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Creating an Investment Portfolio

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You've identified your goals and done some basic research. You understand the difference between a stock and a bond. But how do you actually go about creating an investment portfolio? What specific investments are right for you? What resources are out there to help you with investment decisions? Do you need a financial professional to help you get started?

A good investment portfolio will spread your risk

It is an almost universally accepted concept that most portfolios should include a mix of investments, such as stocks, bonds, mutual funds, and other investment vehicles. A portfolio should also be balanced. That is, the portfolio should contain investments with varying levels and types of risk to help minimize the overall impact if one of the portfolio holdings declines significantly.

Many investors make the mistake of putting all their eggs in one basket. For example, if you invest in one stock, and that stock goes through the roof, a fortune can be made. On the other hand, that stock can lose all its value, resulting in a total loss of your investment. Spreading your investment over multiple asset classes should help reduce your risk of losing your entire investment. However, remember that there is no guarantee that any investment strategy will be successful and that all investing involves risk, including the possible loss of principal.

Asset allocation: How many eggs in which baskets?

Asset allocation is one of the first steps in creating a diversified investment portfolio. Asset allocation means deciding how your investment dollars should be allocated among broad investment classes, such as stocks, bonds, and cash alternatives. Rather than focusing on individual investments (such as which company's stock to buy), asset allocation approaches diversification from a more general viewpoint. For example, what percentage of your portfolio should be in stocks? The underlying principle is that different classes of investments have shown different rates of return and levels of price volatility over time. Also, since different asset classes often respond differently to the same news, your stocks may go down while your bonds go up, or vice versa. Though neither diversification nor asset allocation can guarantee a profit or ensure against a potential loss, diversifying your investments over various asset classes can help you try to minimize volatility and maximize potential return.

So, how do you choose the mix that's right for you? Countless resources are available to assist you, including interactive tools and sample allocation models. Most of these take into account a number of variables in suggesting an asset allocation strategy. Some of those factors are objective (e.g., your age, your financial resources, your time frame for investing, and your investment objectives). Others are more subjective, such as your tolerance for risk or your outlook on the economy. A financial professional can help you tailor an allocation mix to your needs.

More on diversification

Diversification isn't limited to asset allocation, either. Even within an investment class, different investments may offer different levels of volatility and potential return. For example, with the stock portion of your portfolio, you might choose to balance higher-volatility stocks with those that have historically been more stable (though past performance is no guarantee of future results).

Because most mutual funds invest in dozens to hundreds of securities, including stocks, bonds, or other investment vehicles, purchasing shares in a mutual fund reduces your exposure to any one security. In addition to instant diversification, if the fund is actively managed, you get the benefit of a professional money manager making investment decisions on your behalf.

Note: *Before investing in a mutual fund, carefully consider its investment objectives, risks, charges and expenses, which are outlined in the prospectus that is available from the fund. Obtain and read a fund's prospectus carefully before investing.*

Choose investments that match your tolerance for risk

Your tolerance for risk is affected by several factors, including your objectives and goals, timeline(s) for using this money, life stage, personality, knowledge, other financial resources, and investment experience. You'll want to choose a mix of investments that has the potential to provide the highest possible return at the level of risk you feel comfortable with on an ongoing basis.

For that reason, an investment professional will normally ask you questions so that he or she can gauge your risk tolerance and then tailor a portfolio to your risk profile.

Investment professionals and advisors

A wealth of investment information is available if you want to do your own research before making investment decisions. However, many people aren't comfortable sifting through balance sheets, profit-and-loss statements, and performance reports. Others just don't have the time, energy, or desire to do the kind of thorough analysis that marks a smart investor.

For these people, an investment advisor or professional can be invaluable. Investment advisors and professionals generally fall into three groups: stockbrokers, professional money managers, and financial planners. In choosing a financial professional, consider his or her legal responsibilities in selecting securities for you, how the individual or firm is compensated for its services, and whether an individual's qualifications and experience are well suited to your needs. Ask friends, family and coworkers if they can recommend professionals whom they have used and worked with well. Ask for references, and check with local and federal regulatory agencies to find out whether there have been any customer complaints or disciplinary actions against an individual in the past. Consider how well an individual listens to your goals, objectives and concerns.

Stockbrokers

Stockbrokers work for brokerage houses, generally on commission. Though any investment recommendations they make are required by the SEC to be suitable for you as an investor, a broker may or may not be able to put together an overall financial plan for you, depending on his or her training and accreditation. Verify that an individual broker has the requisite skill and knowledge to assist you in your investment decisions.

Professional money managers

Professional money managers were once available only for extremely high net-worth individuals. But that has changed a bit now that competition for investment dollars has grown so much, due in part to the proliferation of discount brokers on the Internet. Now, many professional money managers have considerably lowered their initial investment requirements in an effort to attract more clients.

A professional money manager designs an investment portfolio tailored to the client's investment objectives. Fees are usually based on a sliding scale as a percentage of assets under management — the more in the account, the lower the percentage you are charged. Management fees and expenses can vary widely among managers, and all fees and charges should be fully disclosed.

Financial planners

A financial planner can help you set financial goals and develop and help implement an appropriate financial plan that manages all aspects of your financial picture, including investing, retirement planning, estate planning, and protection planning. Ideally, a financial planner looks at your finances as an interrelated whole. Because anyone can call himself or herself a financial planner without being educated or licensed in the area, you should choose a financial planner carefully. Make sure you understand the kind of services the planner will provide you and what his or her qualifications are. Look for a financial planner with one or more of the following credentials:

- CERTIFIED FINANCIAL PLANNER™(CFP®)
- Chartered Financial Consultant® (ChFC®) and Chartered Life Underwriter® (CLU®)
- Accredited Personal Financial Specialist (PFS)

- Registered Financial Consultant® (RFC®)
- Registered Investment Advisor (RIA)

Financial planners can be either fee based or commission based, so make sure you understand how a planner is compensated. As with any financial professional, it's your responsibility to ensure that the person you're considering is a good fit for you and your objectives.

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