

Sticking to investment philosophy will limit risk and ensure returns

By **ELEANORE SZYMANSKI**

This is the last of a four-part series on investment basics, the part where we put it all together. Here are components of any good investment program.

First, assess the overall economic environment and make some broad judgments about the way you (and maybe your chosen experts) feel about present and future conditions.

Second, prepare a formal, written investment policy statement to establish conditions and products that are acceptable for you, such as expected return, asset allocation percentages and types of products.

Third, learn the basics of the two main investment types _ stocks and bonds _ how they work individually and how they compare to each other.

Fourth, armed with the assurance that proper diversification protects investors against everything except movements of the market itself, the last step is to choose specific investment products. The asset allocation chosen and documented in the investment policy statement will provide the framework for this important last step.

The importance of diversification cannot be overstressed.

Diversification seems like a very simple concept _ a word familiar to everyone. However, in my experience, I know that the concept in practice means widely different things to different people. Here are some things not to do:

Don't keep all your investments with one mutual fund company.

Don't invest your company stock in your 401(k), if you can help it. (If company 401(k) matches are made in company stock, move the stock into another investment as soon as possible.)

Don't invest in individual stocks unless you wish to devote lots of time in researching and understanding individual companies.

Don't deviate from the parameters outlined in your investment policy statement.

Let's say you are in your 40s, you have total investments of \$250,000 (excluding your home) and your investment policy statement states the following:

-- You will invest only in 4- or 5-star mutual funds with a three-year track record and CDs (or U.S. Treasuries).

-- You expect a long-term return of about 7 percent a year.

-- Your long-term asset allocation goal is 60 percent in equities (stocks) and 40 percent fixed-income (bonds).

To choose actual investment products, you must first refine your asset allocation and establish individual ``buckets'' for different investment types, complete with dollar values assigned to each ``bucket.''

(A) Total Equities (Stocks):

60 percent of \$250,000 equals \$150,000

Equity type breakdown (``buckets'')

Large caps: 20 percent or \$50,000

Mid caps: 15 percent or \$37,500

Small caps: 15 percent or \$37,500

International: 10 percent or \$25,000

(B) Total Fixed-Income (Bonds):

40 percent of \$250,000 equals \$100,000.

Fixed-income type breakdown (``buckets'')

Long-term bonds (maturing over 10 years): 10 percent or \$25,000

Intermediate Term bonds (maturing 5 to 10 years): 15 percent or \$37,500

Short-term bonds (maturing 0-5 years): 10 percent or \$25,000

Cash reserve: 5 percent or \$12,500

After naming your buckets, decide how many different investment products you will choose for each bucket.

A rule of thumb would be to have no more than 5 to 10 percent of the total portfolio in any one product.

In the example we are using, 5 percent of \$250,000 would be \$12,500. Thus, you might divide the \$50,000 you were planning to invest in large-cap stock funds into four different mutual funds, each with \$12,500 in it. And you might find three funds each for mid-cap and small-cap stocks and put \$12,500 into each of those. You might split your international stocks into two different mutual funds, each getting a \$12,500 investment.

You could break up the bond investments in much the same way, taking the total you want to invest in any bond bucket, dividing by 12,500 and using that figure to select the appropriate number of funds.

Once the types of funds and amounts planned for each are established, you are ready to select specific mutual-fund products to fill each ``bucket.''

A good place to start for the new investor will be the Morningstar database, which provides data on thousands of mutual funds. Don't be daunted by this number, as only a few will fit your criteria of a three-year track record and four- or five-star rated no-load funds.

Now that the specific funds have been selected, it is time to invest.

You can purchase each of these mutual funds directly from the mutual-fund company, which can create lots of accounts and paper, as monthly statements start streaming in.

Conversely, you can open an account at a discount brokerage (because all the mutual funds selected here are no-load mutual funds), such as TD Waterhouse or Charles Schwab.

The broker will custody all your selected funds and provide a neat monthly statement _ with all the funds in one place.

It is also good to invest in equities on a dollar-cost-average basis.

This would mean investing \$3,125 into each of your equity mutual funds each quarter until you are fully invested after a year.

There are many ways to buy investments and I have outlined here a basic, simple methodology that works.

Those who start here will learn from the experience and, over time, will intelligently make changes and develop their own enhanced investment philosophy.

The most important factor in dealing with investments is that of risk and return.

Developing an investment philosophy and style and sticking to it will limit risk and ensure adequate returns over time.

NOTE: Eleanore K. Szymanski is a fee-only, certified financial planner practitioner and principal of EKS Associates, LLC of Princeton. You may send questions to her in care of The Times Business Desk, P.O. Box 847, Trenton, NJ 08065.