

# Choosing the Right Investments

## 1. Introduction

Like every investor, you want to choose investments that will provide the growth and income you need to meet your financial goals. To do that, it's important to understand what your investment choices are and how different types of investments put your money to work.

It's equally important to understand yourself as an investor. That's because a portfolio that's right for someone else may not be best for you. The factors that make a difference are:

- Your age
- Your goals, or what you want to accomplish by investing
- The time frames for your various goals
- Your attitude toward risk—or what's called your risk tolerance

Once you've devised a strategy for choosing investments appropriate to each of your goals, you've taken a major step toward meeting them. But building your portfolio is just the first part of the process. You may also find that as your life circumstances or priorities evolve, or as a major goal approaches, that you need to change the mix of investments in your portfolio. That's all part of being an investor.

## 2. General Rules of Investing

As a general rule, the younger you are and the more time you have to reach a financial goal, the more investment risk you can afford to take. That means, for example, when you're in your twenties and just starting your career, you may be able to take a more aggressive approach to investing for long-term goals. Aggressive investing means choosing investments that have the potential to provide greater return over an extended period. But these investments also expose you to more risk in the short term because their prices are volatile, which means they might move up and down rather quickly within a short period.

On the other hand, when you're in your late 50s or 60s, you'll probably want to be more cautious about taking on investment risk, since your portfolio may not have a chance to recover from a market downturn before you need to start drawing on your retirement assets. When you retire, your goal is not only providing continued growth while taking limited investment risk but also ensuring that you have a stream of income that can cover a portion of your living expenses.

But these are just guidelines. No single approach to choosing investments will work for everyone or will be right for every situation. Even when you're young, there may be circumstances that make it unwise to take a lot of investment risk—if, for example, you're still in school or have significant debt. Or you may simply be uncomfortable with that approach. Similarly, there may be situations when it makes sense to take more risk in your portfolio later in your working life. So you'll want to tailor your strategy to your own unique needs and circumstances.

What does make sense for all investors is concentrating on investments that, however different they are from each other, share these important characteristics:

- The investments are easy to evaluate because there's lots of information about them. Regulators require that certain information be disclosed to investors through documents such as mutual fund prospectuses, corporate filings for stock issued by public companies that trade on the major stock markets, and prospectuses or offering statements for bonds. In addition, you can find wealth of real-time and historical market data for stocks, bonds, mutual funds and other securities on the Web site of the Financial Industry Regulatory Authority (FINRA) at [www.finra.org/marketdata](http://www.finra.org/marketdata).
- The investments are easy to buy and sell, either through a brokerage account or in some cases directly from the issuer. Thinly traded stocks or securities that aren't listed on a major exchange are rarely a good idea for

most investors.

- The sales charges for buying and selling the investments are clearly explained, as are any fees for selling within a certain time frame.
- The investments are registered with the SEC or your state's securities regulator, and the salespeople who sell them are licensed by FINRA.
- You understand the risks of the investment and how it works.

### 3. Planning for Your Financial Goals

When you're just starting out, you may be comfortable about living from one paycheck to the next without thinking a great deal about the future. But at some point in your life, there will be things you want or need that you won't be able to pay for with just your regular income. If you don't have a strategy in place for accumulating the assets that will let you afford them, you may find that you have to postpone or even abandon some of the things you were counting on.

That's why it's important to create a plan for meeting your financial goals. While everyone's circumstances are a little bit different, there are essentially four steps to creating a strategy for meeting your goals that will work for just about every person and situation:

1. Identify your most important short- medium-, and long-term financial goals.
2. Estimate how much each of your goals will likely cost.
3. Set up separate savings or investment accounts for each of your major goals.
4. Choose investments suited to meeting each of your goals based on your time frame and your tolerance for risk.

#### Your time frame

As you begin thinking seriously about what your goals are, you'll want to be specific about your time frame for meeting them. You may find it helpful to put your ideas down in writing, perhaps in a chart form like this:

	<b>Short-term goals</b> (Less than 3 years)	<b>Mid-term goals</b> (3 to 10 years)	<b>Long-term goals</b> (More than 10 years)
Buy a home			
Get an advanced degree			

Buy a new car			
Pay for children's education			
Retirement			

You may find that the time frames for meeting some of your goals are more flexible than others. For instance, if you know that your children will be graduating from high school in 2018 and 2020, you'll want to make sure you have the money available at that time to pay their higher education expenses. On the other hand, some goals, such as buying a new car or taking a special vacation, may be a little more flexible. That is, if you had to put them off for a year or two, it probably wouldn't derail your overall financial plan.

Whether a goal has a fixed or somewhat more flexible time frame may have some impact on how you invest. For instance, as goals with fixed time frames approach, you may decide to move the money you've accumulated to pay for them into fixed-income investments that are scheduled to mature when you need the money, such as zero-coupon bonds—which pay no interest until the end of their terms—or FDIC-insured certificates of deposit (CDs).

### **An evolving timetable**

Keep in mind that no goal is short-, medium-, or long-term by definition. For instance, retirement will be a long-term goal when you're 35, but will probably be a short-term goal when you're 65. Similarly, paying for your child's higher education will be a long-term goal when she's a baby, but a short-term goal when she's a high-school sophomore. So your investing approach—and your choice of investments—will need to evolve as you draw closer to each of your goals.

As your priorities or life circumstances change, you may also find that you want to delay certain goals by a year or two, while others you may want to try to meet sooner. And some—such as a second car that you were planning to buy or an expensive family trip—you may decide to forego altogether. It's important to stay flexible and adapt your timetable to your changing needs and priorities.

### **What's the price tag?**

Before you can choose investments to meet a particular goal, you need to have an idea of what the goal will cost. It's relatively easy to anticipate the costs of

short-term goals, since they probably won't be significantly different from what they are today.

Estimating the costs of goals that are further in the future, especially major ones like college tuition or retirement, can be a bit trickier. Calculators and other tools available on government, financial, and college planning Web sites can help you gauge these costs. It's a smart idea to try out several, since different tools will likely provide somewhat different results.

For goals that are more than a few years away, you also need to consider the impact of inflation on your assets—something you can figure out using an online calculator. Historically, inflation has averaged about 3% per year. And the costs of tuition at both public and private colleges typically rise even faster—often double or more the rate of inflation. That means you'll have to earn enough on your investments to offset these rising costs.

## 4. Investing for Short-Term Goals

Because you plan to spend the money you set aside for short-term goals relatively quickly, you'll want to focus on safety and liquidity rather than growth in your short-term portfolio. Insured bank or credit union accounts as well as Treasury bills backed by the government's promise to repay are generally considered safe investments. Liquid investments are those you can sell easily with little or no loss of value, such as Treasury bills, money market accounts and funds, and other low-risk investments that pay interest. If those investments have maturity dates, as T-bills do, the terms are very short.

For example, say you're saving for a down payment on a house that you hope to buy in about a year. If you've invested the money in stock funds and your portfolio fell sharply just as you were about to start your home search, you might have to postpone your plans to buy, or choose a less expensive home. On the other hand, if you had given yourself a little more time to accumulate the funds for a down payment and invested them in liquid cash investments or insured bank products such as certificates of deposit (CDs), you could be more confident that the money you need would be available when you were ready to make an offer.

Cash investments typically pay lower interest rates than longer-term bonds—sometimes not enough to outpace inflation over the long term. But since you plan to use the money relatively quickly, inflation shouldn't have much of an impact on your purchasing power. And keep in mind that some cash investments offer the added security of government insurance, such as bank money market accounts and CDs, which are both insured by the Federal Deposit Insurance Corporation. U.S. Treasury bills are another choice for short-term goals. Because they mature in 13 or 26 weeks and are issued by the federal government, they're sometimes described as risk-free investments.

## 5. Investing for Medium-Term Goals

Choosing the right investments for mid-term goals can be more complex than choosing them for short- or long-term goals. That's because you need to strike an effective balance between protecting the assets you've worked hard to accumulate while achieving the growth that can help you build your assets and offset inflation. Here are possible strategies for managing a portfolio of investments for goals that are three to ten years in the future:

- Balance your mid-term portfolio with a mix of high-quality fixed-income investments—such as a mid-term government bond fund or high-yield CD—with modest growth investments, such as a diversified large-company stock fund. Then monitor the stock investments closely and be prepared to sell to limit your losses if there's a major market downturn.
- If your goal is just three or four years away, you might limit your stock to less than 30% of your portfolio. If your goal is eight or nine years in the future, you might invest 60% or more in a stock fund. It partly depends on your tolerance for risk. As your goal draws nearer, you can sell some of your stock fund shares and reinvest the assets in cash equivalents, such as CDs set to mature when you need the money, or a money market account or fund.
- Establish limits for gains and losses in your mid-term stock portfolio. For instance, you may decide ahead of time that you'll sell an investment if it increases in value 20% or decreases 15%—or whatever percentage you're comfortable with. As your goal approaches, you can reinvest your assets in less volatile investments.

Balanced funds, which usually invest in a mix of about 60% stock to 40% bonds, growth and income funds, or equity income funds that invest in well-established companies that pay high dividends, might be appropriate choices for a mid-term portfolio. Ultimately, the key to achieving modest growth while minimizing risk is to keep a close eye on performance and gradually shift to more stable, income-producing investments as the date of your goal approaches.

## 6. Investing for Long-Term Goals

The general rule is that the more time you have to reach a financial goal, the more investment risk you can afford to take. For many investors, that can mean allocating most of the principal you set aside for long-term goals to growth investments, such as individual stock, stock mutual funds, and stock exchange traded funds (ETFs).

While past performance is no guarantee of future results, historical returns consistently show that a well-diversified stock portfolio can be the most rewarding over the long term. It's true that over shorter periods—say less than 10 years—investing heavily in stock can lead to portfolio volatility and even to losses. But when you have 15 years or more to meet your goals, you have a good chance of being able to ride out market downturns and watch short-term losses eventually be offset by future gains.

In addition, some investors successfully build the value of their long-term portfolios buying and selling bonds to take advantage of increases in market value that may result from investor demand. Others diversify into real estate or real estate investment trusts (REITs). The larger your portfolio and the more comfortable you are making investment decisions, the more flexible you can be.

### **Tax-deferred and tax-free accounts**

For long-term goals such as retirement or education for your children, you can give your portfolio a significant boost by taking full advantage of any available tax-deferred and tax-free investment accounts.

When you invest through a tax-deferred account, including traditional individual retirement accounts (IRAs) and employer sponsored plans, such as 401(k)s, you don't owe income tax until you begin making withdrawals from the account, presumably after you retire. Because you don't have to pay taxes on your earnings every year, your investment compounds untaxed, significantly enhancing its long-term growth potential. In some cases, you can defer taxes on your contributions to these accounts as well, helping your account to compound even faster.

You may reap even greater tax advantages with a tax-free retirement or education account, such as a Roth IRA or Roth 401(k) (if your employer offers this alternative), or a 529 college savings plan or Coverdell education savings account (ESA). As with tax-deferred accounts, you owe no tax on current income or capital gains on realized profits in a tax-free account. In addition, your

withdrawals are federally tax-free—and may be exempt from state and local income tax as well, depending on the type of account—provided you follow the rules for withdrawals.

You'll want to give some thought to the types of investments that are best suited for tax-deferred and tax-free accounts. Growth investments, such as stock and stock funds, benefit from the potential for long-term compounding. The only drawback is that withdrawals from tax-deferred accounts are taxed at your regular tax rate, which is higher than the rate you'd pay on qualified dividend income and capital gains. Bonds also have a place in your tax-deferred and tax-free accounts, as do mutual funds and ETFs that invest in stocks and bonds.

Since most bond interest is taxable at your regular rates, you don't increase what you owe by holding bonds in tax-deferred accounts. However, investments that are already tax-exempt, such as municipal bonds or municipal bond funds, are not suitable for tax-deferred accounts and belong in a taxable account or a Roth account. When you hold a tax-exempt investment in either a taxable or tax-free account, you do not have to pay taxes on the interest you earned. But, because of how the tax law works, if you hold a tax-exempt investment in a tax-deferred account, your earnings become taxable when you withdraw them.

### **Tax-deferred annuities**

You can also plan for retirement by purchasing an annuity contract issued by an insurance company. You pay a premium, in either installments or a lump sum, to buy the contract. Any earnings an annuity produces are tax deferred until you withdraw them. At that point, you owe income tax calculated at your regular tax rate.

Annuities are widely available through financial services companies and in some cases through your employer's retirement savings plan. However, selecting an annuity can be confusing because they're available in several different varieties.

Here's a summary of some of the choices you have:

- **Qualified or nonqualified.** A qualified annuity is one that's available through an employer's retirement savings plan. The rules governing contribution limits and required withdrawals are the same as with all the other plan alternatives. For example, you can contribute only up to the annual limit for the plan and must begin to take minimum required distributions when you turn 70 ½. With a nonqualified annuity, which you buy in addition to or instead of an employer's plan, there's generally no limit on the amount you can put into the contract and there is no federal requirement to begin withdrawals at a particular age. States or the

contracts themselves may require that distributions begin by age 80 or higher.

- **Deferred or immediate.** An deferred annuity accumulates value over a number of years, while an immediate annuity begins to pay you a stream of income either right after purchase or within a year. Deferred annuities can be annuitized at maturity, which means the accumulated value of your contract is converted to a stream of income guaranteed to last your lifetime or two lifetimes—yours and your joint annuitant's.
- **Fixed or variable.** A fixed annuity guarantees you'll earn at least a minimum interest rate specified in the contract, subject to the company's ability to pay claims. However, the rate you earn may be higher, based on what the insurer is earning on the investments it makes. Earnings in a variable annuity depend on the performance of the investment alternatives you choose from among those offered in the contract. The alternatives, called subaccounts or variable accounts, resemble mutual funds in the sense that each one owns a number of underlying investments.

In addition, variable annuities may provide a guaranteed death benefit, which is based on the claims paying ability of the insurance company. It means that if you die before you start receiving income from your contract your beneficiaries will receive at least as much as the premiums you paid, and, in some contracts, your premiums plus some earnings.

- **Equity-indexed annuities.** Equity-indexed annuities (EIAs) have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. So EIAs give you more risk (but more potential return) than a fixed annuity but less risk (and less potential return) than a variable annuity.

EIAs offer a minimum guaranteed interest rate combined with an interest rate linked to a market index. Because of the guaranteed interest rate, EIAs have less market risk than variable annuities. EIAs also have the potential to earn returns better than traditional fixed annuities when the stock market is rising. While this may sound simple, EIAs can be extremely complex products, and it can be difficult to determine how the issuer calculates the gain in the index to which the annuity is linked—which impacts any return an investor might earn. Because of the variety and complexity of the methods different issuers use to calculate gains, investors will find it difficult to compare one EIA to another.

A primary drawback of using annuities to save for retirement is that their fees and expenses, especially in the case of variable annuities, tend to be higher than the

costs of other retirement savings plans. Each of the features that can make annuities seem attractive—such as a death benefit or a guaranteed minimum return—will always come with a cost. Since fees reduce your return, that's an issue you'll want to weigh carefully before you choose this approach. Annuities also impose surrender fees, calculated as a percentage of your account value, if you want to take your money out within the first seven or more years. In addition, because a deferred annuity is a long-term contract, you'll want to evaluate whether you'll hold it long enough to offset the cost of buying. Finally, annuities can be complex products that can be difficult to compare. Before you consider an annuity, be sure to determine whether you actually need all the features the contract offers.

On the other hand, a primary advantage of using annuities to manage your income in retirement is that you can reduce the risk that you will outlive your income. Immediate fixed annuities, for example, guarantee a steady, predictable stream of income. Although the payment might not keep pace with inflation over time, if you know you'll need a fixed amount of income to meet known expenses—such as taxes or other predictable payments—you might want to consider annuitizing at least part of your portfolio.

None of us knows how long we will live—which makes it hard to know how much to put away. Be aware that the annuities landscape is constantly changing, and new products with new features—including guaranteed life benefits and guaranteed minimum withdrawal benefits—regularly emerge. If you choose annuities for long-term retirement savings or to manage your income once you've retired, be sure to carefully study each annuity contract you're considering and weigh the pros, cons, and costs of each insurance guarantee (or "rider") to determine whether it makes sense for you.

## 7. Your Risk Tolerance

Both your age and your time frame for meeting specific financial goals play a role in determining your risk tolerance. If you're young and have a long time to meet your goals, you may have a higher risk tolerance than someone who is nearing retirement and is counting on investment income to live on for two or three decades.

But other factors may also affect your tolerance for investment risk. Your personality, personal experiences, and current financial circumstances also come into play. For instance, if you're a single parent, are responsible for the care of a sick or elderly relative, or have lived through a period of economic upheaval such as a major recession, you may be a more risk-averse, or conservative, investor.

On the other hand, if you have a promising career, a generous salary, and little in the way of financial responsibilities, then you may be more comfortable in assuming greater investment risk.

Above all, you need to feel comfortable with the risk you're taking. If changes in the value of your portfolio keep you tossing and turning at night, or your instinct is to sell your investments every time the market drops, then you may want to consider shifting to a more moderate investment mix, with a greater emphasis on predictable, income-producing investments, such as bonds and bond funds.

Or, if you're a risk taker by nature and have at least 15 years to meet your goals, then you may be comfortable allocating most of your assets to a diversified portfolio of stock, stock funds, stock ETFs, and certain fixed-income investments that have the potential to provide the strongest returns over the long run.

Keep in mind that investment risk doesn't mean staking your life savings on highly speculative investments like a new company that a friend is starting. (The only money you'd want to put in investments like that is money you can afford to lose.) But it does mean getting used to the fact that virtually all investments that have the potential to provide substantial returns will drop in value at one time or another—sometimes significantly.

If you're uncomfortable with investment risk, it's important to educate yourself about the long-term rewards of taking well-planned risks. Taking too little risk—or avoiding investment risk altogether—can make it difficult, if not impossible, to meet your long-term financial goals.

## 8. Managing Your Portfolio

As your life changes—in terms of your career, family, or finances—your investing goals and approach to risk may change as well. For example, you may be earning more money, or as your portfolio has grown, your confidence as an investor has grown as well. At that point, you may find you're ready to expand beyond a basic menu of mutual funds and open a brokerage account to purchase individual securities or ETFs.

On the other hand, maybe you've experienced a major life change—for instance, you're raising a family or you've gone through a divorce. In those cases, you may want to revise your investment strategy and approach to risk to accommodate your changing circumstances.

### Market cycles

Even if your investing goals and risk tolerance stay the same, the markets are bound to change. Over time, some of your investments will probably exceed your expectations while others will be disappointing. Similarly, different types of investments—for instance, stocks, bonds, and cash equivalents—tend to gain and lose value at different rates. During a period when stock prices are moving up, bond prices may be stagnant or losing ground, and vice versa.

It is useful to have a plan for responding to these market cycles. You'll want to start by deciding on asset allocation—a recipe outlining what proportions of your total portfolio to invest in different asset classes. An asset class is simply a grouping of one type of investment. For example, domestic stocks, domestic bonds, foreign stocks, foreign bonds, real estate, precious metals, and cash equivalents are all considered separate asset classes. Your asset allocation will depend on your time horizon, age, and personal degree of risk tolerance.

When you are young, you generally are able to tolerate short-term fluctuations in your portfolio value. At this point, it might make sense to devote a greater percentage of your portfolio to asset classes that are volatile but have greater potential for growth, such as domestic and foreign stocks. When you near retirement, you may want more stability and income from your portfolio, so it might make sense then to allocate a greater percentage of your portfolio to bonds.

A few years of market ups and downs may throw the mix of investments you had chosen for yourself out of kilter, however. The proportions of stocks, bonds, and cash in your portfolio may be different from what you had originally planned. For instance, perhaps you're an aggressive investor in your thirties and decided to allocate 50% of your portfolio to a large-company stock index fund, 20% to an

international stock fund, 10% to a small-company stock fund, and 20% to a Treasury bond fund. After a few years of strong performance for small-company and international stock, and mediocre performance for large-company stock and bonds, your portfolio allocation might have shifted to 30% large company, 35% international stock, 20% small company, and 15% Treasuries.

While your instinct may be to hold on to—or even increase—the percentage you’re contributing to the small caps and international investments that have been providing the best returns, that could expose you to much more risk than you had originally intended. Furthermore, one type of investment or asset class can outperform another for a period of time, and then the cycle often reverses itself.

If you keep that balance you have in your portfolio, with little exposure to large-company stock, and the following year happens to be a record one for large-company performance, you could miss out on a significant amount of growth. Similarly, if your international stock fund takes a sudden and dramatic turn for the worse, it could have a major impact on your portfolio, since the fund represents over a third of your portfolio value.

That’s why you’ll want to consider rebalancing your portfolio whenever a particular investment category, such as small- or large-company stock or bonds, represents significantly more or less of your portfolio than you originally intended. For example, you may decide it’s time to rebalance when a type of investment shifts above or below your original allocation by 15% or more. You may also want to change your mix of investments as your priorities change in response to major life events—for instance, getting married or having children—or as you approach major goals, such as retirement.

One benefit of rebalancing is that it forces you to follow one of the most effective of all investment principles: buy low and sell high. You should keep that in mind if you’re hesitating to sell investments that have done very well in order to buy those that have not been doing so well.

### **How are your investments doing?**

Ups and downs are a fact of life in the world of investing. Even the soundest investments will fluctuate in value. So you may be wondering how you measure your portfolio’s performance. This is why individual and institutional investors alike use benchmarks, such as stock market indexes, averages, and other market indicators. Benchmarks can serve as a gauge against which you can measure the performance of the overall market, a segment of the market, or your own portfolio of investments.

For instance, let's say your large-company stock mutual fund earned an annual return of 3% one year—a relatively low return for large-company stocks. But if that same year the Standard & Poor's 500 Index (S&P 500)—one of the most widely followed indexes for large-company stocks—fell by 2%, you could be confident that your large-company fund outperformed the market by a considerable margin.

On the other hand, if one of your mutual funds or ETFs is significantly underperforming its benchmarks for more than a couple of years, it may be time to reconsider your investment choice.

### **Apples to apples**

What you don't want to do is measure the performance of one category of investments against the benchmark for another. For instance, let's say the S&P 500 gained 12% one year, but your small-company stock fund gained only 3%. While the S&P 500 can tell you how the overall large-company market performed that year, it won't tell you anything about how small-company stock performed relative to other small companies. For that, you'd need to look at a small-company benchmark, such as the Russell 2000, which tracks the stock of 2000 small U.S. companies. Small-company stocks face different risks than large-company stocks—and therefore are expected to produce different returns. It is important to select an appropriate benchmark so that you can evaluate your investment fairly—against similar investments with similar risk profiles.

### **The bigger picture**

Just as you can use indexes and averages to measure the performance of your investments against the overall market, you can use economic indicators and other news to give you a snapshot of the broader economic outlook. Economists use monthly changes in key economic indicators, including consumer confidence, the unemployment rate, the inflation rate, productivity, the S&P 500, the yield curve and gross domestic product, to forecast changes in the economy.

Evaluating the market in light of these statistics can help you adjust your expectations. For instance, if stock prices are climbing in the absence of good economic news, the market may be ripe for a correction. On the other hand, if stock prices are depressed but the economic indicators forecast a robust economic picture, then the markets may be poised for a rebound.

There are many risks in trying to time the market based on economic news. And most research suggests that the markets have historically rewarded long-term buy-and-hold investors. But the broader economic context can help you evaluate

whether certain investments may be overvalued or undervalued and guide you in making informed decisions about your portfolio.

## 9. Investing in Your Twenties

If you're starting your career or have recently graduated from college, the financial choices you make now can have a bigger impact on your future financial security than those you make at any other time of your life.

You don't necessarily have to sacrifice a lot to have a big long-term impact. Even modest sums invested regularly in growth investments, such as a well-diversified portfolio of stock, stock mutual funds, or ETFs have the potential to increase to a substantial nest egg over 25 or 30 years or more.

There will be competing pulls on your money if you're paying off student loans or helping your parents or younger siblings with their expenses. And, if you're just starting out on your own, you may be finding it difficult to make ends meet.

On the other hand, you're probably not paying off a large mortgage and home repair expenses or dealing with the costs of raising a family. You probably don't have major healthcare expenses. In addition, if you have a job you like and you're good at, it's reasonable to expect that your earnings will increase.

### Benefits of starting early

Having time ahead of you gives you other advantages. Few people are able to come up with the money they need to meet major expenses—such as buying a home or sending children to college—out of their ordinary income. But by planning ahead and making small but regular contributions to your investment accounts, it becomes easier to accumulate the sums you'll need. If you have the money automatically deducted from your paycheck or checking account, you may never even miss it.

Plus, the longer you have to invest, the greater the potential for your investments to compound, or grow in value. Compounding is what happens when your investment earnings or income are reinvested and start generating earnings themselves. To see how this works, compare the following two individual retirement accounts (IRAs):

	Investor A's portfolio	Investor B's portfolio
Monthly investment	\$150	\$300
Length of investment	40 years	20 years

Total investment	\$72,000	\$72,000
Annual interest rate, compounded yearly	9%	9%
Total value of account at end of investment period	\$667,637	\$202,434

Investor A begins investing \$150 a month in an IRA when he's 25. Investor B, on the other hand, doesn't start investing in an IRA until she's 45, although she contributes twice the amount of Investor A, or \$300 per month. When they turn 65, they've both contributed the same amount of money to their accounts, or \$72,000, and both have earned an average annual rate of return of 9%, compounded yearly—a realistic average rate of return for a diversified stock portfolio.

But while Investor B has \$202,434 in her account by age 65, Investor A has \$667,637 in his account—over three times as much. The difference is that he started much earlier, and his account had 20 additional years to compound.

### **The debt dilemma**

If you have little credit card debt or only a small student loan to repay, you're in an exceptionally good position to start investing. But if you're carrying a high balance from month to month on one or more credit cards, it's probably a good idea to make paying off your high interest debt a priority, even if it means you'll have to invest less at the beginning—or even have to put off investing altogether for a while.

That's because if you own a stock mutual fund that earns, say, an average of 8% per year, but you're carrying consumer debt on which you pay 17% annual interest, then you're actually paying more percentage-wise in interest than you're earning on your investments. If you're in a situation similar to this, it may be the one circumstance when it makes sense to postpone your investing plans and instead concentrate on paying down your high-interest debt.

On the other hand, if you have loans with low interest rates, it may make sense to pay them off over time while you pursue your investing strategy rather than postponing investing until you're debt free. The interest on some student loans is a good example, since it may be lower than the market rate on other loans, or lower than what you could earn from certain investments. Depending on your income, you may also qualify to deduct some or all of student loan interest

payments when you file your federal tax return, which could have the further benefit of lowering your current income taxes.

## **Easy to get started**

As you take the first steps toward contributing to a 401(k) or opening an IRA, you may feel overwhelmed by the decisions you have to make. But it's important to keep in mind that you don't have to resort to complex investing strategies or products to succeed as an investor. The tools you need to build the foundations of future financial security are simpler than you think.

If you're not sure where to start, consider investing in a balanced fund that provides a mix of investment-grade bonds and stock, or a large-company stock or index fund that invests in all of the securities included in the market index it tracks. Or, if you want to put your retirement savings completely on auto-pilot, you can also consider a life-cycle fund that makes and adjusts investment allocations based on your target retirement date. If that date is a long time from now, the lifecycle fund will be more heavily weighted toward stocks or stock mutual funds. But as the date approaches when you will need your money, the investment mix will become weighted more heavily toward fixed-income or stable value investments, including bonds or bond funds and Treasury securities.

As your confidence develops, you can start branching out into other categories of investments that can help you diversify your portfolio. These might include international funds that invest in overseas companies, small-company and emerging growth funds, corporate and government bond funds, and ETFs or individual securities that you can invest in through a brokerage account.

If you need help choosing among different funds, you might ask the bank, brokerage firm, or investment company that handles your account to put you in touch with an investment professional who can point you to appropriate investments. Make sure to review all the investment literature you receive carefully, including any fund prospectuses and research reports, before committing your money. You'll also want to be sure that the investment, whether it's an individual security, a mutual fund, an ETF, or some other type of investment product, fits in with your overall asset allocation and diversification strategy.

Getting an early start is key. Once you start making regular contributions to meet long-term goals, you'll be seeding a portfolio that has the potential to grow for the rest of your working life.

## **Growing your portfolio with growth investments**

You can increase the potential for compounding in your long-term investment portfolio by emphasizing growth investments. Unlike cash equivalents, which tend to provide predictable though modest income, growth investments can increase significantly in value over time.

Stock, stock mutual funds, and stock ETFs may all be classified as growth investments. But some stock and stock funds are more growth-oriented than others. For instance, the stock of larger, well-established companies—also known as large-capitalization stock—tends to grow in value more slowly than other types of stock and the price usually doesn't fluctuate as dramatically.

At the other end of the spectrum is small-company stock—also known as small-capitalization or small-cap stock. While over longer periods of time small-cap stock as a group has historically produced stronger returns than any other investment category, small caps can be extremely volatile. This means that the prices of the individual stocks in this category can fluctuate dramatically in value from year to year as well as day to day.

Because you probably won't be drawing on your retirement assets for several decades, it's worth considering investing a portion of your retirement portfolio in small-cap stocks for the extra growth potential they offer. Many employer sponsored retirement plans such as 401(k)s offer small cap stock funds or funds that seek aggressive growth among their investment choices. You can make similar investments in an IRA of your choosing.

## 10. Investing in Your Thirties and Forties

In your thirties and forties you're probably earning more than you were when you were younger, so you may have more income to invest. On the other hand, your financial needs are likely to be more complex. For instance, depending on your situation, you may be saving for a down payment on a house, making mortgage and car payments, supporting a family, or investing in a college fund for your children as well as building your retirement accounts.

Since these competing financial goals can throw a monkey wrench into your investing plans, it's a good idea to separate the amounts you invest into different accounts that are tailored to your different time frames.

To meet short-term goals, for example, you'll want to make sure that your money is safe and liquid—or can be easily converted to cash at its full value when you need it. Certificates of deposit (CDs), Treasury bills, money market funds, and money market accounts would all be appropriate choices. You'd normally want to avoid more volatile investments, such as stock and stock mutual funds, for goals you need to meet in the next few years, since your portfolio may not have time to recover from a setback before you need the money.

When you're trying to meet mid-term goals that are three to ten years away, you want to strike a balance between protecting your principal and achieving sufficient growth to help you afford your goal. Some people manage this balance by investing in assets that have the potential to increase in value, such as large-company stock or stock mutual funds, and following a strategy of selling these assets at appropriate times either to lock in profits or protect against losses. For instance, you may decide to sell a stock in your mid-term portfolio when it rises or falls in value by 15% or 20%. It's true that you may miss out on potential future increases in value, but if you're approaching the point where you'll need the money, you may decide it's more important to lock-in your gains.

Another approach to investing for mid-term goals is to split your portfolio between cash equivalents and investments with some potential for growth, such as large-company stock. The stock of these larger, well-established companies tends to be less volatile than other types of stock. As the date of your goal approaches, you can shift a greater portion of your assets into stable, fixed-income investments, such as CDs or zero-coupon bonds that are scheduled to mature when you need the money.

While investing to meet your short and intermediate term goals, you don't want to lose track of your long-term goals and an investment strategy for meeting them.

For example, because you're probably not planning to retire for at least another 20 or 30 years, it may make sense to keep most of your retirement portfolio invested for growth in stock, stock mutual funds, and stock ETFs. That's assuming you're comfortable with that approach and can tolerate the risk that your portfolio could lose value, at least in the short term.

If, however, there are other financial circumstances to consider—for instance, you may have a lot of money invested in your own business or you're responsible for significant healthcare expenses for yourself or others—then a more conservative investing approach may be more appropriate for you, even for your long-term goals. It all depends on your personal circumstances.

## 11. Investing in Your Fifties

At this point in your life, you may have more flexibility with your finances. You may be close to paying off your mortgage or perhaps your children are independent by now. If that's the case, you may be able to put more money into your retirement portfolio or accounts earmarked for other goals.

If you're in your early fifties, you're probably not planning to retire for at least another 10 years or so. That means you'll want to consider keeping a substantial portion of your long-term portfolio allocated to growth—in stock, stock mutual funds, and stock ETFs.

As your retirement date approaches, you can shift a larger percentage of your assets into less volatile investments, such as US Treasury issues and highly rated municipal and corporate bonds and bond funds. You wouldn't want to risk a major loss of value to your portfolio at this stage in the game, since you might not have time to recoup the losses—let alone register gains—before you plan to start drawing on your retirement assets.

### Behind schedule?

You may feel you're behind schedule saving for retirement. If you're 10 or 15 years from when you'd like to retire and have little or nothing put away, there's no need to give up hope. But you will have to take a hard look at your finances and make some adjustments. The sooner you get started creating a serious strategy for meeting your retirement needs, the better off you'll be. Here are a few strategies to help put your retirement plans on track:

1. If you're eligible to contribute to an employer-sponsored retirement plan, such as a 401(k) or 403(b), make sure you're contributing the maximum. If you're 50 or older, you're also eligible to make additional annual catch-up contributions to build up the value of your account, provided that your employer's plan offers this feature.
2. Invest additional money outside your employer-sponsored retirement plan in an individual retirement account (IRA), taxable investment accounts, or both, even though you may not receive a deduction for the investment.
3. In addition to contributing the maximum to tax-advantaged retirement accounts, be sure to use taxable accounts to save and invest even more. Getting started in your fifties, you may want to focus on a mix of growth and income investments, recognizing that you likely cannot afford to take

much risk. While stock, stock mutual funds, and stock ETFs can fluctuate in value significantly over the short term, over longer periods of time they have historically provided much stronger returns than bonds or cash equivalents. By also investing part of your portfolio in more stable assets that pay regular income, such as bonds and bond funds, you may be able to offset some of the shorter-term volatility of stock. Plus bonds may provide a stronger return than stocks in some markets.

4. You may need to consider postponing your retirement for a few years—if you have that option—so you get the double effect of accumulating more in your investment accounts while avoiding tapping into the assets you already have. Putting off your plans for a few years may also increase the retirement or Social Security benefits to which you're entitled.
5. If you have a partner or spouse who isn't working, you may decide that additional income may help you meet your shared goals more quickly. You might also consider part-time work or a home business that could provide a transition to something you might enjoy doing during retirement.

## 12. Investing in Your Sixties and Beyond

Because many people can expect to spend 20 or 30 years or even longer in retirement, you may decide to keep a percentage of your portfolio invested for growth even as you begin either tapping the income from the assets you've accumulated during your working life or dipping into your principal. Continuing to seek growth can help protect you against the possibility of running out of money while you're still alive.

### Growth investments

Growth investments that might be appropriate both as you approach retirement and after you retire are a diversified portfolio of large-company stock, stock funds, or stock ETFs, since these established companies tend to pay regular dividends and their stock prices tend to be less volatile than other types of stock. That helps to reduce the risk that your portfolio would lose substantial value in a market downturn.

The percentage of your portfolio that you're comfortable allocating to potentially more volatile growth investments, such as small-company stock or small-company mutual funds, when you're nearing or already in retirement is a personal decision. In most cases, it will likely be influenced by how much wealth you've already accumulated, your tolerance for risk at this stage of your life, your desire to leave money to your heirs, or other estate planning goals.

You'll also need to weigh the anticipated expenses you'll have during retirement. For example, if you or your partner has high ongoing healthcare costs, or you expect you'll need long-term care in the future, you may be less comfortable putting any of your principal at risk. Certainly if you are fast approaching retirement and do not have unlimited financial resources, you'll want to think very carefully about taking too aggressive an approach to investing. If the market suffers a serious downturn, it could wipe out the better part of your retirement nest egg. You'd then have little—or no—time to recover from the impact to your financial health.

Remember, too, that you will also have to begin taking required minimum distributions from your tax-deferred retirement plans—by April 1 of the year following the year you turn 70 ½ for IRAs and usually at the time you retire for employer-sponsored plans. You may want to gradually move some of the assets in your accounts into income producing investments, such as mutual funds whose objectives are providing dividend or interest income, stable value funds, money market accounts, or CDs. Those choices may provide a substantial

percentage of the amount you're required to withdraw each year.

### **Income investments**

Dividend paying stock and the mutual funds that invest in that type of stock can provide regular income, though the amount is not guaranteed and could change to reflect what's happening with an individual company or the markets in general. If you hold those investments in a regular taxable account, your federal tax on the dividend income can usually be calculated at your long-term capital gains rate—a maximum of 15%—rather than at your marginal tax rate.

Highly rated corporate and municipal bonds plus U.S. Treasury issues provide regular income as well. This income is guaranteed—subject of course to the financial strength of the issuer—which means you can count on receiving regular amounts on a regular schedule.

If you previously purchased a deferred annuity contract to save for your retirement, your sixties is the time when you may want to consider annuitizing your contract, which means selecting an option that turns your savings into a steady stream of income.

In addition, you may want to consider investing in an income annuity, also known as an immediate annuity. You usually make a lump-sum purchase—perhaps with a retirement plan payout, proceeds from selling your business, or money from another source. If you select a lifetime payout, these annuities guarantee income for your lifetime or the lifetimes of you and a joint annuitant, subject to the annuity company's ability to pay claims. That income can be a major boost to your standard of living. As with all other investments, though, you'll want to do careful research before purchase, including an evaluation of the claims-paying ability of the insurer issuing the contract.

### **The bottom line**

At every stage of your investing life, the more carefully you plan and the more informed the investment decisions you make, the better the chances you'll have of meeting all of your goals.