developing your investment strategy

DEVELOPING YOUR INVESTMENT STRATEGY

So you are ready to jump into investing, huh? Great! Deciding you are ready to invest is a pretty big decision, but it's only the beginning. Many people hesitate to invest because they are confused by the jargon. Investing comes with a whole new vocabulary, and just knowing the words won't cut it. You also need to understand what those words mean. Once you understand the terms involved, you can move on to develop an investment strategy.

The difference between saving and investing

Making the leap from saving to investing is a big one. Saving is all about preserving and protecting your future. When you begin to invest, the chance for loss enters into the equation. This is why developing an investment strategy is so important. Saving money is safe. Investing money involves risk. An investment strategy will help you understand the path you are about to embark on. There are two major factors to understand as you start to develop a strategy: risk tolerance and time horizon.

Time Horizon

Time horizon is in essence your age. But more specifically, it's your age in relation to when you want access to your funds. The closer you are to needing the funds, the less risk you will want to take.

Risk Tolerance

Risk is a tricky concept to grasp. You are exposed to all kinds of risks on a daily basis, which is why you should have insurance. But when it comes to your money, the risk takes on a new level of importance. So, what type of risk should you take with your money? First, assess your personal risk tolerance. How much investment risk can you handle? Do you lose sleep at night thinking about how your money is being invested? If so, then you likely have a low level of risk tolerance. Generally speaking, you can afford to invest your money at a higher risk level in your 20s, 30s and early 40s. If you're older, you'll need access to your funds sooner, which means you will likely want to be more cautious. Knowing how long you have before you'll need the money you're investing is a major factor in determining your risk tolerance.

Once you've examined your time horizon and risk tolerance, the next step is to understand the difference between cash, stocks and bonds. You might be able to briefly define each of these, but you'll need to know more than that to develop your own investment strategy.

Cash

You know cash because cash is what you are comfortable with. It's what you have in savings. But cash in this context is a little different than the cash in your savings account. In a portfolio, cash is there to stabilize. Stocks and bonds, which we'll get to in a moment, are more volatile in comparison. Cash has the ability to maintain some stability in your portfolio. Cash also presents buying opportunities. When there are changes in the market, you can take advantage of them. In a way, cash is like betting against the market. When the stock and/or bond market is down, you have the cash on hand to buy investments at a price you feel is more appropriate.

Stocks

While there are many benefits to purchasing stock, it's inherently the most risky investment since the value of a stock can fall to zero. Generally speaking, the higher the stock allocation in your portfolio, the more risk you accept.

Bonds

A bond is when you essentially loan money to a company for a set period of time at a fixed interest rate. In terms of risk, bonds are a medium on the risk scale. Stocks and bonds tend to have an inverse relationship in the market. Bonds tend to be used to balance out the riskier nature of stocks.

The roles of cash, stocks and bonds

Now that you understand the nature of cash, stocks and bonds, it's important to understand their roles in your investment strategy. A mix of all three in your portfolio is generally warranted for people of all ages. Modern Portfolio Theory, which is designed to give the highest reward possible for a set amount of risk, suggests that even the youngest investor should hedge their portfolio with bonds. A 100 percent stock portfolio will likely not be able to properly handle the inherent market risks associated with that type of high-risk portfolio. Adding in bonds and cash can better balance a portfolio.

Having a "healthy" mix of stocks, bonds and cash is a subjective solution. There are no ideal percentages to base this decision on. This is why it's important for you to make a decision with help from a financial professional. Having a basic knowledge of investing will serve you well when you meet with a financial professional to create an investment strategy.

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