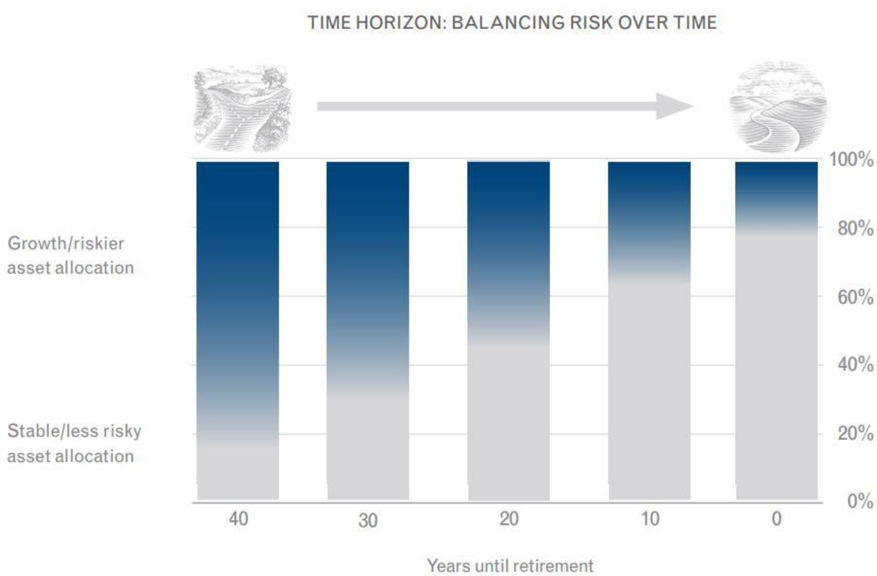
Five fundamental concepts every investor should know

A financial plan is built on a few fundamental concepts...here are some to keep in mind.

When it comes to money matters, everyone should have a basic idea of how they're money is working toward their future goals. And that means knowing and understanding the fundamental concepts behind financial planning and investing. Here are five easy, yet important ideas that make up a well-designed financial plan. Keep these in mind as you and your financial advisor work together to build a solid financial foundation.

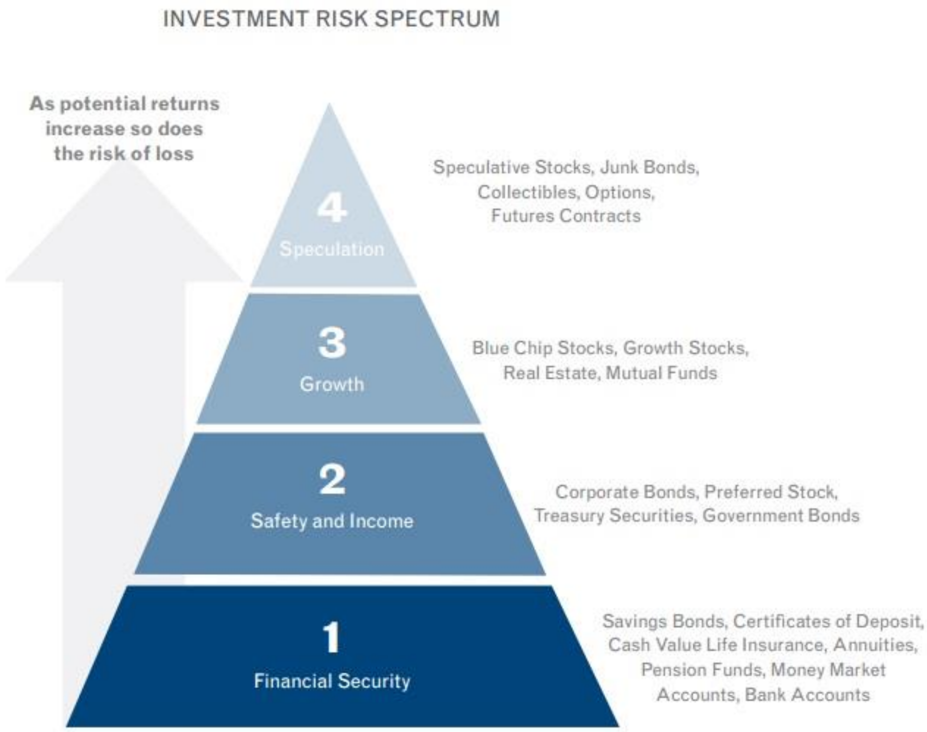
Concept #1: Time horizon

As a general rule, the longer time you have to invest, the greater the risk exposure you may wish to undertake. Someone who is just starting out in a career can typically assume greater investment risk as a trade-off for potentially higher returns given the longer time frame available to offset potential losses. On the other hand, for someone nearing the end of a career and approaching retirement, less risky investments are often preferred. This person may have more savings accumulated and be more interested in preserving assets than growing them, due to less time to recover from possible losses.



Concept #2: The risk planning spectrum

Generally, the rule of thumb is that the greater the risk assumed, the greater the potential return on that investment. One of the best ways to potentially lower a portfolio's risk and still potentially earn attractive returns is by diversifying investments across a spectrum of asset classes with various levels of risk.



Concept #3: Diversification

Diversifying your assets across sectors, strategies and types of investments helps mitigate the risks you face. Every type of investment responds differently to changes in the markets. So if you own a variety of assets, a decline in one can potentially be balanced by lower volatility or increased value in another. Bear in mind, however, that diversification does not ensure a profit or protect against a loss.

Concept #4: Asset allocation

Asset allocation is a long-term strategy designed to help investors achieve their financial goals without assuming undue risk. It's based on the premise that various types of investments, namely different asset classes like stocks and bonds, have different characteristics that often prompt them to respond differently to economic and financial developments. Asset allocation goes further by breaking down each category into classes, such as small-cap stocks or intermediate-term bonds. Recognize, however, that asset allocation does not ensure a profit or protect against a loss. It is important to discuss your total financial picture – including securities in other accounts, real property, collectibles and other assets – with your financial advisor when developing a financial plan. This is to ensure that your total asset allocation is appropriate to meet your objectives and tolerance for risk. Investing involves risk and you may incur a profit or loss regardless of strategy selected.

Concept #5: Tax planning

After you and your advisor settle on an asset allocation, it is important to consider whether to place assets in a taxable or tax-deferred account. After all, what you actually keep after taxes is what matters.

A taxable account, such as a stock portfolio, is where you place after-tax. A tax-deferred account, such as a 401(k) or IRA, enables you to contribute money on which you have not paid income taxes. Tax-deferred accounts enable your money to grow without the burden of annual income taxes on contributions or capital gains. Be aware, however, that you will have to pay ordinary income taxes on the money once it is withdrawn from the account. Tax-deferred accounts make sense for retirement savings because you are more likely to be retired – and in a lower income tax bracket – when you withdraw the money.

Bonus: Monitoring and rebalancing

It’s not enough to establish a financial plan based on asset allocation, risk tolerance, time horizons and diversification. You must then execute and monitor your investments, making periodic adjustments or rebalancing assets as needed to retain the desired allocation percentages designed to meet your financial goals. Market conditions can grow some assets substantially, while reducing others. It’s important to review your investment portfolio with your advisor on a regular basis to ensure it is aligned with your financial objectives. Keep in mind that rebalancing a non-retirement account could be a taxable event that may increase your tax liability.

Understanding and implementing these fundamental concepts can be crucial to achieving your financial and life goals. Educating yourself on what you own and why is not only essential during Financial Literacy month, but throughout the year and for many more to come.