Returns

Real Return

The return on your investment portfolio helps you evaluate the progress you're making toward your financial goals. For example, if your long-term projections require that you achieve an 8% annual return, you may have to reallocate your assets if your return falls below that mark over a period of time. What complicates the picture is that inflation reduces the buying power of your investment return, as well as your investment income. If the inflation rate is 3% in a year that your investment provides an 8% return, your real return, or return after correcting for inflation, is 5%. The greater your real return, the larger your account value grows.

Real return is the primary reason that emphasizing capital preservation to the exclusion of growth can leave you short financially over the long term. That's because your return on the most conservative investments rarely exceeds the rate of inflation by a full percentage point, and is frequently less. If you're earning 1.75% on an insured money market account when inflation is 2%, you have a negative real return of 0.25%.

Subtracting Taxes

Computing real return isn't the end of the line. You also have to correct for income taxes on realized gains and investment income. That's the reason that tax-deferred and tax-free accounts are such attractive ways to invest. You postpone having to subtract the tax that's due; or avoid it altogether.

Factors Affecting Return

If you invest at different times, as most people do, you also need to know what your investments' annual percent return has been to measure one performance against another. To find that figure, you divide the total return from the date of purchase by the amount you invested, to calculate the percentage return. Then you divide the percentage return by the number of years you owned the investment. If you invested $1000 three years ago, and you've earned to date $265, your annualized percent return is 8.83 ($265 ˜ $1000 = 0.2649 ˜ 3 = 0.0883). Pretty good, actually, given current rates.

When you buy and sell also affects your return. If you buy a stock just before its price jumps, the total return will be higher than if you bought after the price stabilized or before it began to drop. That's one reason your results on a mutual fund investment may be different from the total return reported for that fund in the financial press or in fund materials.

Taxes also affect return. The total return on a municipal bond may be lower than the total return on a corporate bond, but if you owe no tax on the municipal bond income, it may end up making you more spendable money.

Total Return

Return is a measure of investment gain or loss. For example, if you buy stock for $10,000 and sell it for $12,500, your return is $2,500. Or, if you buy stock for $10,000 and sell it for $9,500, your return is -$500. Of course, you don't have to sell to figure return on the investments in your portfolio. You simply subtract what you paid from their current value to get a sense of where you stand.

Long-term investors are interested in total return, which is the amount your investment increases or decreases in value, plus any income you receive. Using the same example, if you sold a stock investment for a $2,500 gain after you'd collected $150 in dividends, your total return would be $2,650. If you want to compare total return on two or more investments that you bought at different prices, you need to figure percent return. You do that by dividing the total return by your purchase price. For example, a $2,650 total return on an investment of $20,000 is 0.1325, or a 13.25% return. In contrast, a $2,650 total return on an investment of $30,000 is an 8.84% return. So while each investment has increased your wealth by the same amount, the performance of the first is more than twice as strong as the performance of the second.

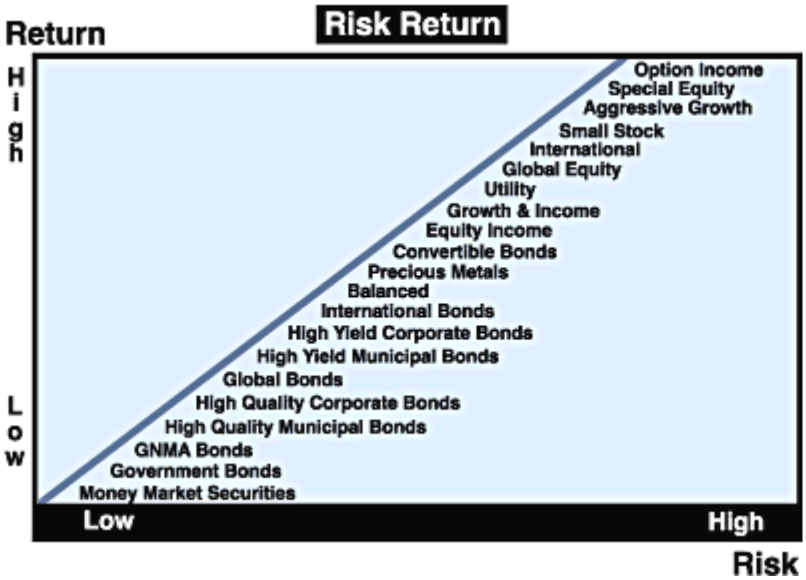
Balancing Risk and Return

Understanding the relationship between risk and return is essential to understanding why people make some of the investment decisions they do. First is the general principle that risk and return are directly related. The greater the risk that an investment may lose money, the greater its potential for providing a substantial return. By the same token, the smaller the risk an investment poses, the smaller the potential return it will provide. For example, a startup business could become bankrupt, or it could become a multimillion-dollar company. If you invest in the stock of this company, you could lose everything or make a fortune. In contrast, a blue chip company is less likely to go bankrupt, but you're also less likely to get rich quick by buying stock in company with millions of shareholders.

The second principle is that if you can get a better-than-average return on an investment with less risk, you may be willing to sacrifice potentially greater return to avoid greater risk. That's sometimes the case when interest rates go up. Investors pull their money out of stocks, which are more risky, and put it in bonds, which are less risky, because they're not giving up much in the way of potential return and they're gaining more safety.

The third principle is that you can balance risk and return in your overall portfolio by making investments along the spectrum of risk, from the most to the least. Diversifying

your portfolio in this way means that some of your investments have the potential to provide strong returns while others ensure that part of your principal is secure.
See the chart below for a graphic on this principle:



Diversification

Diversification and Risk

You diversify a portfolio by investing in different types of assets. In a simplified fashion, think of the major asset classes--stocks, bonds and cash equivalents. Then, drill down a level. Within stocks, buy large cap, small cap, international, and so on... You can include funds, ETFs, Treasuries, even real estate. If you diversify, you may be able to protect your portfolio against some of the risks of investing without giving up the long-term results that you're seeking.

Your goal is to balance, or offset, the risk that any one investment might pose individually by investing in something with different risk/return characteristics. For example, the possibility volatility in the value of a small-company stock might make it a risky investment if it makes up a large percentage of your portfolio. But if your portfolio also includes blue chip stocks, the picture changes because the generally greater stability of the blue chips can help your portfolio maintain its value even if the small-company stock takes a nosedive. At the same time, the growth potential of the small-company stock can help balance the typically slower growth of the blue chips. Remember, the more concentrated your investments, the less diversified you are. While that can leave your portfolio more vulnerable to sudden swings in value and increase your risk for significant losses, a concentrated portfolio can have potential for high returns. So what price are you willing to pay in terms of your comfort level.

Finding the Right Balance

Diversification isn't just about owning more securities. It's about striking a balance among the various investments in your portfolio to reduce your exposure to risk and take advantage of a full range of market opportunities. You have to analyze what you already own first, then you can identify the category or categories that could help diversify. For example, if you own only long-term treasuries in your portfolio, you may look at municipal bonds or corporate bonds, and then stocks. The world is your oyster in that scenario. You can select tax-free income, or greater inflation protection, look at large, blue chip companies. and some smaller company stock. You want securities that tend to perform differently at different times than what you have. In that way, you can offset some of the risks that each investment carries on its own, while picking up some of the return potential of the others.

According to various investing sites, there are generally some tried and true diversification tips:

Balance growth investments with those that produce income.

Invest in both large and small companies, as well as a mix of well established and new companies.

Look for investments in unrelated industries or a mix of corporate and government investments.

Invest in companies based in different countries, or in mutual funds that invest internationally.

Consider some investments that are currently out of favor but that have the potential to increase in value.

Finally, each subclass is made up of hundreds, or thousands, of separate investments for you to choose among. For example, the stocks of the five hundred companies included in the Standard & Poor's 500-stock Index are usually all considered part of the subclass of large-company stocks.

Stocks often shine when corporate earnings are strong and financial markets are expanding. Yet this same environment frequently has the opposite effect on bonds, so that they provide lower than average returns. On the other hand, bond returns sometimes rise in a period when stock values drop. When interest rates go up or when corporate earnings don't meet investor expectations, bond values will go down. When bond prices go down, their yield goes up (more on bonds in our bond course). With some money in both stocks and bonds, you'll be in a position to benefit from owning the one that's up, while limiting your losses on the one that's down, so you get some protection against downturns.