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Introduction to Investment Planning

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What is investing?

Money that works for you

Remember back to when you were a child who wanted some item and learned you had to pay money to get it. You probably soon found out you had to work for that money. So, you mowed lawns, delivered newspapers, or did other chores, earned the money, and bought those things you wanted. As you got older and earned more money than you spent, you became aware of the concept of saving. Eventually, you took your cash out of the piggy bank and opened an interest-bearing savings account. To your delightful surprise, you discovered that money could actually make money.

The investment planning process

You're not a child anymore. You work hard for your money and, if you're fortunate, have some left over after paying the costs of living. You want to commit that extra money to earning a financial return but realize that savings accounts, while insured by the FDIC, provide only limited interest income. You're ready to expand your portfolio to include investments that have the potential to provide greater returns.

First things first; secure a strong financial foundation

Before you begin investing, you need to secure a strong financial foundation. Be sure these basic steps have been taken:

- Create a "rainy day" reserve: Set aside enough cash to get you through an unexpected period of illness or unemployment--two months' worth of living expenses is generally recommended. Put the cash in a money market account or mutual fund so it will earn money and you can still access the funds quickly.
- Pay off your debts: It makes more sense to pay off high-interest-rate debt (e.g., credit card debt) than to put money into riskier investments.
- Get insured: There is no better way to put your extra cash to work for you than by having adequate insurance. It's your best protection against financial loss, so review your home, auto, health, disability, life, and other policies, and increase your coverage, if needed.
- Max out your IRA, 401(k), Keogh, or other tax-deferred retirement plan: Putting money in these accounts defers income taxes means you'll have more money to save. Take full advantage of them if they are available to you.

Getting educated

Once you've decided to become an investor, you should "stick your toe in the water" and get a feel for the environment. The investment world is unique and has its own language, resources, markets, and so forth. Don't dive in until you're at least somewhat familiar with this new territory. Here are some ways to do this:

- Talk directly with a professional financial advisor
- Talk to other more experienced investors
- Surf the Internet--many websites provide glossaries and other educational information
- Subscribe to financial newspapers and periodicals, or visit a library that has such subscriptions

- Buy books or software on investing (but select carefully--there are some bad ones out there)

Here are some elementary investment terms and concepts you should know:

- Time horizon: How long you will remain invested
- Risk: The probability that you will make or lose money
- Risk tolerance: Your capacity to absorb financial loss and your emotional feelings about losing money
- Investment portfolio: A collection of investments
- Diversification or asset allocation: Spreading dollars across a variety of investments to reduce risk
- Liquidity: The ability to quickly convert investments into cash
- Securities: Generally, stocks and bonds
- Index: Group of securities representing a segment of the market
- Exchange: Market where securities are traded
- Yield: Return on an investment
- Bear: The market is down
- Bull: The market is up

A seven-step process

It may be helpful to think of investment planning as a seven-step process:

1. Setting investment goals
2. Understanding your investment personality
3. Designing an investment portfolio
4. Evaluating markets and investments
5. Selecting specific investments
6. Managing and monitoring the portfolio
7. Rebalancing or redesigning the portfolio, if needed

The following discussion presents a brief introduction to some issues typically involved in this process.

Setting your investment goals

The first step is simply taking stock of your particular circumstances. Your current financial condition and future expectations are the basis for all further investment decisions. Who you are as an investor (i.e., your investor profile) will determine which investment strategy or strategies you should implement. For example, you may be saving part of your weekly wages for your 2-year-old child's college education or your own retirement in 30 years. Or, perhaps you won the lottery or received an inheritance, want to invest the lump sum in the short term, and then use the money to buy a new house.

See disclaimer on final page

To help evaluate your situation, here are a few questions you might consider:

- How much money do you have available to invest?
- What are your sources of investment money? Do you have a lump sum, or will you be investing regularly and systematically?
- How much profit do you need the investments to generate?
- What is your current income tax bracket?
- What is your age?
- For what purpose will you use the profits?
- What is your current income?
- What do you expect your income to be in the near future? In the far future?
- What are your current expenses?
- Do you need current income?
- When will you need the money?
- How do you feel about losing money?

For more information, see Setting Investment Goals.

Understanding your investment personality

Risk is the biggest issue in the investment planning process and thus is a key concept you need to understand. Do not proceed until you fully comprehend all of its ramifications and have determined your own risk tolerance. Remember, investing is akin to gambling--there are no guarantees, no matter how safe the investment proclaims to be.

For more information, see Understanding Risk.

Designing an investment portfolio

You have reached step three in the investment planning process. Thus far, you have done some research, data gathering, and a lot of thinking. Now you need to actually make some concrete decisions--matching your investment goals and personality to different investment categories, whether they be simple investments, such as CDs or insurance, or more complex investments, such as stocks or real estate. This is known as asset allocation.

Investment plans come in many configurations that fit the different types of investors that exist. For example, for long-term investors who want high growth and don't need current income, an aggressive plan might be established. An aggressive plan might include 40 percent large company stocks, 25 percent small company stocks, 30 percent international stocks, and 5 percent cash equivalents. By comparison, for investors who want current income and stability over growth, a conservative plan might be established. A conservative plan may consist of 15 percent large company stocks, 5 percent international stocks, 55 percent bond funds, and 25 percent cash equivalents. Any combination is possible. The plan that suits you best depends on your own investor profile.

The major categories are shown in the following table:

Investment Category	Examples of Investment
Cash equivalents (liquid assets)	Bank CDs, U.S. savings bonds, Treasury bills
Debt instruments	Bonds, mortgage-related securities
Treasury securities	Issued by agencies of the U.S. government
Equity investments	Stocks, mutual funds
Insurance-based investment products	Annuities, cash value life insurance
Real estate	Direct investments and via trusts
Hard assets	Metals, collectibles
Other investments	Commodities, warrants, options

Tip: Asset allocation is extremely important. Seeking the advice of an experienced financial planner is recommended at this stage.

For more information, see Designing and Managing an Investment Portfolio.

Evaluating markets and investments

In step three, you chose an asset allocation plan--a plan for dividing your money among investment categories. Now you need to learn about the costs, characteristics, and advantages and disadvantages of the types of investment in each category to get a clearer picture of which ones will meet your goals best. Literally thousands of investments are out there, and finding out how and where to evaluate and buy them can be mind boggling. If you do not have the time or inclination to do this homework, you can seek the advice of a money manager or financial advisor whom you trust.

For the do-it-yourself investor, a wise investment decision involves some knowledge of the capital and money markets, investment theory, how stocks and bonds are traded, how the stock market functions, and how securities are priced, among other things. With a little education, you will soon be able to determine what rate of return you can reasonably expect to earn from a particular investment and how much risk you'll need to take to get it.

Caution: Always get professional help if you are dealing with a complicated or unusual issue.

For more information, see Market and Investment Evaluation Methods.

Selecting specific investments

You have a plan, you have a list, and now you need to actually begin investing your money. It's time to purchase an investment, open a brokerage account, or otherwise begin building your portfolio that is consistent with your goals and selected strategies.

For more information, see Selecting/Screening Specific Investments.

Managing and monitoring the portfolio

Once your investment plan is set in motion, it needs continued managing and monitoring. You should review your plan to make sure it is on track on a monthly, quarterly, semiannual, or annual basis, depending on the types of investments you own.

For more information, see Managing an Investment Portfolio.

Rebalancing or redesigning the portfolio, if needed

A portfolio that is not performing as expected, or significant changes in the market or your personal situation, can trigger the need to analyze and/or change your existing investment plan.

For more information, see Rebalancing a Portfolio vs. Redesigning.

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