Suits Me!

Investment Selection Factors

Preparing to Make Sound Investment Decisions

Look Before You Leap

You've always been interested in the stock market. Recently, your grandfather gave you $1,000 to invest—any way you want! You are so excited that you can hardly contain yourself. Where should you invest first? Then, your grandpa gives you an important piece of advice—slow down and *think* before you make any big decisions.

The stock market can seem like a big, bad place, and investing is a tricky business. But that doesn't mean you shouldn't do it—it just means you need to do your homework before jumping in and investing. Every successful investor realizes the importance of thorough research. You wouldn't choose a college without finding out important information about its academics, its social life, and its tuition costs, would you? And would you buy a car without checking its engine, its mileage, and its accident history? Certainly not! And you shouldn't put your money into any investment without getting all the facts, either. Some of the facts you'll need to learn come from researching the investment, and some of the facts come from taking a close look at *yourself*.

Objectives:

Describe factors in selecting investments.

Discuss the effect of personal factors in selecting investments.

Deciding Among Different Types of Investments

As you know, there are many different types of securities from which to choose. Stocks, bonds, mutual funds, and more—how will you decide? It's important to have a thorough knowledge of each type of security, so you can better assess how it may fit your needs and goals. For example, stocks are generally considered to be a somewhat risky type of investment. If you're at a point in your life when you need to avoid risk as much as possible, you might choose to invest more of your money in CDs or bonds, which are considered "safer" than stocks.

Important Business Factors

When you choose to invest in stock, there are many factors about each individual company you're considering that deserve your attention. Take a look at this list of important questions to ask of each company:

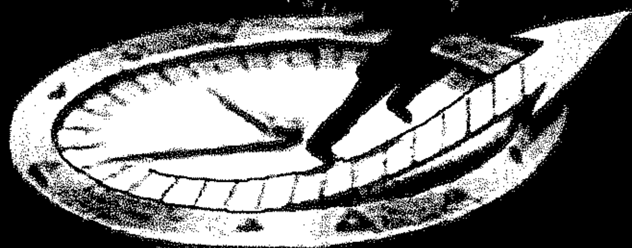
- What is the current market value of this company's stock?
- How has this company's stock performed in the past?
- Has this company introduced any new products to its mix lately?
- How does this company stack up to its competition?
- Is this company under effective management?
- What is going on in this company's industry or sector?

These are just a few of the questions you'll want to find answers to when researching a company. Studying all aspects of a company in an effort to understand its intrinsic value is known as **fundamental analysis**. You'll learn more about fundamental analysis later.

Looking Inward

Before you can choose an investment that's right for you, you have to take a close look at yourself. What is your goal for investing the money? A college education? A house? Retirement? How much can you afford to invest right now? And how long will you keep the money invested? The answers to these and other questions can help you determine what investments are right for you.

When the Time Is Right



Before you begin your self-analysis, make sure you're truly ready to invest. How do you know when you're ready to start investing? You've been told time and time again that the sooner you do it, the better. That's true; however, there are a few necessities to take care of first. Make sure you have adequate insurance coverage as well as a few months' worth of emergency savings tucked away before you start investing. It's also important to have any debt paid off, especially credit card debt or any other high-interest loans.

Risk Tolerance

Your attitude toward risk greatly influences the types of investments you make. As you know, a general rule about investment risk says that the greater risk you are willing to take, the greater the potential return on your investment. On the flip side, however, you also face potentially greater losses.

Risk tolerance is a measure of how much risk you're willing to accept in exchange for potentially higher returns. Now, you may think, "I'm okay with uncertainty! Bring on the risk!" Or, you may think, "I hate the unknown! I don't want to take any risks with my money!" But determining your risk tolerance is based on more than just your feelings. You need to take a serious look at your future as well.

The younger you are, or the longer you have until you need the return from your investment, the more investment risk you are able to tolerate. That's simply because you have more time to recover if your investment loses value over the short term. Let's say that Daisy, a 17-year-old, chooses the same investment as her aunt Susan, who is 60. If the investment loses value, they'll both lose money, but Daisy has about 40 more years before retirement than her aunt does to recover from the loss. When you have more time to invest, it doesn't matter as much if the value of your portfolio rises and falls from day to day, from month to month, or even from year to year.

Based on your risk tolerance, you can classify yourself as an "aggressive" investor (high risk tolerance), a "conservative" investor (low risk tolerance), or perhaps a "moderate" investor (moderate risk tolerance). "Aggressive" investing is best suited for long-term goals, whereas "conservative" investing is the smart move in the short term.

Don't be afraid to take risks—just be smart about it. Sometimes, it's okay to take a big risk. Just don't do it with a *lot* of your hard-earned money, and make sure you have sufficient time to recover if you suffer a loss. One rule of thumb says to take risks only with money you can afford to lose—in other words, the "extra" money you don't need for living expenses.

How Strong Is Your Stomach?

You may not really know exactly how you feel about taking risks in investing. There are several online quizzes you can take that may help you discover more about your attitude. Check out http://moneycentral.msn.com/investor/calcs/n_riskq/main.asp or http://www.rce.rutgers.edu/money/riskquiz/. You can also learn more about your risk tolerance by paying close attention to your mock portfolio. Making investment decisions without having any real money at stake can be a great tool for learning more about your "stomach" for risk taking.

Age and Life Phase

How old you are and where you are in life greatly affect your choice of investments. You already know about the magic of compounding. Getting an early start on investing means that you can build up a million dollars or more for your retirement, all without having to put away large chunks of money at any one time.

So, let's say you've spent the past 50 years carefully investing for retirement. You've taken some risks with your investments and ridden out the ups and downs of the stock market to achieve the returns you desired. Now that you're getting ready to retire, you want to protect the money you've accumulated at all costs. That means you will want to avoid risk. If your money is invested in higher-risk securities, you'll move it to lower-risk ones at this time.

Your current amount of income also means a great deal when it comes to choosing investments. A wealthy executive in his or her early forties will have a lot more money to invest than a young entrepreneur fresh out of college. To the executive, $10,000 might not seem like a lot to invest in a promising stock, but to the entrepreneur, that might be twice what's sitting in the bank account.

Marriage and children change things as well. As a single person, you need to worry only about providing for yourself. When you start a family, however, your needs and goals are revised. Owning a home and establishing college savings accounts may move into the forefront as your top priorities.

Time Horizon

The length of time you have to save for your goals also influences the types of investments you choose. As you already know, the longer you have, the more risk you can accept. Let's take a look at the different "time horizon" categories:

- **Short-term time horizon.** If you are investing for a short-term time horizon, you're going to need your money in less than five years. (Some sources categorize a short-term time horizon as only two or three years.) Since you don't have a lot of time to recover from losses, you'll want to limit your risk as much as possible and keep your money safe. This is the time to be a "conservative" investor. You might face a short-term time horizon when you are close to retirement, or when you want to purchase a home or a new car soon, or if your child is getting ready to go to college within the next few years.
- **Intermediate-term time horizon.** Intermediate-term time horizon investing means you'll need your money between 5 and 15 years from now. (Some sources define an intermediate-term time horizon as between 3 and 10 years.) With intermediate-term investing, it's all about finding balance. You need to choose investments that carry enough risk for potential growth, but you still want to protect your assets. This is the time to be a "moderate" investor.
- **Long-term time horizon.** Investing for a long-term time horizon means you won't need your money for at least 10–15 years and possibly as long as 40–50 years. Long-term investing isn't just for retirement, though—it can be for a newborn child's college fund, a summer home, or a boat, etc. When you have more time to keep your money invested, you can afford to invest in some higher risk securities to maximize potential returns.

Need for Liquidity

As you know, **liquidity** refers to the ease with which you can convert your investment dollars back into cash. Your need for liquidity affects the types of investments you'll choose as well. Simply put, you'll need to make sure that the money you may need access to (such as your emergency savings) is highly liquid. You don't want to have to wait 30 days or more for your money, and you might have to if you're withdrawing it from certain types of investments. Savings accounts, money market accounts, and stocks are considered liquid; however, CDs, bonds, and retirement accounts are more difficult to retrieve money from. Never put money you may need soon into an investment that has a penalty for early withdrawals.

Don't Rush Me!

Whatever you do, don't rush into any investment decision. It never pays to act hastily. Always take time to carefully research an investment and find answers to all the important questions.

Avoiding Fees

No matter how much money you have to invest, you'll want to avoid brokerage and commission fees as much as possible. If you invest in mutual funds, you can choose "no-load" funds and purchase them directly from the company, avoiding the commission fees.

Another way to avoid fees is to use direct stock purchases (**DSPs**) or dividend reinvestment plans (**DRIPs**). With a DSP, you make an initial stock purchase directly from the company, bypassing the brokerage house and its associated fees. DRIPs reinvest company dividends into additional shares of stock, rather than paying out the dividends in cash. With a DRIP, you have the opportunity to accumulate more and more shares of a company's stock, without having to pay the standard brokerage fees for purchasing them. Also, since you don't actually receive the dividends in cash, you avoid paying taxes, another important factor to consider when choosing investments.

Minimizing Taxes

An old saying goes, "Only two things are certain—death and taxes." While this statement isn't particularly pleasant, it's definitely true. Your investment income (interest, dividends, capital gains) is taxable by the government. However, there are several ways to minimize those taxes.

First of all, keep in mind that the more money you make from your investments (and also from your general income), the higher your taxes will be. "Great!" you think. "I'm still a teenager, and I don't make much money, so I don't need to worry about taxes!" Not so fast. It's never too early to start thinking about tax-minimizing retirement plans. Throughout your lifetime, your participation in one or more of these plans can greatly affect your ability to save for the future and to live the lifestyle you desire when you're finished working. Retirement might seem like light years away, but think of it like this—retirement isn't just a time when you stop working to play golf and work in the garden; it's a time when you'll enjoy financial independence. But *only* if you plan and invest wisely.

Tax-Minimizing Retirement Plans

- **Tax-deferred retirement plans.** Tax-deferred retirement plans allow you to deposit money into an investment account and hold off on paying the taxes on it until you start using the money. Let's say you decide to put $2,000 this year into your tax-deferred retirement plan. The $2,000 will be deducted from your income before taxes, lowering the amount of income you must pay taxes on. You won't be required to pay taxes on the $2,000 until you actually retire. Typically, if you withdraw money from the account before retirement, you'll be hit with high fees for doing so.
  - **401(k) plans.** Many employers offer tax-deferred retirement plans called 401(k)s. As an employee, you can contribute your pre-tax income to the account, up to a maximum limit. Sometimes, although this is becoming increasingly more rare, your employer contributes to the account as well, matching your contributions up to a certain amount. Employer-sponsored plans for nonprofit organizations are usually known as **403(b) plans**; for state and local government employees, **457 plans.**
  - **Individual Retirement Accounts (IRAs).** IRAs are tax-deferred retirement plans, usually for people who are not covered by an employer-sponsored plan. You establish an IRA yourself, and you may contribute up to a certain amount of money each year. You may also make a contribution into the account on behalf of a non-employed spouse. Tax-deferred retirement plans for self-employed people are known as **Keogh plans or SEP-IRAs**. They typically allow a greater maximum contribution than other plans.
- **Non-tax-deferred retirement plans.** Introduced in 1998, the **Roth IRA** offers an alternative way to minimize taxes while saving for retirement. The Roth IRA does not defer tax payments until after retirement; rather, your contributions are made with after-tax dollars. However, with this plan, you avoid capital gains taxes entirely, and you owe no taxes at the time you withdraw the money. Roth IRAs are ideal for people (like you!) who are in a low tax bracket now, but expect to be in a higher tax bracket later in life.

Every investor is different and has specific needs and goals. The investments that are right for your mom, your cousin, your neighbor, or your best friend may not be the right investments for *you.* Take the time to research the types of investments that are best suited for your specific needs and goals.