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# Investor Profile and Asset Allocation



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## Saving and Investing Wisely

### Saving builds a foundation

The first step in investing is to secure a strong financial foundation. Start with these four basic steps:

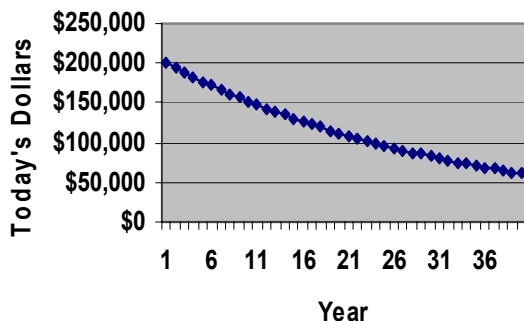
- Create a "rainy day" reserve: Set aside enough cash to get you through an unexpected period of illness or unemployment--three to six months' worth of living expenses is generally recommended. Because you may need to use these funds unexpectedly, you'll generally want to put the cash in a low-risk, liquid investment, such as a money market account or mutual fund.
- Pay off your debts: It may make more sense to pay off high-interest-rate debt (for example, credit card debt) before making investments that may have a lower or more uncertain return.
- Get insured: There is no better way to put your extra cash to work for you than by having adequate insurance. It's 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 any tax-deferred retirement plans, such as 401(k)s and IRAs: Putting money in these accounts defers income taxes, which means you'll have more money to save. Take full advantage if they are available to you.

### Why invest?

#### To keep ahead of inflation

When people say, "I'm not an investor," it's often because they worry about the potential for loss. It's true that investing involves risk as well as reward. However, there's also another type of loss to be aware of: the loss of purchasing power over time. During periods of inflation, each dollar you've saved will buy less and less as time goes on. According to

**The impact of 3% yearly inflation on the purchasing power of \$200,000**

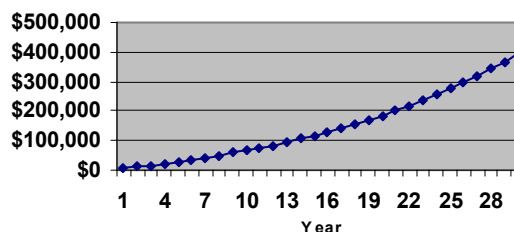


the U.S. Department of Labor, the average annual rate of inflation over the past 20 years has been approximately 3%. At 3% annual inflation, something that costs \$100 today would cost \$181 in 20 years.

#### To take advantage of compound interest

Anyone who has a savings account understands the basics of compounding: The funds in your savings account earn interest, and that interest is added to your account balance. The next time interest is calculated, it's based on the increased value of your account. In effect, you earn interest on your interest. Many people, however, don't fully appreciate the impact that compounded earnings can have, especially over a long period of time.

**Growth of annual \$5,000 investments at 6%**



This is a hypothetical example and is not intended to reflect the actual performance of any specific investment. Taxes and investment fees and expenses are not reflected. If they were, the results would have been lower.

Let's say you invest \$5,000 a year for 30 years (see illustration). After 30 years you will have invested a total of \$150,000. Yet, assuming your funds grow at exactly 6% each year, after 30 years you will have over \$395,000, because of compounding.

Compounding has a "snowball" effect. The more money that is added to the account, the greater its benefit. Also, the more frequently interest is compounded--for example, monthly instead of annually--the more quickly your savings build. The sooner you start saving or investing, the more time and potential your investments have for growth. In effect, compounding helps you provide for your financial future by doing some of the work for you.

***Inflation reduces the purchasing power of your dollars over time.***



## Building on Your Foundation

### Setting investment goals

Setting goals is an important part of financial planning. Before you invest your money, you should spend some time considering and setting your personal goals. For example, do you want to retire early? Would you like to start your own business soon? Do you need to pay for a child's college education? Would you like to buy or build a new house? In addition to these, there are several other considerations that can help you and your financial professional develop an appropriate plan.

### Think about your time horizon

One of the first questions you should ask yourself in setting your investment goals is "When will I need the money?" Will it be in 3 years or 30? Your time horizon for each of your financial goals will have a significant impact on your investment strategy.

The general rule is: The longer your time horizon, the more risky (and potentially more lucrative) investments you may be able to make. Many financial professionals believe that with a longer time horizon, you can ride out fluctuations in your investments for the potential of greater long-term returns. On the other hand, if your time horizon is very short, you may want to concentrate your investments in less risky vehicles because you may not have enough time to recoup losses should they occur.

### Understand your risk tolerance

Another important question is "What is my investment risk tolerance?" How do you feel about the potential of losing your hard-earned money? Many investors would forgo the possibility of a large gain if they knew there was also the possibility of a large loss. Other investors are more willing to take on greater risk to try to achieve a higher return. You can't completely avoid risk when it comes to investing, but it's possible to manage it.

Almost universally, when financial professionals or the media talk about investment risk, their focus is

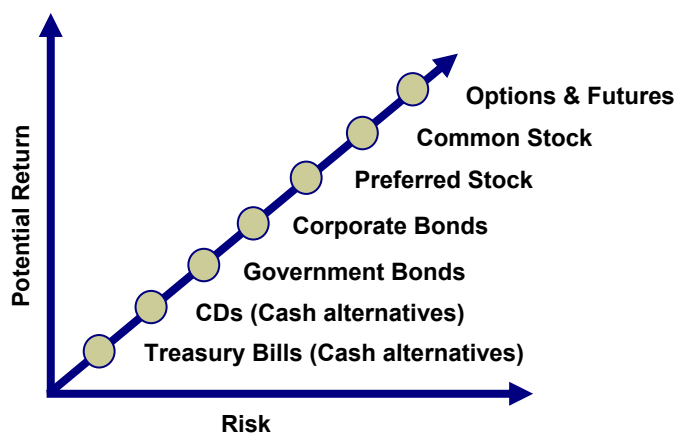
on price volatility. Advisors label as aggressive or risky an investment whose price has been prone to dramatic ups and downs in the past, or that involves substantial uncertainty and unpredictability. Assets whose prices historically have experienced a narrower range of peaks and valleys are considered more conservative.

In general, the risk-reward relationship makes sense to most people. After all, no sensible person would make a higher-risk investment without the prospect of a higher reward for taking that risk. That is the tradeoff. As an investor, your goal is to maximize returns without taking on more risk than is necessary or comfortable for you. If you find that you can't sleep at night because you're worrying about your investments, you've probably assumed too much

risk. On the other hand, returns that are too low may leave you unable to reach your financial goals.

The concept of risk tolerance refers not only to your willingness to assume risk but also to your financial ability to endure the consequences of loss. That has to do with your stage in life, how soon you'll need the money, and your financial goals.

### The risk/return relationship



### Remember your liquidity needs

Liquidity refers to how quickly you can convert investments into cash. Real estate, for example, tends to be relatively illiquid; it can take a very long time to sell. Publicly traded stock, on the other hand, tends to be fairly liquid.

Your need for liquidity will affect the types of investments you might choose to meet your goals. For example, if you have an emergency fund, you're in good health, and your job is secure, you may be willing to hold some less liquid investments that may have higher potential for gain. However, if you have two children going to college in the next couple of years, you probably don't want all of their tuition money invested in less liquid assets. Also, having some relatively liquid investments may help protect you from having to sell others when their prices are down.



## Types of Investments: Stocks

### How do stocks work?

When you buy a company's stock, you're purchasing a share of ownership in that business. You become one of the company's stockholders or shareholders. Your percentage of ownership in a company also represents your share of the risks taken and profits generated by the company. If the company does well, your share of its earnings will be proportionate to how much of the company's stock you own. The flip side, of course, is that your share of any loss will be similarly proportionate to your percentage of ownership.

If you purchase stock, you can make money in one of two ways. The company's board of directors can decide to distribute a portion of the company's profits to its shareholders as dividends, which can provide you with income. Also, if the value of the stock rises, you may be able to sell your stock for more than you paid for it. Of course, if the value of the stock has declined, you'll lose money.

#### Stocks by Size

Size	Description
Large cap (\$10+ billion)	<ul style="list-style-type: none"> <li>Widely bought and sold</li> <li>Often are well-known names</li> </ul>
Midcap (\$2 billion to \$10 billion)	<ul style="list-style-type: none"> <li>Somewhat smaller than large caps</li> </ul>
Small cap (\$200 million to \$2 billion)	<ul style="list-style-type: none"> <li>Less widely traded</li> <li>Fewer institutional investors</li> </ul>
Microcap (\$20 million to \$200 million)	<ul style="list-style-type: none"> <li>May trade infrequently</li> <li>More difficult to research</li> </ul>

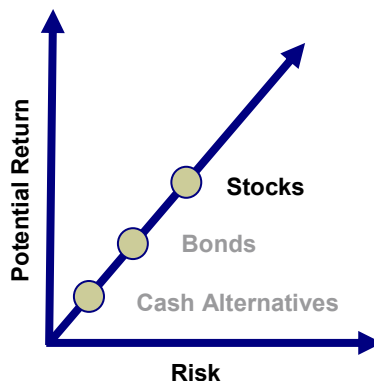
Note: The values used to define companies by size are highly variable. Different organizations define these ranges in different ways, and the ranges can vary over time with general stock market values.

### The role of stocks in your portfolio

Though past performance is no guarantee of future results, stocks historically have provided higher long-term total returns than cash equivalents or bonds. However, that potential for greater returns comes with greater risk of volatility and potential for loss. You can lose part or all of the money you invest in a stock. Because of that volatility, stock investments may not be appropriate for money you count on to be available in the short term. You'll need to think about whether you have the financial and emotional ability to ride out those ups and

downs as you try for greater returns.

The universe of stocks offers enormous flexibility to construct a stock portfolio that is tailored to your needs. There are many different types of stock, and many different ways to diversify your stock holdings. For example, you can sort through stocks by industry, by company size, by location, and by growth prospects or income.



Growth stocks are usually characterized by corporate earnings that are increasing at a faster rate than their industry average or the overall market. Income stocks (for example, utilities or finan-

cial companies) generally offer higher dividend yields than market averages. Value stocks are typically characterized by selling at a low price relative to a company's sales, earnings, or book value.

These are only some of the many ways in which stocks can be identified, and your financial professional can help you decide which might be more appropriate for you than others. With stocks, it's especially important to diversify your holdings. That way, if one company is in trouble, it won't have as much impact on your overall return as it would if it represented your entire portfolio.

#### Advantages

- Historically, have provided higher long-term total return than cash or bonds
- Easy to buy and sell
- Can provide capital appreciation as well as income from dividends
- Ownership rights

#### Tradeoffs

- Poor company performance can affect dividends and share value
- Greater risk to principal
- May not be appropriate for short-term investment
- Subject to market volatility



# Types of Investments: Bonds

## How do bonds work?

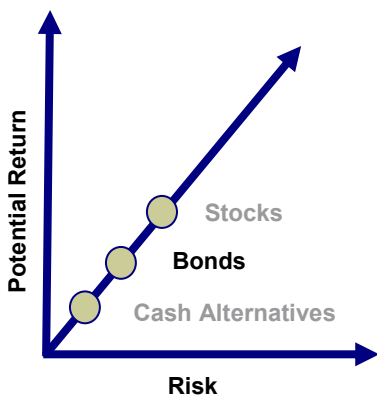
When you buy a bond, you're basically buying an IOU. Bonds, sometimes called fixed-income securities, are essentially loans to a corporation or governmental body. The borrower (the bond issuer) typically promises to pay the lender, or bondholder, regular interest payments until a certain date. At that point, the bond is said to have matured. When it reaches that maturity date, the full amount of the loan (the principal or face value) must be repaid.

A bond typically pays a stated interest rate called the coupon, a term that dates back to the days when a bondholder had to clip a coupon attached to the bond and mail it in to receive each interest payment. Most bonds pay interest on a fixed schedule, usually quarterly or semiannually, although some pay all interest at maturity along with the principal.

There are two fundamental ways that you can profit from owning bonds. The most obvious is the interest that bonds pay. However, you can also make money if you sell a bond for more than you paid for it. As with any security, bond prices move up and down in response to investor demand; they also are sensitive to changes in interest rates. If you sell a bond before its maturity date, you may get more than its face value, depending on how its interest rate compares to others. However, you could also receive less than the face value if you sell before maturity when bond prices are down.

## The role of bonds in your portfolio

One of the most important reasons that investors choose bonds is for their steady and predictable stream of income through interest payments. Bonds have traditionally been important for retirees for this reason. Also, though they are not risk-free—for example, a bond issuer could default on a payment or even fail to repay the principal—bonds are considered somewhat less risky than stocks. In part, that's



because a corporation must pay interest to bondholders before it pays dividends to its shareholders. Also, if it declares bankruptcy or dissolves, bondholders are first in line to be compensated.

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Ways to classify bonds	
<b>By maturity</b>	Long-term (10+ years) Intermediate (1-10 years) Short-term (less than 1 year)
<b>By issuer</b>	Corporate Municipal U.S. Treasury Government-sponsored entities Foreign corporations and governments
<b>By quality</b>	Investment-grade High-yield ("junk")
<b>By tax status</b>	Tax-exempt: municipal bonds (generally exempt from federal tax) Taxable: corporate, U.S. Treasury (exempt from most state and local tax)

The bond market often behaves very differently from stocks. For example, when stock prices are down, investors often prefer bonds because of their relative stability and interest payments. Also, when interest rates are high, bond returns can be attractive enough that investors decide not to assume the greater risk of stocks. Interest from bonds can help balance stock fluctuations and increase a portfolio's stability. And because a bond's face value gets repaid upon maturity, you can choose a bond that matures when you need the money.

### Advantages

- *Generally, a predictable stream of income*
- *Income typically higher than cash investments*
- *Relatively lower risk compared to stocks*
- *Low correlation with stock market*

### Tradeoffs

- *Risk of default (mostly with corporate bonds)*
- *Bond values fluctuate with interest rates*
- *Generally, lower potential returns compared to stocks*

Some bonds are exempt from federal or state and local income tax. This can be appealing to investors in high tax brackets.

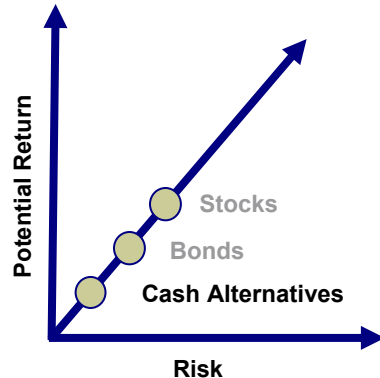


## Types of Investments: Cash

### Cash and cash alternatives

In daily life, cash is all around you, as currency, bank balances, negotiable money orders, and checks. However, in investing, "cash" is also used to refer to so-called cash alternatives:

investments that are considered relatively low-risk and can generally be converted to cash quickly. Some examples of cash alternatives include savings accounts, money market deposit accounts, money market funds, certificates of deposit, guaranteed investment contracts (GICs), government savings bonds, U.S. Treasury bills, Eurodollar certificates of deposit, and commercial paper.



### Using cash alternatives

Because of their conservative nature, cash alternatives involve the least risk. However, there is a

tradeoff for their relative safety: Their potential return is not as high as investments that involve more risk. By focusing solely on playing it safe, you may limit your investment income, especially over longer time periods.

Cash alternatives can be useful in many ways. First, they can provide relative stability. While cash alternatives can't assure you of a gain or protect you from losses, they are generally considered safer than other asset classes, such as stocks or bonds. Also, they can provide income on cash that would otherwise be idle. They can serve as a ready source of cash to pay bills or make purchases. For example, cash alternatives can help preserve money earmarked for a down payment or a family vacation. Readily available cash also can help you cope in a financial emergency. Finally, cash alternatives can serve as a temporary parking place when you're not sure where to invest your money.

#### Advantages

- *Predictable earnings*
- *Highly liquid*
- *Little risk to principal*

#### Tradeoffs

- *Relatively low returns*
- *May not outpace inflation*

## Investing Through Mutual Funds and ETFs

You can invest in all three major asset classes through mutual funds, which pool your money with that of other investors. Each fund's manager selects specific securities to buy based on a stated investment strategy.

Mutual funds offer two key benefits. Because most mutual funds own dozens or hundreds of securities, you achieve greater diversification than buying a few individual securities on your own. Also, the fund manager's expertise is part of what you pay for in buying mutual fund shares.

A mutual fund may invest in one of the three asset classes, or combine them. For example, a balanced fund typically includes stocks and bonds. A lifecycle or target fund adjusts its mix of investments over time, investing more conservatively as the fund's target date gets closer. With an

#### Advantages

- *Professional money management*
- *Small investment amounts*
- *Diversification*
- *Liquidity*

#### Tradeoffs

- *Fluctuating share values*
- *Some money kept in cash for fund liquidity needs*
- *Potential tax inefficiency*
- *Mutual fund fees and expenses*

actively managed fund, the fund manager buys and sells specific securities, trying to beat a benchmark index such as the S&P 500. A passively managed or index fund tries to match the return of a specific index by holding only the securities included in that index.

Before investing in a mutual fund, carefully consider its investment objectives, risks, fees and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.

Like index funds, exchange traded funds (ETFs) typically invest in a group of securities represented in a specific index, and the way they're organized means that expenses typically are lower than those of actively managed mutual funds. Unlike mutual funds, ETFs are traded throughout the day, and can be bought on margin.



## Asset Allocation

The combination of investments you choose can be as important as your specific investments. The mix of various asset classes, such as stocks, bonds, and cash alternatives, account for most of the ups and downs of a portfolio's returns.

Deciding how much of each you should include is one of your most important tasks as an investor. That balance between potential for growth, income, and stability is called your asset allocation. It

doesn't guarantee a profit or insure against a loss, but it does help you manage the level and type of risks you face.



### Balancing risk and return

Ideally, you should strive for an overall combination of investments that minimizes the risk you take in trying to achieve a targeted rate of return. This often means balancing more conservative investments against others that are designed to provide a higher return but that also involve more risk. For example, let's say you want to get a 7.5% return on your money. Your financial professional tells you that in the past, stock market returns have averaged about 10% annually, and bonds roughly 5%. One way to try to achieve your 7.5% return would be by choosing a 50-50 mix of stocks and bonds. It might not work out that way, of course. This is only a hypothetical illustration, not a real portfolio, and there's no guarantee that either stocks or bonds will perform as they have in the past. But asset allocation gives you a place to start.

Many publications feature model investment portfolios that recommend generic asset allocations based on an investor's age. These can help jump-start your thinking about how to divide up your investments. However, because they're based on averages and hypothetical situations, they shouldn't be seen as definitive. Your asset allocation is--or should be--as unique as you are. Even if two people are the same age and have similar incomes, they may have very different needs and goals. You should make sure your asset allocation is tailored to your individual circumstances.

### Many ways to diversify

When financial professionals refer to asset allocation, they're usually talking about overall classes:

stocks, bonds, and cash or cash alternatives. However, there are others that also can be used to complement the major asset classes once you've got those basics covered. They include real estate and alternative investments such as hedge funds, private equity, metals, or collectibles. Because their returns don't necessarily correlate closely with returns from major asset classes, they can provide additional diversification and balance in a portfolio.

Even within an asset class, consider how your assets are allocated. For example, if you're investing in stocks, you could allocate a certain amount to large-cap stocks and a different percentage to stocks of smaller companies. Or you might allocate based on geography, putting some money in U.S. stocks and some in foreign companies. Bond investments might be allocated by various maturities, with some money in bonds that mature quickly and some in longer-term bonds. Or you might favor tax-free bonds over taxable ones, depending on your tax status and the type of account in which the bonds are held.

### Monitoring your portfolio

Even if you've chosen an asset allocation, market forces may quickly begin to tweak it. For example, if stock prices go up, you may eventually find yourself with a greater percentage of stocks in your portfolio than you want. If they go down, you might worry that you won't be able to reach your financial goals. The same is true for bonds and other investments.

Do you have a strategy for dealing with those changes? Of course you'll probably want to take a look at your individual investments, but you'll also want to think about your asset allocation. Just like your initial investing strategy, your game plan for fine-tuning your portfolio periodically should reflect your investing personality.



Even if you're happy with your asset allocation, remember that your circumstances will change over time. Those changes may affect how well your investments match your goals. At a minimum, you should periodically review the reasons for your initial choices to make sure they're still valid. Also, some investments, such as mutual funds, may actually change over time; make sure they're still a good fit.



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