A BATTLE STRATEGY FOR YOUR FINANCIAL FUTURE

by Thomas Collimore, CFA, Director, Investor Education

The movie *300* is a depiction of the battle of Thermopylae, where three hundred Spartans and their allies held off a superior number of opponents for three days. The Spartans were great fighters, but it was the outstanding idea of Spartan King Leonidas to do battle at the "Hot Gates," a narrow pass between a cliff and the ocean, that limited the advance of the opposing army.

The lesson for investors is straightforward: **A sound strategy can make all the difference.** There can be a number of misguided reasons to act quickly: A friend might have a "hot" stock tip, you might be afraid of "missing out on the action," or you might panic following a setback. Resist the temptation to make investment decisions without a clear strategy.

Building wealth is a cumulative process, and the best way to build wealth is to establish and follow a disciplined investment plan. A tool many investors use is the investment policy statement (IPS), a document that defines your investment goals and risk tolerance. A good IPS will vary depending on the needs of the investor, but it should do the following:

- Spell out the overall objective of the portfolio as well as the investor's risk tolerance and any other relevant considerations, including ethical investment constraints.
- Indicate how risk will be measured, what the portfolio benchmarks will be, and how often the portfolio will be rebalanced.
- Set out who is responsible for investment policy, particularly as applies to the allocation of assets and ongoing portfolio management.

An IPS is typically created in collaboration with an adviser and addresses the responsibilities of everyone involved in managing the investments, but you can get started on your own. Begin by taking a personal financial inventory to determine how your money is currently invested and how much free capital you have to invest.

- First, create a personal balance sheet to determine your net worth and review how your capital is currently invested. For example, your largest investment could be your home or your IRA.
- Next, formulate an income statement to help you calculate the amount of capital you have available for investments.

Your personal balance sheet is an inventory of all your assets and liabilities at a particular point in time. Assets are anything of value, such as bank accounts, stocks, bonds, a car, or a home. Liabilities are your debts or your obligations to others. The difference between your assets and liabilities is your net worth.

JOHN A. SMITH
Personal Balance Sheet
December 31, 2009

ASSETS			LIABILITIES		
Savings Account	$	5,000	Mortgage	$	180,000
Checking Account	$	250	Student Loans	$	8,000
Money Market Fund	$	10,000	HELOC	$	2,500
Home	$	250,000		$	190,500
IRA	$	7,000			
Total Assets	$	272,250	NET WORTH	$	81,750

An income statement will help you evaluate your income and expenses and determine how much free capital you have. Free capital is the amount of money you don't need for current living expenses or other immediate obligations. Many advisers recommend retaining at least three months of living expenses in cash for emergencies. Depending on your circumstances (the liquidity of your other assets, the time it will take you to find a new job, etc.), the

JOHN A. SMITH
Personal Income Statement
December 31, 2009

ANNUAL INCOME			ANNUAL EXPENSES		
Salary	$	80,000	Mortgage	$	15,180
Interest	$	150	Utilities	$	1,440
Dividends	$	20	Auto Lease	$	180
Total Income	$	80,170	Property Taxes	$	3,125
			Income Taxes	$	16,000
			Medical Insurance	$	4,200
			Property Insurance	$	1,800
			Food	$	3,600
			Entertainment	$	4,800
			Clothing	$	2,500
			Total Expenses	$	52,825
			FREE CAPITAL	$	27,345
			EMERGENCY RESERVE	$	13,206
			INVESTMENT CAPITAL	$	14,139

equivalent of three months' expenses may or may not be adequate. The balance can be put to use as investment capital devoted to riskier, long-term investments, such as stocks.

Next, begin to form your investment program. Identify your goals: Do you want to have a down payment for a house? Establish a college fund for your children? Or save for retirement? This is an important step in the process because it will influence your risk tolerance levels. The amount of risk you're willing to accept depends on, among other things, your life stage, time horizon, return requirements, and emotional tolerance for loss. Generally speaking, the longer your investment horizon, the more risk you can tolerate.

An IPS should specify your overall portfolio performance objective. Your investment goal, asset allocation, and risk tolerance are important influences on your portfolio's overall expected return because each asset class has a different level of risk and return and will behave differently over time. Make sure you recognize the difference between real and nominal returns. A nominal return is simply the stated return on an investment. If you invest $100 and get $102 in a year, that is a 2% nominal return. A real return is the return on an investment adjusted for inflation. A 2% nominal return in a 2% inflationary environment will leave you exactly where you started in terms of purchasing power. Your goal should include maintaining purchasing power, or your ability to pay for your future.

One way you can mitigate risk is by diversifying your portfolio. Diversification is a risk management technique that takes advantage of the idea that the values of different securities rise and fall at different times. The positive performance of some investments may offset the negative performance of others. One approach to portfolio diversification includes an appropriate asset allocation. Stocks are one asset class; bonds, real estate, and cash are others. In the earlier example, Mr. Smith's largest asset by far is his home, which represents more than 90% of his total assets. Because Mr. Smith already has a significant amount of exposure to real estate, it would probably make sense for him to focus his investment dollars, at least in the near term, on other types of assets, such as stocks, bonds, and mutual funds.

Compare your portfolio's performance going forward with a benchmark. You can track the return against an asset allocation index (standardandpoors.com publishes indices that are available without charge, registration required) or create your own benchmark by blending the return of market indices. Even if your portfolio is achieving its target, you should know how the investments you choose are performing against the overall market. The benchmark you select or create should be memorialized on your IPS and updated each time you change your asset allocation or re-balance your portfolio.

If you've chosen to work with a financial professional, use an IPS to memorialize the responsibilities assigned to everyone involved in the investment process. Doing so will ensure that everyone is on the same page regarding investment style, account turnover, reporting requirements, and communication channels. Defining roles with an adviser at the beginning of the process may also help you clarify your goals and avoid conflict in the future.

The benefit of having a coherent document that outlines an investment plan is clear: It's easiest to evaluate your manner of investing if you take the time to spell it out. The important thing to remember is that regardless of whether you plan or not, you are following an investment strategy.

When you choose to lay out an investment strategy, recall that the Spartans were able to pick the ideal place to fight chiefly because they knew the local terrain. Designations such as the CFA® charter help investors identify experienced guides to help with the investment process. For help finding an adviser with the CFA designation, visit trustCFA.org. For more information about investment policy statements, please refer to *Elements of an Investment Policy Statement for Individual Investors*, a CFA Institute publication.

Frances Melville and William Ortel contributed to this article.

For more information, please consult http://www.cfainstitute.org/about/investor/