

Beginning investors will need to gather information, form a plan

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Second of a four-part series on investment basics.

In our first of this series, we discussed crucial issues to consider before making any investment: Developing an overall investment strategy, defining goals, assessing the larger economic picture, both here and globally, and building a cash reserve.

The next step in the investment process _ still part of the planning stage _ is to establish what we professionals call an Investment Policy Statement.

The IPS can be detailed, but a bare-bones approach that touches all the bases will do just fine. It is, however, important that an IPS be in writing so that issues are clear to you and your advisors.

Once the IPS is prepared, feel free to change your IPS as circumstances change.

Here are the major components of an Investment Policy Statement:

-- Total value of all investments, including those within IRA's, pension plans, and 401K's, at a specific date.

-- Amount that is expected to be added to investments each year and over what period of time. For example, \$14,000 a year to a 401K for 10 years until retirement.

-- Amount that is expected to be withdrawn from the portfolio over what period of time. For retirees, this amount will be the difference between expenses and other income. For example, a person who receives \$250 from social security and another \$200 from a pension would have to withdraw \$150 from investments each month if his total expenses were \$600.

-- Amount of cash reserve to be held in bank or brokerage account, which is not available for investing. Keep this reserve small, because the aim is to get as many funds invested and growing as possible. A cash reserve of \$10,000 to \$20,000 is usually sufficient for most people, especially those who might also have a home equity line of credit available for unexpected emergencies.

-- An overall long-term goal for a reasonable combination of equities (stock-based) and fixed-income (bond-based) investments. This is called asset allocation. Those who are uncertain about this choice might stay with the general goal of 60 percent equities and 40 percent fixed-income investments, which allocation is reasonable for most and which balances return with risk. For maximum return over time with minimal risk, most investors should not go below 50 percent equities and 50 percent fixed-income investments.

-- Return expected on investments over the long term. Here, a review of historical returns would be good to come up with a reasonable expectation. To help with this selection, here are returns for a few asset categories over the last 10 years. In stocks, the S&P 500 Index has returned an average of 10.17 percent, while the S&P midcap 400 has returned 14.85 percent. In bonds, the Lehman Bros. Aggregate Bond has returned an average of 6.85 percent per year in the past decade.

So, with an asset allocation of 60 percent equities and 40 percent fixed income, you might expect a return of about 10.16 percent (60 percent of the average equity return, 12.36 percent, and 40 percent of the fixed-income return, 6.85 percent).

-- Risk tolerance is rather subjective, and most investors would consider themselves ``conservative''. Inexperienced investors or those who have been burned in the past can be extremely reluctant to move into equities again. However, in order to keep up with inflation over time and participate in market upturns, a portion of most portfolios should be in equities. Therefore, risk tolerance must be adjusted and adapted over time. Generally, you should ask yourself how much the value of your investments can drop in value before you can't sleep at night.

-- Specific investments or investment types that are acceptable to you, such as mutual funds (sometimes limited to socially conscious ones), treasury bonds, CD's. You should also decide upon specific investments or investment types that are unacceptable for purchase, such as individual stocks, junk bonds, hedge funds, derivatives.

-- Your current marginal tax bracket must be considered in any and all investment choices. For example, those in higher brackets might choose municipal bonds or municipal bond funds, which are not taxable, over taxable bonds from corporations.

While the Investment Policy Statement as a whole is an important aspect of any investment program, it is not necessary to obsess over any one aspect. It is okay to make reasonable estimates and judgments, because you can change your IPS with increased investment experience and comfort level or changing circumstances and needs.

Investors who have engaged an investment advisor will likely have prepared an Investment Policy Statement _ either formally or informally, and are accustomed to the benefits of doing so.

Investors without an investment advisor, such as those who deal directly with their brokers, will find that the IPS makes a world of

difference in their communication and services. An IPS clarifies all the factors that go into investing so your broker can do a better job.

Having no Investment Policy Statement is like going into a restaurant and asking for dinner and expecting the waiter to guess what you might like to eat based on your appearance and mannerisms.

An IPS clearly enumerates your situation so that you, and your advisor, can make the best choices of investment products for a portfolio tailored to you.

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