Investment Management Fundamentals

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What's in your portfolio?

For most people, investing tends to elicit one of two emotions – excitement or fear. Excitement at the thought of making money. Fear at the thought of losing it.

Regardless of whether you manage your portfolio yourself or use a professional advisor or manager, it's wise to review the basics of investing.

Let's get started by going over the investment categories.

Investment Categories

There are four main investment categories to consider when planning your mix: Cash, Bonds, Stocks and Alternative Investments. We'll review each.

Cash

Most people think of cash as paper currency or bank balances. In investing, cash can also mean cash alternatives – investments that are considered relatively low-risk and can generally be converted to cash quickly. Examples of cash alternatives include money market funds, certificates of deposit, U.S. Treasury bills, commercial paper, bankers' acceptances, repurchase agreements, etc. Because of their conservative nature, cash alternatives typically involve the least risk. However, there's a trade-off for their relative safety; their potential return is not as high as investments that involve more risk.

The role of cash in your portfolio | Cash alternatives can be useful in many ways. First, they can provide relative stability. While cash alternatives can't totally protect you from a loss, they are generally considered much safer than other asset classes like bonds or stocks. Also, they can provide income on balances that might otherwise be idle, or serve as a source to pay bills or make purchases. 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.

Bonds

When you buy a bond, you're basically buying an IOU. Bonds are essentially loans to a corporation or government entity. The borrower (the bond issuer) typically promises to pay the lender (the 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 amount or face value) must be repaid.

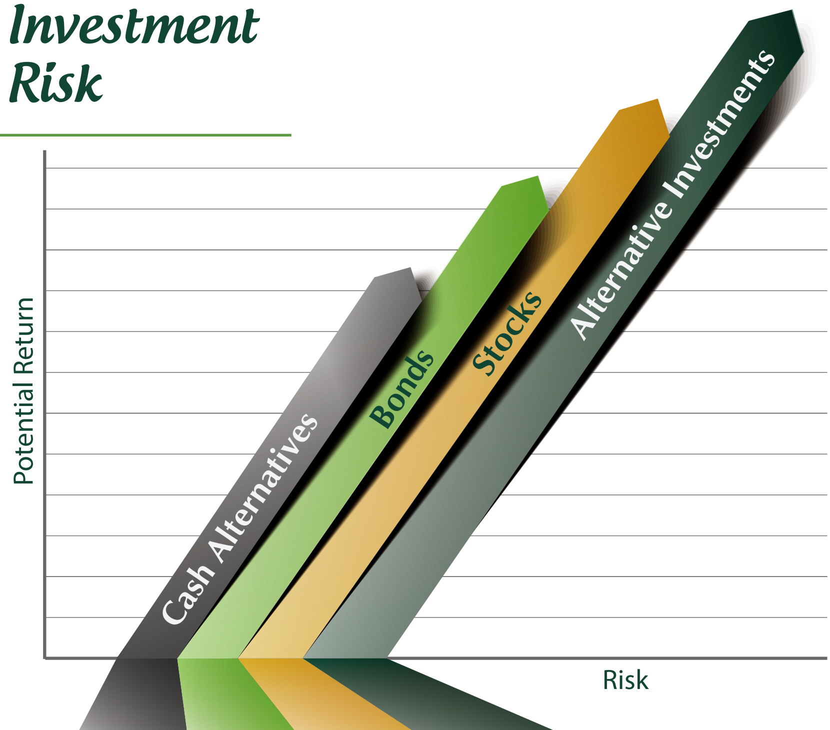
A bond typically pays a stated interest rate called the coupon. Most bonds pay interest on a fixed schedule, usually quarterly or semi-annually, although some pay all interest at maturity along with the principal.

There are two ways that you can profit from owning bonds:

1. From the interest that bonds pay;
2. 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're also very sensitive to changes in interest rates. If you sell a bond before the 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.

Investment Risk



The role of bonds in your portfolio | One reason investors choose bonds is for their steady, predictable stream of income from interest payments. For this reason, bonds have traditionally been important for retirees. Although they are not risk-free (for example, a bond issuer could default on an interest payment or even fail to repay the principal), bonds are generally considered less risky than stocks, because a corporation must pay interest to bondholders before it pays dividends to the shareholders. If the company declares bankruptcy or dissolves, bondholders are first in line to be compensated.

The bond market often behaves very differently from stocks. For example, when stocks prices are down, investors often prefer bonds because of their relative stability and interest payments. When interest rates are high, investors may 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.

Bonds come with varying maturities and can be classified as either investment grade or high-yield (junk) debt. Also, some bonds are exempt from federal or state and local income tax. This can be appealing to investors in high tax brackets.

Stocks

When you buy a company's stock, you're purchasing a share of ownership in that business. You become one of the company's owners/stockholders/shareholders. Your percentage of ownership in the company also represents your share of the risks taken and profits generated.

If you purchase stock, you can make money in one of two ways:

1. 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.
2. If the value of the stock rises, you may be able to sell your stock for more than you paid for it. Of course, you could lose money if the value of the stock has declined.

The role of stocks in your portfolio | Stocks have historically had greater long-term total returns than cash equivalents or bonds. However, that potential for greater returns comes with the greater risk of volatility and potential for loss. Because of that volatility, stock investments may not be appropriate for money that you need to be available in the short-term.

Stocks offer enormous flexibility to construct a portfolio that is tailored to your needs. There are many different types of stocks (domestic, foreign, growth, value, large-cap, mid-cap, small-cap micro-cap, etc.), 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. Income stocks are also popular with many investors because of their higher-than-average dividend payments.

With stocks, it is 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.

Alternative Investments

Alternative investments are all investments other than cash alternatives, bonds or stocks. The term is a relatively loose one and may include financial assets such as commodities, private equity, distressed securities, hedge funds, funds of hedge funds, venture capital and financial derivatives. However, in its strictest terms, alternatives might also include such tangible assets as precious metals, art, real estate, wine, antiques, coins, stamps, etc.

The role of alternative investments in your portfolio | For decades, it was widely accepted that cash alternatives, bonds and stocks were the only asset classes needed in most investment portfolios. After all, cash alternatives provided stability. Bonds and stocks moved in opposite directions. When the prices of bonds went down, the prices of stocks went up – and vice versa. Risk could be balanced with a proper combination of all three asset classes.

Then came the Recession of 2007 – 2009! Cash alternatives did, in fact, provide stability. But at the cost of virtually zero income. At the same time, the prices of stocks and bonds declined together! It was – literally – the perfect storm in the investment world. The old rules went out the window.

With the knowledge that if it could happen once, it would undoubtedly happen again, professional money managers began looking for new ways to minimize the risk in their investment portfolios. They discovered that alternative investments – if properly chosen and in the proper percentages – could not only reduce the volatility in a portfolio, they could also potentially boost returns in times of exceptional market stress.

The largest issue with alternative investments in a portfolio is their complexity. Determining which alternative investments provide the correct combination of liquidity and non-correlation with the other asset classes is *strictly* a job for professionals.

What's your asset allocation?

■ The combination of investments you choose can be as important as the individual securities. The mix of various asset classes such as cash equivalents, bonds, stocks and alternative investments account for most of the ups and downs of a portfolio's returns. The balance between the potential for growth, income and stability is called your "asset allocation".

Customizing your Portfolio

Ideally, you should strive for an overall combination of investments that minimizes the risk you are trying to achieve for 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.

Even within an asset class, you need to consider how your money is 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 countries and 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. There are also a wide variety of alternative investments available, but make absolutely sure you understand their liquidity (or lack thereof), the risks involved and how they fit into your portfolio.

Your asset allocation 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.

Monitoring your Portfolio

Even if you've initially chosen the "perfect" asset allocation for your needs, market forces may quickly begin to undermine 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 not be able to reach your financial goals. The same is true for other asset classes. Changes in your personal circumstances (for example, a greater/lesser income requirement or an earlier/later retirement date than expected) will also affect your ongoing asset allocation. Do you have a strategy in place for dealing with those changes?

In addition, the fortunes of individual companies – and even government entities – change over time. Management teams come and go. Competitive forces can shift quickly and dramatically. Mutual fund strategies can change over the lifetime of a single fund. You need to have a way to monitor the individual issues in your portfolio in addition to your asset allocation strategies.

We can help

■ We are happy to review your portfolio to determine if, in our opinion, it is properly designed to meet your objectives. No cost or obligation.

Professional Money Managers

Many people feel they don't have the time or skills to properly manage their investments and prefer to use professionals. Investment professionals can be divided into two groups: *commission-based advisors* and *fee-only managers*. Commission-based advisors charge a commission to buy/sell investment securities and products. And, although there are thousands of fee-only managers in the U.S. and abroad, they can be grouped into three distinct styles.

1. Single-Style Managers are the managers who specialize in one particular style at all times. For example, there are a number of very well-known and highly-regarded managers who use only U.S. domestic stocks in their investment portfolios. Some use only foreign stocks. Still others specialize in global, fixed-income or distressed debt portfolios. There are numerous style classes. Many of these single-style managers tend to do quite well for their clients when their particular style is in favor. However, investment styles go in-and-out of favor over time. While a single style manager may do well for its clients when its style is in favor, it may also do very poorly when its style is out of favor.

2. Portfolio Strategists are the managers that tend to take large "bets" in particular securities, industries, countries or strategies. This style includes many hedge funds as well as so-called "market timers". Portfolio strategists can, theoretically, switch from 100% in stocks to 100% in cash and back again in a relatively short period of time. Or, they may make large wagers regarding corporate takeovers, reorganizations, leveraged buyouts and/or mergers. Portfolio strategists can do extremely well for their clients when their outlook or strategy is correct. On the other hand, the investment results can be disastrous if they're wrong.

3. Multi-Class Managers

These are the managers who feel it is imprudent to use the same investment style at all times (i.e., single-style managers), but also feel it is difficult to impossible to outguess the markets on a long-term basis (i.e., portfolio strategists). Multi-class managers, therefore, tend to take a more conservative, "in-between" approach. In other words, they prefer to use some combination of cash equivalents, bonds, stocks and alternative investments in their portfolios. Portfolios are customized for each individual client, depending on that client's time horizon, risk tolerance and income requirements. Multi-class managers tend to assume less risk – albeit sometimes at the cost of a lower return – than either single-style mangers or portfolio strategists.

Choosing your Money Manager

Advisors and money managers are happy to discuss the positives of their investment styles and firms, but rarely want to reveal the negatives. This is your money. You can't be too careful. *Do your homework!* Here are some questions to ask a prospective money manager.

- How long has the person been in the investment industry and in what capacity?
- Does the person or firm have a history of regulatory complaints or lawsuits?
- Do the investment returns being quoted seem suspiciously high? (If it sounds too good to be true, it probably is.)
- How is this person compensated? Is he/she a fiduciary?
- Does the advisor/manager have professional designations? What do they mean?
- Have all costs been fully explained?
- Who actually holds your money?
- How liquid are the investments being recommended?
- How quickly/slowly will your portfolio be implemented – and why?
- What is the communication process between you and the advisor/manager?
- How often will you be provided with statements on your account? How easy are these statements to understand?
- Can you view your account on-line?
- How difficult will it be to close your account if you're dissatisfied?
- Is the advisor/manager annoyed that you're asking so many questions?

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