

20 Keys to Being a Smarter Investor



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Since 2000, the Financial Planning Association® (FPA®) has been the principal professional organization for CERTIFIED FINANCIAL PLANNER™ (CFP®) professionals who seek advancement in a growing, dynamic profession. FPA believes everyone can benefit from the advice of an experienced and qualified financial planner.

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Like Many Investors, You're Probably Torn Between Risk and Return

On the one hand, you want to generate as high of 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, offers 20 key steps to wisely manage 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 professional.



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 no risk of losing principal and can have immediate access to your funds.

Investing is for larger, long-term goals—at least five years away — such as retirement, college or general wealth building. 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 spending plan, or budget, in order to free up money for regular investing. Pay off expensive credit cards or other non-deductible high-interest consumer debt that eat up valuable investment dollars. Build a cash emergency fund that includes three to six months of living expenses 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 you might incur market losses or costly tax consequences.

3. Clarify Your Goals

Smart investing means investing with a specific purpose—those life goals such as wealth building, your desired retirement lifestyle 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 and prioritize your goals and discuss them with your family.

4. Don't Just Grab for the Highest Return

A commonly misunderstood aspect of investing is the belief that investing is all about seeking the highest possible returns. This misperception encourages investors to look backwards and buy last years' winners without diversifying or considering their own investment objectives. This 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 risk and return.

5. Understand Your Own Risk Tolerance

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 financial planner 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)?
- How diversified is your portfolio?
- How liquid are your investments?
- What are the tax consequences if you sell certain investments?

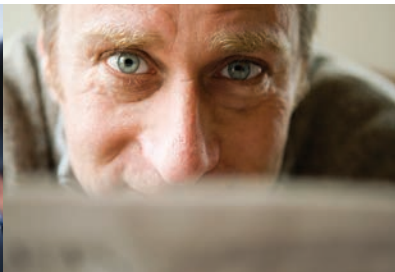
6. Educate Yourself about Investments and Investing

Even if you work with a financial planner or other investment professionals, 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 in 2008. Risk is not limited to stocks, either. You can lose money in real estate, corporate bonds, gold and commodities. This is why it is important to note that diversification among different asset classes may help reduce risk.

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, ask for help before you invest. Invest a little in education first. Ask your financial planner or investment professional for resources to help you make the best decisions.



7. Hold Realistic Market Expectations

According to Morningstar, large-company stocks, as measured by the performance of the stocks tracked by the S&P 500, returned an average annual rate of 9.8% per year from 1926 through 2009. During that same time period, on average, small-company stocks returned 11.9% a year, and long-term government bonds returned 5.4% a year.

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 and should be reviewed periodically.

The plan outlines such things as:

- Investment goals and time horizons
- Minimum average annual return needed to achieve your stated 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
- Updating income needs due to inflation and medical costs

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, your timeline for achieving them, and the investments you already own. 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

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 health care.

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 10–20% of the account's value. But this can be difficult to do if the employer will only match your plan contributions with company stock. Consequently, you may need to try to diversify your overall portfolio through other types of assets you hold outside your 401(k) plan. With some companies, there could be tax-favored tools to unload company stock when you retire.

12. Don't Chase 'Hot' Performance

Today's hot investments are often tomorrow's cold turkeys.

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.

13. Don't Ignore 'Cool' Performance

The opposite of chasing hot investments is ignoring those suffering through tough times. During the economic crisis in 2008, small cap stocks returned 38% less. In 2010, investors regained some of their appetite for risk and the small companies returned 47%.

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 policy statement.

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% (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%. Those who waited three months before getting back in gained only 14.8%. The secret is time, not timing!

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 8% 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

Risk and return 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 financial planners 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 market declines bring more attention to losses making investors more aware of overhead, trading costs and other investment expenses. You can't control the market, but you can control your investment 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 financial planners 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% stocks, 25% bonds and 10% 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 will 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 financial planner 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 risk and return.



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