From the Desk of Stephen P. Ahern, CPA/PFS, CFP®
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The Finer Points Proper Investing

Getting Started

One day a seeming sane man met with me in the offices of Charles Schwab, a referral from the team there. He had become distraught because his investments were vanishing. Not because someone was stealing them, but because he was day trading...a single stock. His plan was to buy Microsoft when it went down and sell it when it went up. Great in theory, until the day that it went down after it went down. He kept watching the stock as it fell and before long he was frozen, not willing to sell and unable to buy more (he had been buying more on the way down. Emotion, one of many factors that can destroy a long term investment portfolio. He had no hard sell policy and no diversification. (He thought the size of MSFT would be diversification enough.) Did I mention that this happened in 2001?

It is very important to have a strategy for your portfolio. A sound portfolio management strategy begins with your goals and time frame for your portfolio assets. Your best bet is to start with an allocation to various types of investments, thereby spreading your risk to different companies, countries, markets, and types of assets. This is called **asset allocation** and dividing your investments among the many categories of equities, bonds, and cash, should be the result of taking your cash needs, timing and goals into account along with an assessment of your comfort with the ups and downs of the market. Once you set a broad asset allocation (the amount you want in equities or bonds or cash), only then, can one make finer distinctions within each broad category. For example, within the ***equity*** category, you could diversify among large, small, and international companies. Within the ***bond*** category you could separate short-term, intermediate-term and long-term bond investments not to mention credit quality, taxability, and risk.

Modern Portfolio Theory is the basis for this type of diversified investing. The theory is that since most investment categories have unique characteristics of risk and return that set them apart from others. By mixing and matching the assets we can come up with a portfolio that has less risk and provides a more steady return over the long term. You can't get that by buying and selling one stock over and over! .

Rarely do all the categories rise or fall at the same time. In 2008 we saw an example where most markets moved in virtual lock step as the very fabric of our financial markets was called into question and panic ensued. Some called it the end of Modern Portfolio Theory! Soon after the investing public realized that it was not the end of the financial world, the markets snapped back into reality where their more normal risk and return characteristics returned.

Setting the Course

So, what do you do now that you have a better understanding of the right way to invest? First, determine when you will need the money (a house purchase next year or retirement in twenty years). Make sure you keep enough cash aside for short term needs. It typically makes sense only to invest money in the markets money you will not need for at least five years. If it is shorter term than that, you should go with your savings account, money market, some CDs or treasuries with maturities no longer than your time horizon for that money. This also applies to

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your emergency fund -- We usually recommend keeping six months to a year's worth of your spending in a money market fund, short-term CDs or a savings account. You won't make much interest on this, but you will thank me if you have job loss or big expenses (think car problems or house problems). Remember that investing in money-market funds is neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency, but your bank savings account is probably protected...do your homework!

You should also think about paying off high interest rate credit you owe as well. That gives you a guaranteed fixed return (interest you won't be paying!) and your monthly payments can fall as well, giving you better cash flow that you can direct toward your investments if you like!

Once you have your financial house in order and a list of goals for your money, then you should start to think about how well you will sleep if the market takes a 10% tumble, what about 25%? If the answer is that you will be up all night tossing and turning, you can invest more conservatively. There are many online risk assessments and the one at http://www.docstoc.com/docs/21922002/Investment-Risk-Tolerance-Quiz does a pretty good job assessing your tolerance for risk. Once you determine the right risk level for you and the time table for your needs, then look at your investment options.

Determining the right mix of investments for your portfolio is complex. But what does that mean? Let's take a closer look at how various investment types can complement each other to offer potentially higher returns while allowing you to sleep at night.

Going to the Core!

Core investments are the stodgy boring traditional portion of your portfolio. They're designed to generate solid long term performance and offer your portfolio stability over that long term.

Your core holdings may include stocks of U.S. companies, developed foreign markets and high-quality interest-paying securities, such as bonds and money market funds. (Please note that bonds are subject to interest rate risk. Generally, as interest rates rise, bond values fall.) Bear in mind that stocks generally provide the best growth potential, but at a greater risk than bonds and cash investments As discussed above, diversification through an asset allocation plan can reduce overall portfolio risk and volatility.

I suggest that you start simple with a core portfolio of stock and bond mutual funds. The more conservative you are, the more cash and bonds funds you should start with. If you are a more aggressive and fearless investor, you should weight your portfolio toward equities.

Because bond performance has limited correlation to stock performance — meaning bonds often do well when stocks are down — owning both can even out your investment performance over time. The same is true of owning foreign stocks, which provide similar growth potential to U.S. stocks but generally move out of step with the U.S. stock market.

You may further diversify your portfolio by dividing your stock holdings between contrasting investment styles. For instance, you can pair a growth fund with a value fund or blue-chip stocks with up-and-coming small-cap stocks.

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Venturing out to more risky (and possibly more rewarding) Investments

Noncore investments act to capture extra return or outpacing performance in your portfolio by adding diversification and increasing its performance potential. Noncore investments might include specialized asset classes, such as real estate investment trusts (REITs), commodities, emerging foreign markets, high yield bonds, or alternative investments (like hedge funds and private equity).

For example, investing in REITs, gets you very diversified shares of real estate ownership. REITs are a popular investment choice because they're similar to stocks but have limited correlation to U.S. stock markets. Absolute return hedge funds similarly provide a range of returns based upon a benchmark, with little correlation to stocks, bonds or REITs and they are a good diversifyer as well.

Non-core investments are long-term nature, with fluctuating income risk, and sometimes lack of liquidity (like in a hedge or private equity fund). You should work with a financial professional to determine if these are suitable for your portfolio.

High-yield bonds, or junk bonds, are debt securities issued by credit-challenged companies. Though some can be quite risky, they can generate significant income over the returns on a core bond portfolio.

Further diversification and performance benefits can be reaped by adding stocks from emerging markets, such as Russia, China, Indonesia, Eastern Europe and South American countries. Commodities, such as metal-based (gold, silver, copper, platinum, etc.) stocks or mutual funds can also be risky but add to a portfolio's performance. There are special risks associated with international investing, such as increased political, social and economic instability. These risks are heightened in emerging markets. Even individual-sector mutual funds (for example, those that invest only in health care or technology) can be part of the noncore portion of your portfolio if you feel they will provide you will excess return and help maintain a reasonable level of overall portfolio risk.

On its own, each of these investments lacks diversification, thus introducing substantial risk. But by owning them in small amounts surrounded by a strong group of core investments they can help you build a successful long-term portfolio. Once built, keep to the plan and rebalance your investments back to their planned percentages. Do this a few times a year or when the market makes a big move. DO NOT get emotionally attached to any investment and stick to the plan.

Charting the best course for you

Get your financial house in order first, then start to invest with a core of diversified investments. Once you get comfortable with that, you can start to venture into more exotic areas. Just being diversified will put you ahead my Microsoft friend. And sticking unemotionally with your plan and rebalancing will make you a solid long term investor.

There is no one-size-fits-all solution for determining which investments belong in your investment portfolio and how much you should invest in each area. You can, however, craft a

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proper overall investment plan that takes into account the level of risk you are willing to take, your time horizon and goals, and your income tax profile. Evaluating your portfolio in terms of core and noncore investments can help you achieve the mix that allows you to earn the highest returns possible at a risk level you're comfortable with.

If you think this is all great but you'll never have the time to set it up and keep on top of it, a **fiduciary** investment professional can help you figure it all out and monitor it all for you. If you find the right advisor they will enable you to rest comfortably in the knowledge that there is a trusted, seasoned professional watching out for you!

Fiduciary Wealth Management is what we do so please feel free to call us and even spend an hour with us to determine if we are a good fit for you. We can help put you on the right path and/or manage the whole process for you. We have developed a process that we call the Chronos Wealth System that enables us to provide true wealth management. It is about time…yours! Let us help.

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