PORTFOLIO STRATEGIES WORKSHOP

Getting Started: Developing an Investment Plan From Ground Level

By Maria Crawford Scott

"Start investing early" is perhaps the most common advice given to the younger generation. The benefits of starting a plan at an early age, allowing time to help savings and investment results accumulate, are fairly obvious.

But how do you start an investment plan when you are beginning at the bottom, with very little in the way of current savings? A case study offers one approach.

Starting at Ground Level

Ricky and Louisa Perez are young and starting to build a life together. They married recently, after graduating from college, and have now started their careers.

From gifts, savings from summer jobs, and frugal purchasing, Louisa and Ricky were able to set up their new household and were pleasantly surprised to find that they had a small amount of money left over—$2,500. They have decided that they would like to set this money aside and use it as a base upon which to build their savings.

The decision, though, raises a number of questions, in particular: Where should they invest the money? The couple decide that in order to answer that question, they really need some sort of investment plan.

But to develop an investment plan, they first need a goal.

Why?

An investment plan ultimately boils down to the issue of risk and return: How much risk are you willing to take on to achieve a given return? If you don't have any idea of what kind of return you need or should be seeking, it is hard to evaluate the risk/return equation. A goal does not need to be carved in stone; it merely serves as a starting point in the investment planning process, which consists of setting a goal and then evaluating how to achieve it.

Louisa and Ricky sit down and make a list of the "goals" that pop into their heads:

- They want to make a lot of money quickly.
- They want to 'beat the market.'
- They want to save enough for their retirement and other future major purchases.
- They want to earn enough so that their savings are able to grow faster than the rate of inflation.

As the couple discuss the goals on the list, they decide to eliminate the first two as too undefined and not particularly practical. Louisa points out that 'making a lot of money quickly' assumes that the investment route is a short-cut to easy riches, which she knows is not the case. It also seems to imply that they should ignore the issue of risk.

What about beating the market?

Louisa complains that this is merely a comparative goal that doesn't really get them anywhere. If market rates of return are good, she points out, what difference does it make whether they 'beat' the market or simply match the market rate? A loss won't be able to meet any expenses even if they manage to beat the market in the process. And there are no awards for individuals that beat the market. Lastly, this goal relates primarily to the stock market, and Louisa points out that they need other assets in their investment plan—cash and bonds, for example.

Ricky goes to the next item on their list: saving for their retirement and other major future expenses.

Louisa concedes that this is actually a very useful goal. But as they discuss their future, they realize that they have absolutely no basis on which to judge future needs. They aren't sure what their expenses will be in the next few years, much less when they retire; they don't know if they want to buy a house, although they suspect they do; and they haven't really thought about children. "We're

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just starting out," Louisa says. "Do we really need to plan the rest of our lives just to start our savings plan?"

Ricky turns to the last goal listed: earning a real rate of return so that their savings will grow faster than the rate of inflation. At this stage in their lives, they decide that that goal probably makes the most sense for them.

The First Investment

With their goal in mind, Louisa and Ricky examine the rates of return they can reasonably expect to earn in various investment categories to have their assets grow in real terms. Balancing those possible returns against the level of risk they feel they can accept and other personal considerations, such as liquidity needs and tax exposure, allows them to first determine an allocation among the major asset classes, and then allocate further down within the asset segments.

Here's the allocation they eventually come up with:

	Percent	$ Amt
Cash	10	250
Bonds	20	500
Large-cap stocks	50	1,250
Small-cap stocks	10	250
International stocks	10	250
	100	$2,500

With their investment plan set, Ricky and Louisa start to look for suitable mutual funds for each of their planned commitments. As they start examining the funds, however, they begin to see a major obstacle to implementing their plan: The funds that they have selected all have minimum initial investments of at least $2,000, much higher than the amounts they can commit to any one segment.

"Now what do we do?" they ask themselves.

Louisa and Ricky go back to the drawing board, first trying to figure out if they could have possibly overlooked any other savings. And they are amazed to discover that they have—Louisa's company has a 401(k) plan to which the employer contributes. Louisa had not paid much attention to it until now, and her vested amount is very small, since she has been working there for such a short time. Nonetheless, it currently amounts to $500, and the plan offers a large number of investment choices with no minimum initial investments.

Including this amount in their overall portfolio obviously raises the dollar amounts committed to each segment:

	Percent	$ Amt
Cash	10	300
Bonds	20	600
Large-cap stocks	50	1,500
Small-cap stocks	10	300
International stocks	10	300
	100	$3,000

More importantly, investing the 401(k) assets in one of the smaller- segments would allow them to more easily meet the minimum initial requirements for their remaining savings.

On the other hand, at this point they still can't meet the minimum initial requirements for the other segments based on this allocation.

Ricky and Louisa realize that, although they will keep this ultimate allocation in mind, they can't implement their full investment program at once, but will have to build toward it.

How?

First, they recognize that they need to make sure they have enough savings to meet liquidity needs—they do not want to be in the position of being forced to withdraw funds from their savings plan to meet emergencies or other cash needs. Although they already have some money in their checking account for immediate living expenses, they decide to set up a savings account in which they will invest their $300 "cash" allocation.

What about their $2,200 in remaining taxable funds?

They discuss two alternatives:

• *The use of balanced or asset allocation funds:* The first option they ponder is to invest all of their savings in a balanced or asset allocation fund that divides its assets in a relatively set range between stocks, bonds, and cash. They can make additional investments to the fund until they have saved enough to begin investing in other funds that focus on more specific market segments.

The advantage to this approach is that they have immediate diversification in the major asset categories with one minimum initial investment. The disadvantage is that they have no control over the allocation, and Louise and Ricky may want a greater commitment to stocks than is offered by many of these kinds of funds. In addition, as they build up their savings, they eventually will outgrow the balanced or asset allocation fund and switch to several different funds, at which time they will have to pay taxes on any gains.

As Louisa and Ricky look into these kinds of funds, they also discover that the names can be confusing, and they are going to have to make sure they understand the fund's investment strategy if this is the route they choose. Some funds that call themselves "asset allocation funds" try to time the various market segments by changing their asset mix depending on their outlook; these are funds that Louisa and Ricky will avoid, and will instead seek funds that have a relatively fixed allocation to the major market segments.

• *The use of an index fund as a core*: The other option they ponder is investing their assets in a broad-based stock index fund. The index fund would serve as the core of their overall portfolio, and it will consist of the most conservative portion of their stock market commitment, composed primarily of large-capitalization stocks. When they are able to add on, they can add on the more aggressive segments—international or small-cap stocks, for instance.

The advantage to this approach is that it minimizes the tax consequences for their taxable savings—instead of selling fund shares that no longer meet their needs, they will simply buy, hold, and add. In addition, the use of an index fund would give them exposure to the stock market but take out "manager" risk—the risk that the active investment decisions made by a portfolio manager will cause the fund to deviate substantially from the overall market. This approach is appealing to Louisa and Ricky, who are investment newcomers and somewhat daunted by mutual fund selection.

The disadvantage to this approach is that they will be fully exposed to the stock market, although since they are just starting out they recognize that they can afford to take on substantial stock market risk. Ricky and Louisa recognize that before they choose this option, they are going to have to carefully reassess their risk tolerance.

In addition, since the fund will be a core stock holding, they will have to select a fund that targets a large-cap stock market index, such as the S&P 500 or a broader index that still encompasses large-cap stocks but includes smaller-cap stocks—for instance, the Wilshire 5000. Investing in a fund that covers this latter index has the advantage of including one of their other market segments—small-cap stocks—although they have no control over the amount committed to that segment.

The Ultimate Decision

At long last, Louisa and Ricky make the decision to invest their $2,200 in an index fund that invests in the Wilshire 5000 index.

Using this approach, they are able to come relatively close to their original investment plan. First, they can invest Louisa's 401(k) plan assets in a fixed-income fund, which will help balance the all-stock commitment of their taxable savings. Second, the broad-based fund includes smaller-company stocks within its purview.

As they build their savings, they will eventually be able to add more aggressive stock investments missing from their current allocation, most likely an international fund. And they can use Louisa's 401(k) plan and other employer-sponsored plans in which they may participate to help meet their target allocations in market segments in which they do not have enough taxable savings to meet funds' minimum initial investment requirements.

Final Thoughts

Here are some thoughts to keep in mind if you, too, are starting to build an investment plan with very few current savings:

- Try to start with a useful and practical goal that can eventually be boiled down into an actual desired rate of return figure that is reasonable and can be achieved at an acceptable level of risk. For younger investors with uncertain plans and unlimited opportunity, it isn't necessary to plan out your entire life; a goal of simply growing your savings is sufficient at this stage in life.
- Based on your goal, try to develop an overall investment strategy that you will aim for, even if you can't implement the strategy immediately.
- Build and maintain a cash reserve to meet short-term emergencies and other liquidity needs
- Resist the temptation to use minimum initial investment requirements as the main criteria for selecting funds; instead, select funds that meet your investment strategy, and use the minimum initial investment as a secondary consideration.
- Select a balanced fund (for less aggressive investors) or a broad-based index fund (for more aggressive investors) for your initial investment, and build from there.
- Don't agonize over small deviations from your overall allocation plan. For instance, if a minimum investment in a small stock fund results in a 13% commitment to small stocks rather than 10%, go ahead and make the commitment. Your overall allocation goal is only a rough guide.