Building a portfolio

By Sheyna Steiner • Bankrate.com

Courting lady luck is a risky proposition in the business of investing. Picking stocks and timing the market is hard, but developing a solid investment strategy is easy when you approach it as a science.

"Building a portfolio is not an art, it's engineering," says Kirk Kinder, CFP and owner of Picket Fence Financial in Bel Air, Md. Once you know the basic asset classes you should invest in and how much of your funds should be allocated to each, picking the right investment becomes the final step.

"Asset allocation will actually drive about 94 percent of the total return in your portfolio. That's been documented in a number of different places. That's why you need the right asset mix within the portfolio," says Kevin Brosious, CPA, CFP and president of Wealth Management Inc., in Allentown, Pa.

Minimizing the fear factor

Determining how to fold different asset classes into your strategy begins with your investment time horizon. A person retiring in two years will have a more conservative investing philosophy than a 25-year-old who's launching a career. The longer the timeline, the more aggressive investments can be, as long as the investor can emotionally weather the peaks and valleys of the market.

Risk tolerance measures the likelihood that you will spend long, sleepless nights crying over the inevitable dips in your portfolio, and it is a second factor in determining how much money should go into each investment class.

"The emotional investor gets nervous about the market and gets out and they never see the appreciation on the way back up," says Mike Flower, managing partner in Financial Principles LLC, in Fairfield, N.J. "If we balance it out properly for that person, they're not going to have those times where they get forced out by their emotions."

"Risk profiles show me whether a person is willing to accept risk, is willing to accept a lot of risk or if they are risk-averse and want a very conservative portfolio," says Brosious, an adjunct professor of investments and other business courses at Penn State and DeSales University.

However, Brosious would like to see those with a long investment time horizon develop a thick hide with which to weather market volatility. "I tell my younger clients, you are going to be rewarded for assuming this short-term volatility by being more aggressive. In the long-term the market has, over time, returned 10 (percent) or 11 percent. That's the historical return. In the short-term, don't even look at your portfolio," he says.

Are you a nervous Nellie or trembling Tom?

Take this quiz to determine your own risk tolerance.

Most experts shy away from using rules of thumb as far as how portfolios should be

divided, but a "typical" moderately conservative portfolio might have a 60 percent allocation to equities and a 40 percent allocation to fixed-income investments. A more aggressive portfolio would apportion more money to equities, whereas a more conservative one would have a higher weighting in bonds.

A smoother ride

Steadier returns over time come from diversification within both hemispheres of the portfolio. Real diversification requires using assets that move in different or varying patterns to one another, says Kinder. "What you want to do when you build a portfolio is look for assets that have no or very little correlation to one another -- or things that zig while others are zagging."

In an ideal world, asset classes would move in opposite directions, but that will never exist, says Brosious. The best you can do is spread out investments into many different segments that have little to do with one another.

"A truly diversified portfolio contains mutual funds with large-cap U.S. stocks, U.S. small-cap stocks along with small-cap international stocks, emerging markets stocks, real estate investment trusts and even commodities such as oil, gold, industrial metals, agriculture and livestock. Even with bonds, investors need Treasury (inflation-protected) bonds along with international bonds to complement the usual medium-term Treasury and corporate bonds," says Kinder.

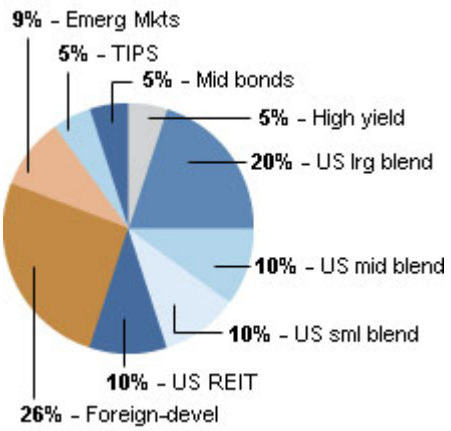
"When you add these things together you're going to get a smoother ride, as well as higher returns," he says.

Once your investment pie is meted out into individual slices and money is poured into investments, sticking within the planned proportions becomes the maintenance work. Kinder recommends rebalancing accounts at the end of every year. To bring the percentages back into line with the original plan, "you sell a portion of the assets that did well during the year and buy more of the assets that did poorly so you're always going to have a systematic process where you sell high and buy low."

Asset allocation strategies

Aggressive portfolio

An aggressive portfolio is most appropriate for younger investors or those with a long time horizon. It's geared for growth and should include a number of different asset classes, as shown, to improve performance and reduce volatility. Investors willing to assume a high level of risk have been rewarded, historically, with annual returns of between 9.5 percent and 10.5 percent. Of course, past performance is no guarantee of future returns.

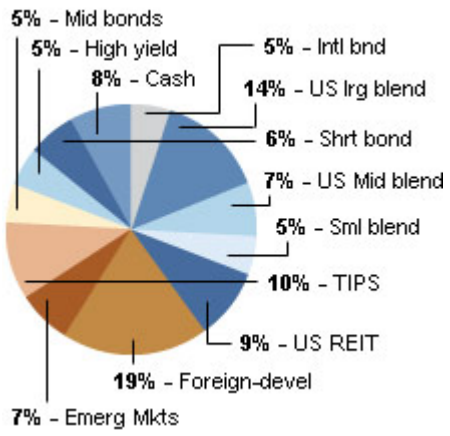


Source: Bankrate.com

Courtesy of Kevin Brosious, CPA, CFP and president of Wealth Management

Moderate growth portfolio

This portfolio is most appropriate for investors who are approaching retirement. Most people prefer to dial back on exposure to equities as the investment window narrows. With less time to recover from market dips, keeping a larger percentage of money protected from volatility makes sense, as does keeping a larger reserve of cash equivalents for distributions. However, the portfolio still has a sizable equity component because a young retiree needs the portfolio to last 30-plus years. Historical returns have averaged between 8.5 percent and 9.5 percent.



Source: Bankrate.com

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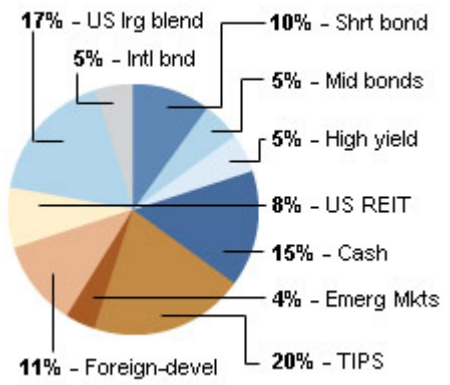
Moderately conservative portfolio

This structure is usually most appropriate for retirees who want more stability of principal within their portfolio. This allocation gives an investor a moderate exposure to the stock market for some growth but fixed income makes up the majority of the holdings. Again, in anticipation of distributions or withdrawals, a large portion may be held in cash equivalents or short-term bonds. Historical returns have averaged between 7.5 percent and 8.5 percent.



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