Introduction to Investment Planning

What is investment planning?

The investment planning process

If you're fortunate enough to have money left over after paying the costs of living, you may be able to make that extra money go to work for you by investing it to earn a financial return. Investment planning involves deciding how best to put your money--your capital--to work to achieve your financial goals.

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 relatively stable and liquid investment that can earn money but still lets you access the funds easily.
- 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 investments that involve an uncertain return.
- Get insured: Having adequate insurance is 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, leaving you more money to put toward your financial goals. 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
- Do online research--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 with an investment
- 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 try to reduce risk (although diversification alone can't guarantee a profit or ensure against a loss)
- Liquidity: The ability to quickly convert investments into cash
- Securities: Generally, stocks, bonds and other investment instruments
- Index: A group of securities that represent a specific market or segment of a market
- Exchange: Facility (physical or electronic) for the trading of securities
- Yield: Generally, the return on an investment
- Bear market: Occurs when securities are declining in value
- Bull market: Occurs when securities are rising in value

A six-step process

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

1. Setting investment goals
2. Understanding your investment personality
3. Designing an investment portfolio
4. Selecting specific investments
5. Managing and monitoring the portfolio
6. 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 want to invest a lump sum for a short period, and then use the money to buy a new house.

To help evaluate your situation, here are a few questions you might consider when setting investment goals:

- 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 distant future?
- What are your current expenses?
- Do you need current income?
- When will you need the money?
- Are you more focused on earning a high return or minimizing the possibility of loss?

Understanding your investment personality

Understanding risk is a key part of the investment planning process. A smart investor needs to fully comprehend how risk is measured and its potential ramifications. You also need to determine your own risk tolerance. Remember, no investment plan is likely to be successful if it doesn't fit your temperament and your individual financial situation.

Designing an investment portfolio

You have reached step three in the investment planning process: designing and managing an investment portfolio. So 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 a combination of various investment categories, whether they be simple investments, such as CDs, or more complex investments, such as stocks or real estate. The process of determining how much of your assets to put into each of various categories of investments is known as asset allocation.

No one asset allocation strategy is appropriate for everyone. For long-term investors who want high growth and don't need current income, an aggressive plan--one that focuses primarily on potential growth--might be established. For example, an aggressive investment plan might include 40 percent large company stocks, 25 percent small company stocks, 30 percent international stocks, and 5 percent cash alternatives. By comparison, for investors who put a higher priority on current income and stability than growth, a more conservative plan might be established; for example, it might consist of 15 percent large company stocks, 5 percent international stocks, 55 percent bond funds, and 25 percent cash alternatives. Any combination is possible; these are only hypothetical examples. The plan that suits you best depends on your own investor profile.

The major categories of investments available for inclusion in an asset allocation strategy are shown in the following table:

Investment Category	Examples of Investment
Cash alternatives (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
Insurance-based investment products	Annuities, cash value life insurance
Real estate	Direct investments and via trusts
Collectibles	Art, antiques, gems, and collectibles
Alternative assets	Metals, commodities, warrants, options

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

You'll also need to understand the various financial markets well enough to select individual investments, which can be a daunting (and time-consuming) task. If you do not have the time or inclination to evaluate markets and investments, 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 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 pursue that return.

Always get professional help if you are dealing with a complicated or unusual issue. Also, remember that all investment involves risk, including the possible loss of principal, and there can be no guarantee that any investment strategy will be successful.

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 set up your investment account, select specific investments, and otherwise begin building your portfolio in a way that's consistent with your goals and selected strategies.

Managing and monitoring the portfolio

Once your investment plan is set in motion, your portfolio needs ongoing management. You should review your plan regularly to make sure it's on track. As your circumstances or the investment landscape change, your portfolio may need some adjusting. That review can occur, monthly, quarterly, semiannually, or annually, depending on the types of investments you own and your own need and desire to monitor your investments.

Rebalancing or redesigning the portfolio, if needed

During your periodic reviews of your portfolio, you may find you need to make changes if it is not performing as expected. For example, you may need to rebalance or redesign your portfolio. Rebalancing means adjusting the amount invested in various categories to return to the original asset allocation; redesigning your portfolio would involve adjusting it to take into account significant changes in the market or your personal situation.
