

Beginning Investor

A series providing guidance for new investors on how to become successful investors. See AAII.com for the other articles in this series.

What to Watch in Your Portfolio

Portfolio monitoring is often misperceived as simply watching price changes. Though wealth is created by the combination of rising prices and dividend (or interest) payments, being concerned only with performance can be detrimental to your wealth.

The goal of portfolio monitoring is to determine whether something positive or adverse has occurred to your investments. Specifically, you need to look out for news or developments that could alter the long-term attractiveness of your stocks, bonds and funds. Companies, industries and funds evolve over time, and so will your portfolio.

Here are suggestions on what to pay attention to.

Stocks

Earnings Growth: A decline in the rate of earnings growth can be a sign that business conditions have changed. The question that needs to be answered is why. Normal business and product cycles will always cause a high growth rate to slow. Growth rates can also be affected by economic and industry conditions. Particularly worrisome, however, are poor management decisions or competitive threats that curtail growth rates.

News Events: While most headlines shouldn't impact your decisions, pay close attention for news that alters your outlook. Downwardly revised earnings guidance, unexpected changes in management, scandals and questionable business strategy announcements can be reasons to sell. Also be on the lookout for news by competitors, customers or suppliers that could impact the company you own.

Valuation: When many investors believe a company's success will continue into the future, the stock's price and valuation will rise. High valuations are a sign of high optimism and lead to a greater risk that future results won't be good enough to satisfy current shareholders and traders. This is why it is important to be more cautious with highly valued stocks.

Bonds

Financial Condition: A bond is a loan, and the ability of bond's issuer to repay its debt is of prime importance. Track the financial statements, particularly cash flow from operations (found on the cash flow statement), to ensure the company is generating adequate levels of cash to meet its debt obligations.

Credit Ratings: A downgrade to a bond's issuer implies analysts believe that the risk of default has increased. A change from investment grade to junk status is particularly worrisome. A ratings upgrade is a positive event and can cause the bond to rise in price.

Funds

The following suggestions apply to mutual funds, exchange-traded funds (ETFs) and closed-end funds.

Changes in Management: The long-term performance of an actively managed fund is often dependent on a manager's skills. If a talented manager leaves, the fund's future returns should be monitored more closely. The new manager may be as talented or more so, but there is also the risk that he may not be able to replicate his predecessor's success.

Change in Objective: Occasionally a fund may change its objective. This means it may start following a different strategy or invest in different assets than it previously did. Though the fund company may announce the change, details may be buried in the annual report or prospectus. If a change is made, reevaluate the fund to make sure it still meets your investment needs.

Size: Mutual funds and ETFs run the risk of having too much or too little in assets under management (AUM), a measure of a fund's size. A fund that targets a specific industry, country or strategy may have difficulty replicating past success if it becomes too large relative to the size of its targeted investments. This may prompt a change in strategy or force the manager to invest in less attractive investments. Conversely, if a fund's assets fall significantly, it may be shut down or folded into another fund.

—Charles Rotblut, CFA, Editor, AAI Journal