#57 Investments for Beginning Investors

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Investing when you're just getting started can be intimidating, especially in an uncertain economy. You face a tough balancing act. You can't ignore important long-term goals such as retirement or college. Maybe you're trying to bulk up reserves while paying off a credit card, too. But relax — you can build an investment plan that gets you up and running with confidence.

Getting Started

To begin building an investment plan, you need the following:

- A budget with dollars earmarked to invest
- Specific goals, with costs, due dates, and savings requirements for each (see Strategy #13 for help with this)

Your projected timeline helps determine how much risk you can take so you can choose the right investments. A goal chart, such as the one in Table 57-1, helps you focus on the key element of the time horizon for each objective.

Table 57-1 Sample Goal Chart

Goal	*How Much*	*Monthly Allocation*	*Goal Date*
House down payment	$40,000	$450	4 years
Retirement savings	$2,750,000	$1,000	35 years
College for child	$120,000	$340	16 years

Matching Investment Types to Your Time Table

With the investment industry so anxious to sell stuff, people have come up with a dazzling number of products — so many that it's sometimes hard for even the experts to sort through all the options. So what'll it be? Hedge funds? Commodity futures? The mattress?

For most purposes, investments can be broken down into three categories:

- **Stocks:** Stocks are shares of ownership in a company that entitle you to part of the profits, and they produce the biggest returns. But they also carry the most risk. They go up and down in value more frequently. The swings, called *volatility,* are greater than in bonds and cash, too.
- **Bonds:** Bonds represent a debt that a company or government owes you, the investor. They give you more modest returns but a smoother ride than stocks. The company or government that issues the bonds agrees to pay interest and to return the principal.
- **Cash:** In investment terms, cash is a short-term store of value that's accessible, safe, and can pay interest. Cash doesn't change in value very much. The amount of risk to your principal is little or none, but the downside is that cash gives low returns. (Refer to Strategy #17 for details on the types of cash accounts available.)

Risk is the amount of volatility in returns over a given period — in other words, how drastically the value of your investment goes up and down. High risk generally leads to a higher return, but lower risk ensures the funds you need in the short term don't disappear just when you need them. So for your emergency fund (see Strategy #9), a low-risk fund such as cash is the best bet. For a retirement that may be 30 or more years off but will require a substantial pile of money, more stocks are a good choice. Bonds are a great fit for a goal coming due in an intermediate period of time.

REMEMBER

Risk is a normal and even healthy part of the market cycle, and avoiding all risk isn't an option. Investments that are too conservative may mean you're just trading the risk of gut-wrenching market gyrations for the equally scary prospect of having to move in with your adult children. For long-term goals, get comfortable with investment risk and stay the course (but review your portfolio annually to make sure you're still on track).

In any economy, you should tie your investment decisions to when the money must be available. Check out Table 57-2, which matches time tables with acceptable levels of risk.

Table 57-2 Investments for Short-Term and Long-Term Goals

	Short-Term Goals	*Intermediate-Term Goals*	*Long-Term Goals*
Years until	0–3 years	4–10 years	11+ years
Acceptable risk	Low	Low to moderate	Higher
Type of assets	Mostly or all cash	Cash and bonds	Stocks and bonds
Investments you may pick	Savings account Money market fund CDs Short-term bond fund	CDs Short-term bond fund Intermediate-term bond fund Conservative allocation fund	Mostly stock and bond funds Growth and income funds Target date funds Target allocation funds
Accounts you may use	Bank or credit union Investment account	Bank or credit union Investment account 529 college savings plan	Retirement (401(k), Roth IRA) 529 college savings plan Investment account

Here's a guideline for the maximum percentage of a portfolio that should be invested in stocks, based on when the funds will be needed:

Time Horizon	*Maximum Invested in Stocks (Percent)*
0–3 years	0%
4–5 years	20%
6 years	30%
7 years	40%
8 years	50%
9 years	60%
10 years	70%
11–15 years	80%
15+ years	90%

Building a Foundational Portfolio

No one can reliably predict the markets. But because investment requires being *in* the markets, it's important to control what you can so you limit potential losses. The things within your control include the following:

- **Allocation:** Allocation is the portion of your treasure in each of the big three: stocks, bonds, and cash.
- **Diversification:** Diversification means owning enough different investment positions in each asset category.
- **Costs:** High investment expenses can eat away at your hard-earned dough.

As a beginning investor, you need just a few — or maybe even just one — investment vehicles to hit all your asset classes and to be diversified. And you don't want to pay big expenses and commissions. *Mutual funds* — investment companies that sell shares to the public, pool their money, and buy a large number of various stocks or bonds — are the best choice for beginning investors because they offer automatic diversification.

REMEMBER

Mutual funds can be either actively or passively managed. *Actively managed funds* have managers who try to beat the market by stock picking and market timing. *Index funds* own shares of an entire sector, hoping to passively match the market. Fans of indexing believe that markets move randomly, so active managers can't accurately and consistently predict the direction or timing of markets. And because active management has higher costs, index funds may have a leg up. (For more on mutual funds, see Strategy #21.)

Following are a couple of ideas for foundational portfolios:

- **One-stop shopping:** A number of fund companies now offer life cycle, target date, or asset allocation funds that include large and small U.S. stocks, international stocks, bonds, and cash in one bucket. Some are geared for a particular objective, such as retirement or college, ratcheting back the riskier assets as the goal approaches. Others cater to specific asset mixes, from conservative to aggressive. These plug-and-play funds are good options if your funds are limited or if you just like the convenience. Look for one using index funds.
- **Simple index fund portfolio:** For beginning investors who want more leeway on allocations, try the following:
  - Total U.S. stock market index
  - Total U.S. bond market index
  - Total international (non-U.S.) stock market index

  Plunking 40 percent each into the U.S. stock and bond funds and 20 percent into the international fund can provide a moderate investor with broad diversification and a great start toward building long-term wealth. See Part III for strategies on getting the asset mix that's right for you.