20 Keys to Being a Smarter Investor

FPA®
THE FINANCIAL PLANNING ASSOCIATION

The Financial Planning Association™ (FPA®) is the membership organization for the financial planning community. Its members are dedicated to supporting the financial planning process in order to help people achieve their goals and dreams. FPA believes that everyone needs objective advice to make informed financial decisions and that when seeking the advice of a financial planner, the planner should be a CFP® professional.

To locate a CFP® professional in your area, please call FPA's National Financial Planning Support Center at 800.647.6340 or visit www.fpanet.org.

Like many investors, you're probably torn between greed and fear.

On the one hand, you want to generate as high a return as possible from your investments in order to pay for a comfortable retirement, fund the high cost of college education, start a small business, pass money on to your heirs or finance a myriad of other major life expenses.

At the same time, you may fear the investment markets. Perhaps you've been burned by market declines, bad investment advice or taking on too much risk by grabbing for high returns. Or maybe investments and investing appear so complicated you're afraid to venture beyond the basic savings accounts you know.

This brochure, produced by the Financial Planning Association (FPA), the membership association for the financial planning community, offers 20 key steps to rein in that greed and ease your fears through the wise management of your investments. The brochure is not designed to make you a great stock picker or predict the next market boom or decline. Rather, it shows you how to apply time-tested investing principles and techniques so that despite the inevitable ups and downs of the markets, you can realistically achieve your family's financial goals.

The information presented here is also valuable whether you intend to manage your investments yourself or work closely with a financial planner or other investment advisor.

1. Understand the difference between saving and investing.

Saving is for smaller, near-term goals, such as the next family vacation, a car or a financial emergency. Keep cash in a savings account, money market or short-term certificate of deposit where you would have little or no risk of losing principal and can have immediate access to your funds.

Investing is for larger, longer-term goals—at least five years away—such as retirement or college. Investing carries risk such as loss of principal or not earning as much as anticipated. But wise investing also provides a greater opportunity for earning a significantly higher rate of return over the long run than you can earn through savings.

2. Put the rest of your financial house in order first.

Before investing, consider tackling several other household financial issues. Create a budget, or spending plan, in order to free up money for regular investing. Pay off expensive credit cards or other high-interest consumer debt that eat up valuable investment dollars. Build a cash emergency fund and buy the right kinds and amount of insurance to protect against a financial setback—otherwise, you may be forced to raid your investment accounts for cash at a time when the market is down or with costly tax consequences.

3. Clarify your goals.

Smart investing means investing with a specific purpose—those life goals such as retirement or passing money on to heirs. Investing with purpose makes it easier to stick to your investment plan and to invest income you might otherwise spend. Goals should be realistic, with a specific amount to accumulate by a reasonable target date. "Retirement" isn't a goal. What kind of retirement you want and when you want to retire are. Write down your goals and discuss them with your family.

4. Don't just grab for the highest return.

One of the most misunderstood aspects of investing is the belief that investing is all about seeking the highest possible returns. This misperception is why so many investors got into trouble during the booming stock market of the late 1990s when they disdained "average" returns and began chasing the riskiest of stocks. Their purpose was simply to "make as much money as possible in the shortest time." This example illustrates why investment goals are important. With reasonable, specific goals, you can make informed, realistic investment decisions designed to accomplish your financial goals without taking unnecessary risk. Making decisions based on these investment goals is what steers you on an even course between the rocky shores of greed and fear.

5. Understand your own tolerance risk.

In addition to understanding the risks of each type of asset and investment vehicle, you need to understand how much risk you're willing to take and which types of risk worry you the most. Risk tolerance is partly a function of your investment goals, how much time you have to invest, other financial resources you have and, frankly, your “fear factor.” Investments that keep you awake at night, regardless of how “good” they might be for your needs, are not the right investments for you.

Accurately gauging your tolerance for risk can be tricky, however. It’s easy to feel confident when the market is up and conservative when it is down. A CFP® professional can help you assess where you truly stand. Questions you and your planner might ask include:

- Are you more concerned about losing principal or losing purchasing power?
- How much principal are you willing to lose?
- How worried were you about your investments during the recent market decline?
- Which of your current investments keep you awake at night?
- Do you track your investments daily (a possible indication of unease)?

6. Educate yourself about investments and investing.

Even if you work with a financial planner or other investment advisers, you need to have a solid understanding of how different types of investments work, their potential returns, their risks and how you can assemble them in a cohesive portfolio that’s right for your needs and goals.

Pay particular attention to investment risk. All investments carry some degree of risk. While stocks in general tend to perform well over long periods of time, for example, their short-term risk can be high, as many investors painfully learned during the market decline of 2000–2002. Risk is not limited to stocks, either. You can lose money in real estate, corporate bonds, gold and commodities.

Even so-called “safe” investments carry some risk. U.S. Treasury bonds, for example, are federally guaranteed against loss of principal as long as you hold them until they mature. Because they are subject to interest-rate risks like any other type of bond, however, it’s possible to lose money if you sell them before maturity.

Don’t understand interest-rate risk? If you don’t understand how a particular investment works, or the risks that come with it, don’t invest in it. Instead, invest a little in education first. Ask your financial planner or investment adviser for resources to help you make the best decisions.

7. Hold realistic market expectations.

One of the downfalls for many investors during the booming market of the late 1990s was their belief that high double-digit returns were normal for stocks. But historical investment returns reveal otherwise.

According to Ibbotson Associates, large-company stocks, such as those found on the Dow and the S&P 500, returned an annual average of 10.7 percent from 1926 through 2001. During the same period, small-company stocks returned 12.5 percent and long-term government bonds averaged 5.3 percent.

But these are only averages over many years. In any given year, you will probably not earn the annual "average" return. You'll earn either more or less than the average. Knowing the historical average returns can keep these fluctuations in perspective.

8. Follow a detailed written plan.

Formally, this is called an investment policy statement. It's a road map to keep you on course through good times and bad, to eliminate investment ideas that don't fit your circumstances, and to provide a way to monitor the actual performance of your investments. This plan is, of course, subject to changes over the course of your investing lifetime.

The plan outlines such things as:

- Investment goals and time horizons
- Minimum average annual return needed to achieve those goals
- Current income needs from the portfolio, if any
- Types of investments you will and won't include
- What investment vehicles you'll use, such as individual securities, mutual funds, separately managed accounts, or taxable and tax-favored accounts
- How assets are to be allocated within the total portfolio
- Rebalancing procedures
- Potential tax consequences
- Estimated risk level of the portfolio

9. Allocate investments according to goals and needs.

How will you divvy up your investment dollars among various asset categories such as large-company and small-company stocks, international equities, government and corporate bonds, cash, real estate, and other assets?

The answer depends on several factors. Key among them are your investment goals and your timeline for achieving them. The sooner you'll need the funds, usually the more conservative your investments should be.

Also, what other financial resources are available to you? If Social Security and a good pension will generate most of your income needs in retirement, you may feel comfortable with a more aggressive approach to your investment portfolio. You may opt for a more conservative approach, however, if your investment portfolio will be a primary source of retirement income.

10. Diversify your investments.

Too often, individual portfolios invest heavily in a single type of asset, often to the near exclusion of other types. A popular choice in recent years has been large-company U.S. stocks, also called "large-caps." These stocks outperformed other major asset categories in 1989 and from 1995 to 1998. Yet, in all other years between 1965 and 2004, large-caps were outperformed by small company stocks, international stocks, intermediate bonds or investment real estate.

Because it's almost impossible to identify in advance which asset classes will lead the way during any given time, it's wisest to spread dollars among several investment classes. Research has shown that this diversification reduces risk while at the same time maintaining or even improving portfolio performance.

Investors also may want to diversify within broad categories. Among stocks, for example, they might divide their money between value and growth stocks, or between large-cap and small-cap. They may also want to include a variety of industries or sectors like technology, consumer goods and healthcare.

11. Don't overload on company stock.

As many employees at Enron and other large bankrupt companies learned the hard way, loading up your 401(k) with your employer's stock can be disastrous. Both your job and your retirement security are riding on the fortunes of a single employer and a single industry.

Financial planners typically recommend limiting company stock to no more than 10 or 20 percent of the account's value. But this can be difficult to do if the employer will only match your plan contributions with company stock while restricting how soon you might sell the stock and diversify through other investment options offered. Consequently, you may need to try to diversify your overall portfolio through other types of assets you hold outside your 401(k) plan.

12. Don't chase 'hot' performance.

Today's hot investments are often tomorrow's cold turkeys. The most recent glaring example of this was tech stocks, represented by the Nasdaq stock index. The Nasdaq returned a record-smashing 85.6 percent in 1999, but fell nearly 40 percent the following year, and lost another 21 percent the next year.

The major problem with chasing the current hottest investments is that by the time most investors discover that an asset category or specific investment is "hot," the investment often has already realized much or most of its run-up in value. Consequently, investors often get in at about the time the investment is ready to fall.

Calculations by DALBAR, a consulting firm, show that stock investors who frequently trade in and out of mutual funds earned a meager 3.51 percent annually between 1984 and 2003—dramatically below the 12.98 percent annual average earned by the S&P 500 stock index over the same period.

13. Don't ignore 'cool' performance.

The opposite of chasing hot investments is ignoring those suffering through tough times. Real estate investment trusts, for example, did poorly in 1998 and 1999, but boomed in 2000 and 2001 when stocks faltered. Government bonds lost money in 1994, but returned nearly 14.5 percent the next year.

A time-tested way to avoid the problems of ignoring cool performance and chasing hot performance is to stay diversified and stick with the asset allocations spelled out in your investment plan.

14. Stay in the market.

Nervous investors often sit on the sidelines during down markets until they're "convinced" the market is rebounding. But by the time they get up enough nerve to get back in, they've likely missed much of the rebounding market's gains, which commonly occur in the early stages of recovery.

SEI Investments studied 12 bear markets since World War II. Investors who either stayed in the market through its bottom, or were fortunate to enter at the bottom, saw the S&P 500 gain an average of 32.5 percent (not counting dividends) during the first year of recovery. Investors who missed even just the first week of recovery saw their gains that first year slide to 24.3 percent. Those who waited three months before getting back in gained only 14.8 percent.

15. Start investing early.

Remember the famous image of Archimedes moving the world on the end of a long lever? Investing over time provides that same kind of leverage. The longer you invest money (the longer the lever), the more it "works" for you by growing faster and faster.

For example, invest $10,000 at an eight percent annual return inside a tax-deferred account such as an IRA and you end up with $21,589 after ten years. Keep the money in for 20 years and it grows to $46,610. Keep it in for 30 years and the same $10,000 initial investment balloons to $100,627.

16. Invest regularly and automatically.

Greed and fear often tempt investors to try to "time" the market by judging when to be in during up markets and out during down markets. But even professional investors can't consistently time the market.

That's why CFP® professionals strongly recommend investing on a regular basis regardless of what the market is doing. This keeps your eyes on the long-term goals and not on the interim volatility. Funding investment accounts through automatic withdrawals from your paycheck makes this a lot easier.

17. Pay attention to investment expenses.

During booming markets, investors often don't pay much attention to investment expenses. But the market decline of 2000–2002 and the recent mutual fund scandals have made investors more aware of overhead, trading costs and other investment expenses. You can't control the market but you can control your expenses. Investing with an eye toward lowering investment costs can significantly improve your returns over many years.

18. Don't let taxes dictate.

Investing with an eye on tax-saving strategies can save money. But many investment advisers believe that tax-saving strategies should not override the underlying economics of a particular investment. For example, investors sometimes are reluctant to sell a profitable asset, even though it might make economic sense to do so, because they hate paying the capital gains taxes—only to see the investment stumble in a down market, costing them far more in lost value than if they had sold it and paid the taxes in the first place.

19. Rebalance your portfolio.

The asset mix that you originally assigned to your portfolio will probably become unbalanced over time as different types of assets perform differently. A portfolio allocated to 65 percent stocks, 25 percent bonds and 10 percent cash might shift to a 75/20/5 mix during a booming stock market.

You'll want to return these allocations to their original mix after the boom—otherwise, your portfolio has become riskier because it's more heavily weighted to stocks than before. You can adjust by either selling off some stocks and reinvesting in the other categories, or perhaps diverting new money into the under-weighted categories.

How often to rebalance your portfolio depends on several factors including your income needs, age and life events. Many experts recommend rebalancing at least once a year, depending on individual circumstances.

20. Monitor and revise your investment plan.

As with any financial plan, you should revisit your investment plan at least once a year.

First, you'll want to see if you're sticking with the guidelines outlined in your investment policy statement. Second, you may want to make changes if the financial circumstances in your life or your tolerance for risk have changed. For example, you may want to adjust investment mixes as you near or enter retirement. A marriage, divorce, death in the family, birth of a child or a new job also may warrant a different asset allocation. Third, you may also want to make changes if a particular investment is underperforming its competition or is not generating the income you need.

You're not alone. Investing can be overwhelming, but there is plenty of help out there. Your CFP® professional can provide investing expertise, objectivity, advice on how your investment plan fits in with your overall financial needs and even day-to-day management of your investments.

Whether you turn over the management of your investments to a professional or do it all yourself, you are ultimately responsible for the results. This is your money and these are your life goals. The more you learn about investing and the more care you take to develop a sound investment plan, the less likely it is you'll be caught between those nasty twins—greed and fear.

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