The Rules of Engagement

The key to a successful investment portfolio is the way you put it together.

The amount you invest and the investments you select are key factors in determining whether you're able to meet your financial goals in the timeframe you've set. It's important to choose securities that you think will increase in value or provide income. But, it's just as important to select investments that will interact well with the others you already own.

Putting a portfolio together doesn't mean randomly buying a stock here and a mutual fund there. If you don't follow a strategy, you could end up taking on more—or less—risk than you intend. The good news is that there are tested strategies you can use as you make your choices.

ASSET ALLOCATION

Asset allocation, which means spreading your investment dollars across the major asset classes, is a strategy that's essential to effective investing. It works because not all investments react in the same way to changing market conditions.

Stocks and bonds, for instance, are **negatively correlated**. When stocks are flourishing, bonds typically falter, and when stocks are flagging, bonds typically do well.

If you allocate a percentage of your portfolio to each of the major asset classes, you can help protect your principal and still have the potential for gains throughout the market cycle.

PUTTING STRATEGY INTO PRACTICE

There isn't a right or wrong way to allocate your assets. But the way you do it should always be based on the amount of time you have to invest to meet your goals and how much risk you can tolerate without selling in a panic.

If you're investing for the long term, you generally have the time to take more risk. So you might select a more **aggressive** allocation and concentrate your portfolio in stocks or stock mutual funds.

If you're closer to reaching a financial milestone, or if several people depend on you financially, you might prefer a more **conservative** allocation. This might mean putting an emphasis on government bonds and cash equivalent investments to help preserve capital.

Many investors use a **moderate** allocation, striving to achieve a balance between what would be too much risk or too much safety to suit their goals.

INTEREST RATE

INFLATION

DIVERSIFICATION

DOLLAR COST AVERAGING

DIVERSIFICATION

Diversification is also essential. This strategy involves selecting a variety of individual investments, mutual funds, or exchange traded funds (ETFs) within each asset class. The reason is, as you'll discover, that some investments are successful and others, which seemed to have similar potential, are not—often for reasons no one could predict.

If you invest in a variety of stocks or bonds, you'll help protect your portfolio from losses from any one investment, expand the potential for a strong overall return, and spread out your risk.

GO SOLO OR IN A POOL?

Mutual funds or ETFs can simplify the diversification process for all investors, and new investors in particular. That's because each fund is already diversified since it holds a number of individual investments chosen from a particular segment of the investment market.

In choosing these pooled investments, though, you should keep in mind that funds with narrowly focused objectives, such as a sector fund that invests in one slice of the economy, are less diversified than funds that invest in a broader cross section. You can research how a fund invests by checking the fact sheet provided on the fund company's website or reading its prospectus.

BONDS

STOCKS

MUTUAL FUNDS

ASSET ALLOCATION

AS TIMES CHANGE

As you grow older, or meet some goals and develop others, you may need to **reallocate**, or modify your asset allocation, to better suit your situation. For instance, as you near retirement, you may move out of higher-risk stock investments into more stable options, like bonds, to protect the wealth you've accumulated.

You do want to be careful, though, that if you buy several mutual funds to diversify your portfolio that each is invested differently. Owning two funds that invest in many of the same securities won't help you get the diversity you seek.

DOLLAR COST AVERAGING

Dollar cost averaging is another strategy that can help you build your investment account. To use this approach, you add a fixed amount of money on a regular schedule to a mutual fund or dividend reinvestment plan (DRIP).

This means that you'll be buying more shares when prices are low, and fewer shares when prices are high. If you invest on a regular basis, as the price goes up and down, the average price you pay will be lower than the average price per share. But it won't work if you stop buying when prices drop.

Dollar cost averaging will help you build your long-term portfolio, but it won't guarantee you'll make a profit, or that your investments won't lose value.

ALIKE OR DIFFERENT?

Correlation describes the extent to which different investments respond to changing market conditions. Positively correlated assets tend to react similarly, and negatively correlated assets usually move in opposite directions.