Key Investing Concepts

1. Introduction

Virtually every investor has the same basic goal—to achieve the maximum amount of investment growth at a tolerable level of risk.

Accomplishing that balance means knowing yourself as an investor. What level of risk are you comfortable taking? Are you a conservative investor who does not want to risk losing any or most of your principal? Are you a moderate investor who wants to protect your assets while increasing the value of your portfolio? Or, are you an aggressive investor who is willing to take calculated risks with the expectation of achieving greater-than-average returns?

As your goals and priorities change over time, you may find that you need to modify your approach to investing. For instance, if you take on additional financial responsibilities or expect to retire in the near future, you may find it's time to shift to a more conservative investment strategy.

Whether you're a new or more experienced investor, and whether you're investing in a modest or substantial portfolio, it's important to understand key investing principles—like risk and reward, the time value of money, diversification and volatility—that are the foundation of a sound investment strategy.

2. Return and Rate of Return

Return

Investment return is the money you get back on an investment you make. Ideally, the return will be positive, your initial investment or principal will remain intact and you will end up with more money than you invested. But because investing typically involves risk—especially if you invest in securities such as stocks and bonds, or mutual funds that invest in stocks and bonds—your returns are subject to market changes, so they can be negative, meaning you wind up with less money than you initially invested.

For example, let's say you buy a stock for $30 a share and sell it for $35 a share. Your return is $5 a share minus any commission or other fees you paid when you bought and sold the stock. If the stock had paid a dividend of $1 per share while you owned it, your total return would be a gain of $6 a share before expenses. However, if you bought at $35 and sold at $30, you would have lost $5 on your investment, not counting expenses. If you earned a dividend of $1 per share, your actual loss would be reduced to $4 a share. This brings us to the concept of "total return."

Total return = Gain or loss in value + Investment earnings

Total return is a measure of your profit or capital appreciation *before* taxes and commissions or fees. When you evaluate your return on an investment, you should separately assess the impact of these other important costs, as they will impact your bottom line. In the example above, if the commissions you paid both to buy and to sell the stock—plus any taxes you must pay on net capital gains—totaled more than $5, then you would have lost money. If you are investing in mutual funds, you will find both total annual returns and after-tax annual returns in the fee table in the prospectus. Investment firms also typically post commission and fee schedules on their websites, so you can get a sense of what they charge for trading in different products and using their services.

Rate of Return

Having determined the return on an investment, you will want to be able to compare that return to returns on other investments. The dollar amount by itself doesn't tell you the whole story. To see why, compare a return of $5 per share on a $30 investment with a return of $5 per share on a $60 investment. In both cases, your dollar return is the same. But your rate of return, which you figure by dividing the gain by the amount you invest, is different.
In this comparison, the rate of return, also called the percent return, on the $30 investment is 16.67 percent ($5 ÷ $30 = 16.666) while the rate of return on the

$60 investment is 8.33 percent ($5 ÷ $60 = 8.333)—just half.

Rate of return = total return ÷ investment amount

You can evaluate the rate of return on savings accounts, bonds, mutual funds and the entire range of investment alternatives in much the same way. The more you invest to get the same dollar return, the smaller your rate of return will actually be.

The other factor that you have to take into account in evaluating your return is the number of years you own the investment. There's a big difference in realizing a return of 16.67 percent on an investment you own for just one year, or what's called an annual return, and realizing the same return on an investment you own for five years. Your annualized return over a five-year period is only 3.13 percent. This is derived by (.

Annualized Return = $(1+\text{return})^{1/\text{years}} - 1$ so in this case $(1+.1667)^{(1/5)} - 1 = 3.13\%$

Using Return

Return can be a useful tool in evaluating whether the investments you own are performing the way you expect, especially when you compare their return to that of similar investments or an appropriate benchmark, such as a market index that tracks the return of a group of similar investments. Specifically, you might compare the annual return on a large company stock or the return on a large-company stock fund to the annual return of the Standard & Poor's 500 Index (S&P 500).

You can also use historical returns to compare the average annual return over time of different categories of investments, known as asset classes. In the context of investing, the most common asset classes include stocks (equities), bonds (fixed-income securities) and cash or cash equivalents. The research firms that track historical returns have found that, both over the past century and during shorter 10-year cycles, stock has had the strongest return among the major asset classes, bonds the next strongest and cash equivalents the most stable but the lowest.

While the annual return for any asset class, or mutual fund investing in that asset class, may surpass its historical average in a given year or series of years, the return may underperform the average as well. Past performance rarely if ever is predictive of future results. Do not assume that your return on an investment will be substantially higher than the average return on that investment over time. In fact, there's no guarantee that it won't be lower.

Yield

Yield is another term you will hear when talking about investment performance. The yield on an investment is the amount of money you collect in interest or dividends, calculated as a percentage of either the current price of the investment or the price you paid to buy it. For example, if a stock pays annual dividends of $1 per share when the price is $35, the current yield is 2.9 percent ($1 ÷ $35 = 0.02857). However, if you bought the stock for $25, that same $1 dividend would be 4 percent ($1 ÷ $25 = 0.04).

While yield is just one of the factors you typically use to evaluate stock performance, it figures much more prominently in evaluating bonds and other interest-paying investments where current income is often of primary importance. In fact, with fixed-income investments, yield is measured in different ways depending on what you want to know about the income you're receiving:

- Coupon yield, for example, is the income a bond is paying as a percentage of the bond's par value, usually $1,000. It's the same as the bond's interest rate. So a bond that pays 4.5 percent, or $45 annually, has a coupon yield of 4.5 percent.

- Current yield, however, is the income a bond pays as a percentage of its current price, which may be more or less than $1,000. For example, if a bond's coupon yield is 4.5 percent, but the bond's market value is $1,050, its current yield is 4.29 percent ($45 ÷ $1050). In contrast, if its market price is $950, its current yield is 4.74 percent ($45 ÷ $950).

- Yield to maturity is calculated using a more complex formula. It accounts for the bond's future earnings until its maturity date, the amount you'll gain or lose when par value is repaid, and what you would earn by reinvesting the interest you're paid at the same rate during the bond's remaining term.

3. The Risk-Return Relationship

The level of risk associated with a particular investment or asset class typically correlates with the level of return the investment might achieve. The rationale behind this relationship is that investors willing to take on risky investments and potentially lose money should be rewarded for their risk.

For example, if Investor A puts all of the money she has to invest into a promising young company, she could make a great deal of money if the company succeeds—or she could lose everything if the company fails to get off the ground. By contrast, if Investor B puts his money into a diversified stock mutual fund, he may not make a fortune, but he's also far less likely to end up losing everything.

In the context of investing, reward is the possibility of higher returns. Historically, stocks have enjoyed the most robust average annual returns over the long term (just over 10 percent per year), followed by corporate bonds (around 6 percent annually), Treasury bonds (5.5 percent per year) and cash/cash equivalents such as short-term Treasury bills (3.5 percent per year). The tradeoff is that with this higher return comes greater risk: as an asset class, stocks are riskier than corporate bonds, and corporate bonds are riskier than Treasury bonds or bank savings products.

Exceptions Abound

Although stocks have historically provided a higher return than bonds and cash investments (albeit, at a higher level of risk), it is not always the case that stocks outperform bonds or that bonds are lower risk than stocks. Both stocks and bonds involve risk, and their returns and risk levels can vary depending on the prevailing market and economic conditions and the manner in which they are used. So, even though target-date funds are generally designed to become more conservative as the target date approaches, investment risk exists throughout the lifespan of the fund.

If you want to reap the financial rewards of investing successfully, you have to be willing to take some risk. But risk doesn't mean taking every opportunity that comes along—or putting all of your assets on the line in a few highly speculative investments. In fact, many of the investment risks you face can be managed with some foresight, knowledge and good planning.

Nonsystematic Risk

As an investor, you have more control over some risks than over others. Let's say that the company in which Investor A bought stock failed because of poor management decisions. This is called a nonsystematic risk, because the risk lies with the individual investment rather than with shifts in the investment market or asset class as a whole.

As a careful investor, you may have a certain amount of control over your exposure to nonsystematic risk. For example, by thoroughly researching potential investments before committing your money, you may be able to avoid companies whose disappointing sales and earnings records suggest they aren't poised for long-term success. Research will also help you uncover companies with higher than average debt, which could limit their growth potential.

In addition, you can help insulate yourself from many of the effects of nonsystematic risk by diversifying your portfolio with securities in different asset classes, and different types of products within the same asset class.. That way, if one of your investments drops in value, those losses may be offset by gains in some of the others.

For example, if Investor A had some of her assets in large and mid-sized company stocks, as well as in start-up company stocks, some of those investments might increase in value or pay dividends, or both. She might further diversify by choosing to invest in two or more small companies in a fast-growing area of the economy and buying shares in mutual funds and exchange-traded funds (ETFs) with broadly diversified portfolios. By purchasing a small number of bond funds, each investing in a different type of bonds, for example, you could achieve more diversification than by selecting individual bonds and so more risk protection.

Systematic Risk

Risks that you can predict will occur—though not when they will happen—are known as systematic risks. These risks are part and parcel of investing in the financial markets. While learning to accept risk as a normal part of investing is necessary to your success as an investor, there are ways to minimize the impact of systematic risks on your portfolio:

Type of systematic risk	**Description**	**Risk-management strategy**
Market risk	• Economic factors may cause segments of the financial markets and any investments within those segments to fall in value	• Allocate your assets so you own investments that respond differently to various economic factors • Avoid panic selling and

		locking in losses when prices are low if the investments' long-term prospects are still good
Interest-rate risk	• The market value of an existing bond may fall if interest rates decrease because newly issued investments will pay higher rates than older bonds • Increases in interest rates can potentially lower the demand for stocks to the extent that newly issued bonds or other interest-bearing products with higher coupons allow investors to take less risk for a competitive return	• Diversify with short- and mid-term bonds and bond funds, since they're less sensitive to interest-rate changes • Hold individual bonds to maturity • Ladder your bond portfolio across three or four bond issues with different maturities
Inflation risk	• As inflation rises, the value of fixed-rate investments, such as bonds and CDs, declines, because their interest rates aren't adjusted to keep pace	• Allocate a percentage of your long-term portfolio to stock and stock funds to outpace inflation • Allocate a portion of your portfolio to inflation-linked bonds
Currency risk	• As the U.S. dollar rises in value, the value of overseas investments may decline, and vice versa	• Diversify both domestically and abroad in both developed and emerging markets
Political risk	• Political instability in an interconnected global economy can affect the value of domestic and international investments	• Allocate a percentage of your portfolio to products that are less vulnerable to market turmoil

Allocating assets in your portfolio across a broad spectrum of asset classes (and within classes) is a good way to help manage systematic risk. For instance, you might invest a percentage of your portfolio in bonds and bond funds, another percentage in a variety of stocks, stock mutual funds and ETFs—including international stock as well as small-, medium-, and large-company domestic stock—and another percentage in cash equivalents, such as CDs and U.S. Treasury bills. Some investors also include real estate, precious metals and other products in their portfolios, often by choosing funds that invest in those products.

There are also certain market conditions when you may be able to find competitive investment returns with comparatively less risk. For instance, when interest rates rise, bonds may offer returns that are on par with some stock returns but with less risk to principal. That's the case, in part, because they are less volatile.

One of the biggest risks you may fall prey to, however, is trying to avoid risk altogether. If you invest very conservatively or don't invest at all because you're afraid of losing your principal, you become vulnerable to inflation, which can erode the value of your interest-bearing savings and investments over the long-term.

Volatility

Volatility, or the tendency of some investments to fluctuate rather quickly in value, is another type of investment risk. The more volatile an investment is, the more it can potentially lose or gain value in the short-term.

Not all investments are equally volatile. For instance, stock and stock mutual funds tend to change price more quickly than bonds. And the prices of smaller or newer company stocks may fluctuate faster and more dramatically than those of larger, well-established companies—sometimes known as blue chips. By the same token, high-yield bonds, which may be called high-risk bonds or junk bonds**,** are much more volatile than highly rated investment-grade bonds. In fact, high-yield bonds may change price just as quickly as some stocks.

Measuring Volatility

Stock analysts measure the relative volatility of a particular stock by comparing changes in its price to the overall market. This measurement is called the stock's beta and it has a base, or co-efficient, of 1. This means a stock with a beta of 1 is about as volatile as the average for all stocks. The higher the beta, the more volatile the stock is. For example, a stock with a beta of 1.5 is 50 percent more volatile than an average stock. That means it will have the tendency to change price more rapidly and more extremely than a stock with a beta of 1. On the other hand, a stock with a beta of 0.5 is 50 percent less volatile than the average stock, and will tend to change price more slowly and less dramatically than an average stock.

Managing Volatility in Your Portfolio

Some degree of volatility is a fact of investing. Even if you don't consider yourself a risk taker, you needn't avoid volatility at all costs. A thoughtful, long-term investment outlook, combined with a well-diversified portfolio, can let you take advantage of some of the upside of volatility.

For example, during a strong market with rising prices, you can sell any riskier investments you own to lock in your earnings—and you can then use your gains to make other investments. Or, if the opposite occurs and volatility drives prices down, you might be able to avoid losses by waiting until the financial markets rebound as they have historically done. Price swings that may seem dramatic in the short run tend to smooth out over time—even though it may take a while for prices to return to, and ideally pass, a previous high.

Liquidity

Liquidity, from your perspective as an individual investor, is the ease with which you can convert an investment into cash without losing value. The most liquid investments are those in savings accounts and money market accounts, which you can withdraw on a dollar-for-dollar basis (perhaps with a small amount of increased interest) at a moment's notice. Most bank certificates of deposit (CDs) are also highly liquid since you can always redeem them, though you might sacrifice some or all of the interest you expected to receive if you withdraw money before the end of the term. There are certain long-term CDs, however, that don't permit early withdrawal, so you should be certain of any restrictions before you purchase one.

Similarly, U.S. Treasury bills are highly liquid since you can always sell them readily and their market value changes very little because the terms are so short. U.S. savings bonds are also highly liquid, though there is a penalty for selling them—also known as liquidating—within the first five years of purchase.

At the other end of the spectrum, collectibles and most real estate are considered illiquid, which means they could be hard to sell for the price you want at the time you want. Certain other investments, such as private equity investments and hedge funds, are almost entirely illiquid during what is known as the lock-up period—since the managers of these investments count on having the money to invest over the long term in order to provide the returns they anticipate. That lack of liquidity is one of the reasons that they're not appropriate choices for most people.

Between these extremes are investments such as stocks and bonds, which you can almost always sell, though there's no guarantee you can sell them for as much as or more than you paid to purchase them. Stock in some very small companies, especially those that trade over-the-counter (OTC) or in the “pink sheets,” is often less liquid than stock in larger, well-known companies because the stock may not trade very often so finding a buyer may take time. In fact, they’re sometimes described as thinly traded.

The Liquidity Tradeoff

The more liquid an investment, the less you will generally earn by holding it. For example, the return on a savings account, which is highly liquid, almost always pays a lower interest rate than other bank accounts or other fixed-income investments, such as CDs or bonds. (There may be exceptions when banks are competing to attract customers.) Many highly liquid investments are also insured, which increases their attraction to people who are more comfortable with limited investment risk.

Although gaining liquidity may require you to sacrifice some return, it’s often a good idea to include some highly liquid investments in your portfolio. That way, you’ll have money available if you need it for emergencies, or to make new investments, without having to sell off the investments you hold. In addition, in years when more volatile investments provide disappointing returns, the interest you earn on a CD or Treasury bill can help cushion those losses.

4. Time and Your Portfolio

Time can be an investor's ally in several important ways:

- Time gives you the freedom to take investment risks, which is key to long-term portfolio growth and offsetting the eroding effects of inflation.

- Time lets your investments compound, or grow in value.

- Time makes it possible to plan for long-term investment goals, such as retirement, which are often the biggest and most challenging to meet.

Based on historical data, holding a broad portfolio of stocks over an extended period of time (for instance a large-cap portfolio like the S&P 500 over a 20-year period) significantly reduces your chances of losing your principal. However, the historical data should not mislead investors into thinking that there is no risk in investing in stocks over a long period of time.

For example, suppose an investor invests $10,000 in a broadly diversified stock portfolio and 19 years later sees that portfolio grow to $20,000. The following year, the investor's portfolio loses 20 percent of its value, or $4,000, during a market downturn. As a result, at the end of the 20-year period, the investor ends up with a $16,000 portfolio, rather than the $20,000 portfolio she held after 19 years. Money was made—but not as much as if shares were sold the previous year. That's why stocks are always risky investments, even over the long-term. They don't get safer the longer you hold them.

This is not a hypothetical risk. If you had planned to retire in the 2008 to 2009 timeframe—when stock prices dropped by 57 percent—and had the bulk of your retirement savings in stocks or stock mutual funds, you might have had to reconsider your retirement plan.

You should also consider how realistic it will be for them to ride out the ups and downs of the market over the long-term. Will you have to sell stocks during an economic downturn to fill the gap caused by a job loss? Will you sell investments to pay for medical care or a child's college education? Predictable and unpredictable life events might make it difficult for some investors to stay invested in stocks over an extended period of time.

Compounding

Compounding is what happens when your investment earnings or income are reinvested and added to your principal, forming a larger base on which earnings can accumulate. The larger your investment base, or principal, grows, the greater the earnings your investment can potentially generate. So the longer you have to invest, the more you can potentially benefit from compounding.

For example, compare what happens to the investment accounts of Investors A and B:

	Investor A	Investor B
Total Investment	$10,000	$10,000
Average annual rate of return	9%, not compounded	9%, compounded yearly
Total dollars generated by investment after 20 years	$28,000	$56,044
Total dollars generated by investment after 40 years	$46,000	$314,094

Both Investor A and Investor B invest the same amount of money and get the same average annual rate of return of 9 percent. The difference is that Investor A chooses to withdraw, rather than reinvest, the return. At the end of 20 years, Investor B's investment will be worth more than twice as much as Investor A's, and at the end of 40 years, that difference will have grown to almost seven times as much.

In this second example, you'll see that the effect that time has for two investors who have both chosen compounding:

	Investor C	**Investor D**
Monthly investment	$200	$400
Average annual rate of return, compounded yearly	9%	9%
Length of investment	40 years	20 years
Total value of account	After 40 years: $883,900	After 20 years: $267,670

Again, both Investors C and D invest the same amount of money—$96,000—at a 9 percent average annual rate of return, this time compounded yearly for both.

But while Investor C puts away $200 a month for 40 years, Investor D puts away $400 a month, for only 20 years. At the end of the investment period, however, Investor C's account is worth more than three times Investor D's account. That's because Investor C's account benefited from 20 extra years of compound growth.

It's worth noting that while you can accurately determine the value of compounding on an investment or savings account offering a fixed rate of return, you can only estimate the return you will receive on investments that fluctuate, such as stock or mutual fund investments. All other things being equal, though, the investor who starts earlier and reinvests returns is going to be much better off than the one who starts later and does not reinvest those returns.

A Matter of Time

If you have long-term financial goals, such as achieving a comfortable retirement or paying for your children's college education, the time you have to meet these goals can give you a decided advantage.

Long-term goals, such as retirement, seem the most daunting because they're often the most expensive. For example, by most estimates, you can expect to spend at least 30 years in retirement, and you'll need about 80 percent or more of what you currently earn annually to maintain the lifestyle you're accustomed to once you retire. To accumulate such a sum over a short period of time would be virtually impossible for most people.

But having time on your side—together with a long-term investing strategy—can put even challenging financial goals within reach. Even modest but regular contributions to a tax-deferred account that emphasizes growth investments, such as stock and stock mutual funds, can grow substantially over 25, 30 or 40 years. That's because time lets you take the calculated risks that you may not be comfortable taking over the short term. Plus, the more time you have to invest, the more your investments stand to benefit from compounding.

This potential for growth is sometimes called the time value of money, which means that money you invest today to accumulate earnings can be worth more in the future.

Outwitting Inflation

Investment growth is also the best way to combat the long-term effects of inflation. Depending on how you look at it, you can define inflation as either:

- continuous increases in the cost of living; or

- continuous decreases in the buying power of your money.

Many conditions can affect the inflation rate, which varies from year to year, but it has averaged about 3 percent annually since 1926. While it doesn't sound like a high number, at this rate this means prices will double every 20 years. Low unemployment rates can fuel inflation, since employees can demand higher salaries, driving prices up. Consumer spending can also set inflation in motion when demand for goods and services outstrips available supply. Economic conditions and Federal Reserve Board monetary policy, which helps determine interest rates, can also have a major impact on inflation.

Regardless of its causes, inflation can significantly erode the value of your financial assets over the long term if you don't have a strategy to combat it.

For example, compare what happens to the portfolios of Investors E and F. Investor E is a conservative investor, and rather than risk his assets in the stock market, he puts $15,000 in an insured money market account earning 3.25 percent a year for 20 years. Investor F, on the other hand, is a moderate investor, and invests the same amount of money in a large-company stock index fund earning an average annual return of 8 percent.

	Investor E	**Investor F**
Starting balance	$15,000	$15,000
Annual investment return	3.25%	8%
Length of investment	20 years	20 years
Account balance	$28,438	$69,914
Average annual rate of inflation	3%	3%
Real rate of return	0.25%	5%
Value after adjusting for inflation	$15,745	$38,710

After 20 years, Investor E's money market account would hold $28,438, which sounds like a reasonable outcome for a risk-free investment. But after adjusting for annual inflation of 3 percent, the value of Investor E's savings, in terms of buying power, is actually $15,745 in today's dollars. That's just $745 more than the original deposit.

Investor F, on the other hand, would have an account balance of $69,914 after 20 years and buying power of almost $39,000 after accounting for inflation. That's more than two and half times the original deposit.

You should note, too, that this simplified example does not adjust for taxes that might be due on account earnings.

Real Return

Inflation is the reason that many investors measure the progress they're making towards their investment goals in terms of real return, which is inflation-adjusted return, rather than in terms of total return. While total return measures your total investment gain and loss (less costs, fees and taxes), plus any dividend or interest income, real return measures your investment return after taking inflation into account. In the example above, Investor E's annual total return is 3.25 percent, but his real return, after inflation, is 0.25 percent. Investor F's percent return is 8 percent, but her real return, after inflation, is 5 percent.

For your portfolio to grow, you'll typically want to invest a substantial part of it in investments (such as stock and stock funds) that have good chance of significantly outpacing inflation.

5. Allocating the Assets in Your Portfolio

When you use asset allocation as an investment strategy, you decide how much of your principal to invest in each of the different asset classes, or investment categories. For example, you might decide to put 80 percent of your assets in stock, 10 percent in bonds and 10 percent in cash equivalents. Or you may decide to put 60 percent in stock, 35 percent in bonds and 5 percent in cash.

Asset allocation can make a major difference in both your investment return and level of investment risk. Because each asset class has its own unique characteristics and risks, the performance of your overall portfolio will partly reflect the asset mix you choose.

For example, compared to bonds, cash and real estate, stock is the most volatile asset class in the short run, but over longer periods has outperformed those other asset classes. So a portfolio heavily allocated in stock is likely to be volatile in the short term, but has the best chance of providing strong returns over 15 years or more. On the other hand, a portfolio heavily weighted in bonds will tend to provide predictable income but considerably more modest returns over a similar term—though there may be some years when the return on bonds is stronger than the return on stock.

The Right Mix

One of the chief benefits of asset allocation is that you can offset some of the characteristics of one asset class with those of another. For instance, a portfolio that includes a substantial percentage of stock, but also some bonds, may have the potential to provide much of the robust growth associated with stock while reducing some of the risk of volatility. Similarly, a more conservative investor might be able to boost returns in a portfolio heavily allocated in bonds, without necessarily increasing volatility, by including a percentage of stock in the asset mix as well.

Asset allocation can also provide a buffer to broader economic conditions, since various asset classes can react in different ways to changes in the financial markets. One example is that, historically, stocks have tended to provide strong returns in periods when interest rates are low, and bonds have tended to slump in those periods. The opposite has been true when interest rates increase.

When asset classes react in a similar way to particular economic environments, providing similar returns over a period of time, they are described as highly correlated. But when classes react differently or to different degrees to the same situations, they are said to have a low correlation. As the example of response to interest rates illustrates, stocks and bonds generally tend to have a low correlation.

By spreading your principal across different asset classes, taking care to include those with low correlations and negative correlations, if possible, and leaving that allocation more-or-less in place over a number of years, you are in a position to benefit from whichever asset class happens to be outperforming the others. That means you can offset potential losses in an underperforming asset class with values or gains in another.

Your Investing Style

How you decide to allocate your assets—whether you choose a conservative, moderate or aggressive allocation mix based on your tolerance for risk—is sometimes called your investing style, or profile.

Your investing style reflects your personality, but it is also influenced by other factors like your age, financial circumstances, investment goals and experience. For example, if you are approaching retirement or have lived through a period of major economic upheaval, such as a recession, you may be inclined to invest more conservatively. That might also be the case if you run a small business or are the sole provider for your family.

On the other hand if you're still early in your career, have few financial responsibilities or own substantial assets, you may be willing to take more risk in your portfolio because you don't need all of your current assets to meet your financial obligations.

Conservative Investing Style

Conservative investors make capital preservation, or safeguarding the assets they already have, their highest priority. Because they normally aren't willing to put any of their principal at risk, conservative investors usually have to settle for modest returns.

The portfolios of conservative investors are typically heavily allocated in bonds, such as U.S. Treasury bills, notes and bonds, highly rated municipal bonds, and insured investments, such as CDs and bank money market accounts. While conservative investors tend to avoid stock because of its volatility, they may allocate a small portion of their portfolios to large-company stocks, which sometimes pay dividends and tend to be more stable in price than other types of stock.

The Risks of a No-Risk Portfolio

As counterintuitive as it may sound, avoiding risk altogether can make conservative investors vulnerable to other types of risk—notably inflation risk. If you invest so conservatively that your invested assets barely keep pace with the rate of inflation (which has averaged 3 percent annually since 1926, but can sometimes spike higher), then your invested assets may barely be growing at all in terms of real buying power. If you're also paying taxes on those assets, then they may in fact be shrinking compared to inflation. That's why a conservative investment strategy can make it difficult to meet long-term investment goals, such as a comfortable retirement.

When a Conservative Approach Makes Sense

There are some circumstances, however, when a conservative approach to investing may be appropriate. If you're investing to meet shorter-term goals—for instance, you plan to make a down payment on a house in the next two or three years—then you may not want to put those assets at risk by investing in volatile securities, since your portfolio may not have time to recover if there's a market downturn. Similarly, if you have substantial amounts of money invested in your own business or have other major financial responsibilities, you may be more comfortable taking a more conservative approach with your investment portfolio.

Moderate Investing Style

Moderate investors seek a middle course between protecting the assets they already have and achieving long-term growth. They strive to offset the volatility of growth investments, like stocks and stock funds, by allocating a portion of their portfolios to stable, income-producing investments, such as highly rated bonds. While moderate investors may favor large-company domestic and international stocks, they may also diversify their portfolios by investing in some more volatile small-company or emerging-market stocks, to take advantage of the potential for higher returns.

There is no hard and fast rule about exactly what mix of assets is appropriate for someone striving to achieve an asset mix for moderate risk, since that mix depends to some extent on individual circumstances and tolerance for risk. For instance, a portfolio that is invested 35 percent in large cap domestic stocks, 15 percent in small-company and international securities, and 50 percent in bonds, might be considered very moderate—even conservative—for someone with 30 or 40 years until retirement. However, this same asset mix would carry more risk for someone with only a few years until he or she retires.

If you're not a risk taker by nature, a moderate investing approach may make sense in almost all circumstances. In broadest terms, a moderate approach means finding the mix of assets that gives you both the potential for long-term growth yet adequate protection for your assets given your age and financial circumstances.

Aggressive Investing Style

Aggressive investors focus on investments that have the potential to offer significant growth, even if it means putting some of their principal at risk. That means they may allocate 75 percent to 95 percent of their portfolios in stock and stock mutual funds, including substantial holdings in more speculative investments, such as emerging market and small-company stock and stock funds. Aggressive investors with large portfolios may also allocate some of their assets to private equity funds, derivatives, direct investments and other alternative investment products.

Aggressive investors tend to keep only a small percentage of their assets in cash and cash equivalents so they maximize their potential returns but have cash available when new investing opportunities arise.

An aggressive approach is best suited to people with 15 years or more to invest to meet a financial goal, and who have adequate resources, so that they can absorb potential losses without jeopardizing their financial security. While past performance is no guarantee of future results, history demonstrates that an aggressive investing style coupled with a well-diversified portfolio, combined with the patience to follow through on a long-term strategy, can be very rewarding in the long run.

6. Diversifying Your Portfolio

Once you've decided how much of your portfolio to allocate to stock, bonds, cash equivalents and other assets that are appropriate for your financial situation, there's another step you can take to further minimize risk in your portfolio.

You've probably heard the expression "Don't put all your eggs in one basket." Diversification is the process of putting that advice into practice. When you diversify, you aim to manage your risk by spreading out your investments. You can diversify both within and among different asset classes. You can also diversify **within** asset classes. In this case, you divide the money you've allocated to a particular asset class, such as stocks, among various categories of investments that belong to that asset class.

These smaller groups are called subclasses. For example, within the stock category you might choose subclasses based on different market capitalizations: some large companies or funds that invest in large companies, some mid-sized companies or funds that invest in them, and some small companies or funds that invest in them. You might also include securities issued by companies that represent different sectors of the economy, such as technology companies, manufacturing companies, pharmaceutical companies, and utility companies.

Similarly, if you're buying bonds, you might choose bonds from different issuers—the federal government, state and local governments and corporations—as well as those with different terms and different credit ratings.

Diversification, with its emphasis on variety, allows you to manage nonsystematic risk (company or industry risk) by tapping into the potential strength of different subclasses, which, like the larger asset classes, tend to do better in some periods than in others. For example, there are times when the performance of small company stock outpaces the performance of larger, more stable companies. And there are times when small company stock falters.

Similarly, there are periods when intermediate-term bonds—U.S. Treasury notes are a good example—provide a stronger return than short- or long-term bonds from the same issuer. Rather than trying to determine which bonds to buy at which time, there are different strategies you can use.

For example, you can buy bonds with different terms, or maturity dates. This approach involves investing roughly equivalent amounts in short-term and long-term bonds, weighting your portfolio at either end. It allows you to limit risk by having at least a portion of your total bond portfolio in whichever of those two subclasses is providing the stronger return.

Alternatively, you can buy bonds with the same term but different maturity dates. Instead of investing $15,000 in one note that will mature in 10 years, for instance, you invest $3,000 in a note maturing in two years, another $3,000 in a note maturing in four years, and so on.

Finding the Right Balance

As with asset allocation, there is no magic formula for a perfectly diversified portfolio that will work for everyone. In general, though, the more narrowly focused, or concentrated, your portfolio is, the greater the risk you assume. On the flip side, the more broadly diversified your portfolio, and the less you have riding on the performance of any individual investment, the less risk you are exposed to.

Diversification is about finding the right mix to reduce your risk exposure to a comfortable level, while taking advantage of the full range of opportunities the investment market has to offer at any given time.

One approach to diversification is to purchase broadly diversified mutual funds, ETFs or a selection of funds to achieve variety and balance in your portfolio. For instance, an investor with a moderate investing style might select an ETF tracking the Standard & Poor's 500 Index and an international stock mutual fund investing in developed markets overseas for her stock allocation. An investor with a more aggressive style might combine a portfolio of medium- and large-company stocks and funds specializing in particular market sectors and industries together with an international fund diversified in both developed and emerging markets.

But keep in mind that owning a variety of funds or owning lots of investments within a particular asset class doesn't, in itself, mean your portfolio is diversified. If you own shares in an ETF tracking the Dow Jones Industrial Average and shares of a large-company stock mutual fund, your stock portfolio probably isn't truly diversified because you have little or no exposure to smaller-company or international stock.

Stock subclass examples *(can also apply to other asset classes)*

Asset class	**Subclass**	**Subclass examples**
Stock		
	Market industries and sectors	• Healthcare • Banking and finance • Consumer staples • Energy • Telecommunications
	Cyclical stocks (companies that tend to perform well when the economy is strong)	• Airlines • Automobiles • Travel and leisure
	Non-cyclical stocks (companies that tend to perform well even when the economy is weak)	• Food • Electricity • Gas • Healthcare
	Market capitalization (groupings of companies based on market value, which is calculated by multiplying share price by the number of shares outstanding)	• Large cap • Medium cap • Small cap • Micro cap
	Growth stock	• Stocks in smaller and newer companies with

		the potential to appreciate rapidly in market value
	Value stock	• Stock whose market price is lower than the company's sales, earnings and overall financial situation seems to merit
	International stock	• Developed economies: e.g., Western Europe, Canada, Australia, Japan • Emerging economies: e.g., Latin America, China, India, Indonesia

7. Rebalancing Your Portfolio

If you have implemented an asset allocation and diversification strategy, either on your own or with the help of a financial professional, you've taken a major step towards achieving your investment goals.

But your work doesn't end there. From time to time, you'll want to review and perhaps modify your strategy to make sure it's still in line with your goals. While some investors review their portfolio with an eye to rebalancing it on a regular schedule—say every one, two or three years—there are some circumstances when you'll definitely want to take a fresh look at your portfolio:

1. You may want to reconsider your strategy in response to a change in your financial priorities or circumstances, such as getting married, having children, getting divorced or receiving an inheritance.

2. As retirement approaches, you'll want to consider shifting some of your assets out of volatile growth investments into those that produce more predictable income. That's because your portfolio may not have time to fully recover from a downturn in the market.

3. If your actual asset allocation becomes significantly out of line with what you originally planned, either over time or because of exceptionally strong or weak performance in a particular asset class, you may want to sell, buy and/or otherwise reallocate your portfolio to bring it back into line with your original allocation intention. This is called rebalancing.

Because different asset classes and subclasses grow at different rates, it's likely that your portfolio will need to be rebalanced at least every few years to make sure it is in line with your allocation and diversification strategy. You may decide that doing it routinely on a yearly or bi-yearly schedule works best for you. Other investors prefer to wait until one asset class is at least 15 percent above or below their intended allocation before they consider rebalancing.

One argument for waiting to rebalance is that market ups and downs may bring your portfolio back into balance without your having to make any changes. On the other side, the primary reason you don't want to ignore a drift away from your preferred allocation is that your portfolio could end up exposing you to a very different level of risk than you intended.

Ways to Rebalance

You also have choices about *how* to rebalance your portfolio. For instance, as you make contributions to your investment account, you may decide to allocate future contributions to asset classes whose performance has been below expectations until your allocation is more in line with what you originally intended. Or you may decide to add new investments to the underperforming asset classes. Still another possibility is to sell some of the investments that have increased in value and reinvest the gains in the underperforming class or subclass.

It may seem counterintuitive to channel contributions to underperforming investments or to sell your best performers. But keep in mind that shifting away from your original asset allocation model could expose you to greater investment risk than you're comfortable with. In addition, you may miss out on investing in an asset class that is poised to rebound and produce strong returns.

Keep in mind that account shifting means potential sales charges and other fees. Aside from the costs you might incur, switching out of investments when the market is doing poorly means locking in your loss. If this occurs in a taxable account, you may be able to take a tax deduction. However, if you are rebalancing in a retirement savings account like a 401(k), you can't take a tax deduction on capital losses. Also, be aware that if your investments have increased in value, selling them to rebalance your portfolio in a taxable brokerage account could result in your having to pay capital gains taxes on any realized profits. Be sure to discuss your rebalancing strategy for your taxable account in advance with your accountant or tax professional.

Growing Your Portfolio

All in all, you'll have the best chance of achieving your investment goals by sticking with a regular, long-term investment approach. You can accomplish this by contributing a percentage of every paycheck to an employer-sponsored retirement plan such as a 401(k), IRA, taxable investment account or some combination of these accounts. While many investment experts recommend contributing 15 percent or more of your pretax salary to meet long-term goals, even contributions of 5 percent or 10 percent made early in your career can compound into substantial sums with the right long-term strategy in place.

Setting up automatic deductions from your paycheck or checking account—either to your 401(k) or an account you set up yourself—can make it easier to stick to your plan. Since the money is automatically deducted before you have a chance to spend it, you probably won't even miss the extra cash. Plus, adding a fixed amount of money on a regular schedule to an investment account or dividend reinvestment plan (DRIP) lets you take advantage of a long-term investment strategy known as dollar-cost averaging.

8. Dollar-Cost Averaging

With dollar-cost averaging, sometimes known as a constant dollar plan, you invest the same amount of money on a regular basis, whether the markets rise or fall. Because you'll end up buying more shares when the price of the investment drops, the average price you pay per share will usually end up being less than the average cost of shares over the same period of time. Take a look at the following examples to see how dollar-cost averaging can work.

Let's say in January, you make a one-time investment of $800 in a stock with a share price of $35. You can buy 22.86 shares of the stock for that amount.

Suppose, instead, you make your one-time purchase in April. The stock has hit a low of $20, so your $800 investment will buy 40 shares:

	January (Market high)	**February**	**March**	**April (Market low)**
Amount invested	$800			$800
Share price	$35			$20
Number of shares purchased	22.86			40
Average share cost	$35			$20

Now look what happens when you practice dollar cost averaging. Instead of making a one-time investment of $800, you invest $200 on a regular schedule for a total of $800. Since the stock price changes from month to month, you would have been able to buy more shares when the price was low and fewer shares when the price was high:

	January (Market high)	**February**	**March**	**April (Market low)**
Amount invested	$200	$200	$200	$200
Average share price	$35	$28	$24	$20
Number of shares purchased	5.7	7.15	8.3	10
Total number of shares	31.15			
Average share cost	$25.68			

As you can see from the tables, if you had purchased all your shares at the market low in April, you would have been able to buy about nine more shares than if you used dollar-cost averaging.

However, compared to making your entire purchase at the market high in January, you would have been able to purchase eight more shares by using dollar-cost averaging. Because it’s impossible to know with certainty whether a stock price is headed up or down, dollar-cost averaging may help you pay a lower average share price over time, and end up with more shares for the same dollar investment.

What’s more, by adding new money on a regular basis you can build your account value without putting a strain on your budget. It’s much easier, for example, to add $76.92 a week or $333 a month or to your individual retirement account than it is to find $4,000 to invest as the deadline for the year draws closer.

But there are two cautions to be aware of with dollar-cost averaging. Investing regularly softens the effect of downturns—as well as upturns—in the market. But it does not protect you against those downturns, so there's no guarantee that you won't lose money following this strategy. Equally important, you'll need to continue investing when the markets are down in order to benefit from dollar-cost averaging. If you buy only when the market is doing well, you'll pay only the highest prices.

9. Investing Tax Strategies

Another way to maximize the potential for long-term portfolio growth through compounding is by taking advantage of tax-deferred and tax-free investment accounts.

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

You may reap even more 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 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.

One major consideration is the types of investments to emphasize in each type of account. For instance, you should think carefully before including any investments in a tax-deferred account that are already tax-exempt, such as municipal bonds or bond funds that invest in munis. That's because you won't receive any additional tax benefit and you'll owe taxes at your regular rate on any interest earnings at withdrawal, even though that interest would have been tax exempt had you held the investments in a taxable account.

You may also want to evaluate whether to purchase annuities in your IRA since annuities are already tax deferred. In addition, the annual expenses on deferred annuities are typically higher than on mutual funds that make similar investments.

If you have bonds or other fixed-income investments, apart from municipal bonds or municipal bond funds, it's best to put them in tax-deferred or tax-free accounts. Tax-deferred and tax-free accounts are also well-suited for growth investments, such as stocks and stock funds, which may benefit most from the potential for long-term compounding. Although you will have to pay tax on your withdrawals at your regular income tax rate rather than the long-term capital gains rate, you probably anticipate that your income tax rate will lower after you retire. While many people do fall into a lower income tax bracket in retirement, be aware that this isn't always the case.

Taxable Investment Accounts

While you may want to invest as much as you can—up to the annual limits— in tax-deferred and tax-free accounts, there are also reasons to invest in taxable accounts. Taxable investment accounts, such as a brokerage account, can work especially well if you're a buy-and-hold investor because you owe no income tax on price appreciation until you sell the investment. If you've held the investment for more than a year, you owe tax on any gains at the long-term capital gains rate, which is significantly lower than your income tax rate.

While you will owe taxes on dividends and mutual fund distributions, they may also be taxable at the low long-term capital gains rate if you've held the investments for the required amount of time and they qualify for this tax treatment, which stock in most U.S. corporations and a number that are based overseas do.

Interest you earn on bonds and cash equivalents, such as CDs are taxable as income. But you may be able to minimize the tax bite by choosing municipal bonds or municipal bond funds for income. The interest they pay is exempt from federal taxes and may also be exempt from state and local taxes if the bonds are issued by your home state. There are two potential downsides. Municipal bond interest may be subject to the alternative minimum tax (AMT), so you'll want to discuss the potential implications with your tax or investment professional. In addition, municipal bonds usually pay interest at a lower rate than other bonds because of their attractive tax status.

When choosing funds for a taxable portfolio, you might want to consider funds with low portfolio turnover, which pay out fewer short-term capital gains. Index funds and ETFs are usually tax efficient since they buy and sell investments only when there's a change in the index they track. Some actively managed funds also emphasize tax efficiency as an investment objective.

One potential benefit of having some of your assets in taxable accounts is that you generally can sell your investments and spend the money without any penalty or red tape. That's not the case if all of your investments are in IRAs and employer-sponsored plans, which can make it difficult to get access to your money if you need it in an emergency.