Choosing Investments

1. Introduction

Like every investor, you want to choose investments that provide the growth and income you need to meet your financial goals. Think of the various types of investments as tools that can help you achieve these goals. Each broad investment type—from bank products to stocks and bonds—has its own general set of features, risk factors and ways in which they can be used by investors.

It's important to understand what your investment choices are and how different types of investments put your money to work. It's equally important to understand yourself as an investor. That's because a portfolio that's right for someone else may not be best for you. Some factors that make a difference are:

- your goals, or what you want to accomplish by investing;
- the time frames for your various goals; and
- your attitude toward risk—or what's called your risk tolerance.

Once you've devised a strategy for choosing investments appropriate to each of your goals, you've taken a major step toward meeting them.

2. General Rules of Investment Selection

No single approach to choosing investments will work for everyone or will be right for every situation. But here are a few tried-and-true rules for sound investment selection:

- **Understand what you own.** Focus on investments that are easy for you to evaluate and give you access to reliable information about them. Regulators require that certain information be disclosed to investors through documents such as offering circulars, mutual fund prospectuses and corporate filings for stock issued by public companies that trade on the major stock markets. In addition, you can find a wealth of real-time and historical market data for stocks, bonds, mutual funds and other securities on FINRA's Market Data Center at www.FINRA.org.

- **Assess liquidity.** Make sure there is a market to trade your investments. Highly liquid investments are easy to buy and sell, either through a brokerage account or in some cases directly from the issuer. Thinly traded stocks or securities that aren't listed on a national exchange tend to be less liquid—and are rarely a good idea for most investors. Likewise, exercise caution when considering securities such as non-traded REITs that may be illiquid—meaning you can't cash out of them even if you really need do—for long periods of time.

- **Know the true cost.** Have a clear understanding of any costs, sales charges and fees involved with buying and selling the investments, including whether there are penalties or additional fees for selling your investment within a certain time frame.

- **Comparison shop.** Costs and services can vary significantly from firm to firm.

- **Verify registration.** Check whether your investments are registered with the SEC or your state's securities regulator. Most investments have to be. And also use FINRA BrokerCheck to check whether the salespeople who sell them are licensed.

- **Understand the risks**. All investments carry some level of risk. Be sure you know how you can make or lose money with your investment.

3. Investment Selection and Timeframe

When it comes to selecting investments, the timeframe in which you plan to use the money—in the short, medium or long-term—will likely dictate the type of investments you select. The more time you have to reach a financial goal, the more investment risk you can generally afford to take. For instance, if you are saving for a short-term goal such as a wedding, you may want to take little or no risk with your money and select a safe haven such as a CD or a savings account. On the other hand, if you are saving for a long-term goal, such as financial security when you retire a few decades from now, you can perhaps afford to take a bit more risk with your money, in the hope of getting a better investment return.

Timeframe also matters in the investments you select as you are saving for retirement. For example, when you're in your twenties and just starting your career, you may be able to take a more aggressive approach to investing for retirement. Aggressive investing means choosing investments that have the potential to provide greater return over an extended period. But these investments also expose you to more risk in the short term because their prices are volatile, which means they might move up and down rather quickly within a short period. And as you get older, you will likely scale back on investments that are volatile and expose you to greater risk. There is more information on investment timeframes and goal setting in our Prepare to Invest module.

4. Risk Tolerance and Investment Selection

When it comes to investment selection and risk, here's a reality check: All investments carry some degree of risk. Stocks, bonds, mutual funds and

exchange-traded funds can lose value, even all their value, if market conditions sour. Even conservative, insured investments, such as certificates of deposit (CDs) issued by a bank or credit union, come with inflation risk. They may not earn enough over time to keep pace with the increasing cost of living.

What Is Risk?

When you invest, you make choices about what to do with your financial assets. Risk is any uncertainty with respect to your investments that has the potential to negatively affect your financial welfare.

For example, your investment value might rise or fall because of market conditions (market risk). Corporate decisions, such as whether to expand into a new area of business or merge with another company, can affect the value of your investments (business risk). If you own an international investment, events within that country can affect your investment (political risk and currency risk, to name two).

There are other types of risk. How easy or hard it is to cash out of an investment when you need to is called liquidity risk. Another risk factor is tied to how many or how few investments you hold. Generally speaking, the more financial eggs you have in one basket, say all your money in a single stock, the greater risk you take (concentration risk).

In short, risk is the possibility that a negative financial outcome that matters to you might occur.

A variety of factors—such as your human capital, alternative sources of income and your time frame for meeting specific financial goals—can play a role in determining your risk tolerance. If have a long time to meet your goals, you may have a higher risk tolerance than someone who is nearing retirement and is counting on investment income to live on for two or three decades.

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

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

Above all, you need to feel comfortable with the risk you're taking. If changes in the value of your portfolio keep you tossing and turning at night, or your instinct is

to sell your investments every time the market drops, then you may want to consider shifting to a more moderate investment mix, with a greater emphasis on predictable, income-producing investments, such as bonds and bond funds. You need to understand, however, that there will always be a measure of risk no matter what you invest in.

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

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

Time Can Be Your Friend or Foe

For every financial goal you set, think about the timeframe in which you might need the money you have invested. For shorter term goals, or as you reach longer term goals, you'll want to consider moving some or all of your portfolio into liquid, lower-volatility investments such as short-term bonds, certificates of deposit and cash.

For longer term goals, stocks and mutual funds that invest in stocks have the potential to provide higher returns. 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.

Investors 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.

The Bottom Line

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