

Investing For Retirement

Our last article addressed how much and how you should save in order to accumulate your retirement nest egg. Now we'll discuss how to invest those savings.

Since we can't predict the future no one knows what the *ideal* portfolio will turn out to be. However, we *can* construct a *sensible* one that is broadly diversified, low-cost, tax-efficient, and consistent with your goals, time horizon, and investing temperament, in order to improve your chances of reaching your retirement goals.

We will examine the specifics of portfolio construction in future articles, but let's focus now on the key steps to developing an effective retirement investment plan.

Clearly identify the goals for your portfolio. What do you want it to accomplish in the period leading up to retirement, during retirement, and after you are gone? In addition to a secure retirement, are you planning to leave assets to family members or a charity? If so, how much do you plan to leave?

Understand your risk tolerance. This is the most important thing to know before you invest. It is your willingness to accept short-term losses in exchange for expected, but uncertain, longer-term gains. If you can't sleep at night fearing that a severe drop in the market could cost you a significant portion of your assets, a portfolio that holds a high percentage of risky investments such as stocks may not be right for you. Your risk tolerance affects your portfolio design so take the time to get this right.

Determine your time horizon. The time horizon for your portfolio will have two or possibly three phases. They are the period before retirement, your retirement years, and many years after you're gone, if you plan to leave assets for others. For someone in their fifties, those three phases could total over five decades. To increase the chances that your assets will continue to grow, and keep ahead of inflation, you will likely need to include some higher risk assets such as stocks in the mix.

Establish your asset allocation. The most important investment decision you will make is the portfolio's asset allocation, which is determining the portion of your investable assets you want in the three major asset classes of stocks, bonds, and cash. This decision will determine the majority of your portfolio's performance and risk.

Different asset classes have different risk and return characteristics, and can respond differently to economic and market forces. Therefore, you can balance a portfolio's risk and return by spreading your investments among different types of assets. This doesn't guarantee a profit or ensure against a loss, but it can help you manage the level and type of risks you face. A sensible asset allocation depends upon your investment objectives, time horizon, risk tolerance, and other personal and financial circumstances.

Diversify through sub-asset allocation and security selection. To further diversify your portfolio you'll need to select the sub-asset classes and specific funds that offer you the exposure within the specific stock and bond categories you want.

Determine your asset location. Different types of accounts, assets, and gains are taxed differently. Therefore, choosing which assets to hold in which accounts can help improve after-tax returns. Generally, investors should hold tax-efficient investments such as broad market index funds in taxable accounts, and tax-inefficient investments such as taxable bond funds in tax-advantaged accounts. However, factors including short-term cash needs and estate planning decisions can dictate exceptions to this strategy.

Rebalance periodically. Asset classes perform differently during the year, so in order to maintain your target asset allocation, and manage your portfolio's risk; you should rebalance the portfolio periodically.

Minimize costs. Investment expenses reduce performance. Choose funds that do not charge sales commissions, or impose high annual fees.

The bottom line: although you can't predict the future, having a *sensible*, well thought out investment plan can give you peace of mind and a better chance for a comfortable retirement.

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