shows why you must be invested all the time and can't time the markets. It shows what your return would have been had you been out of the market the best 10, 20, and 30 days.
Source: Standard & Poor's and Thomson Datastream