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Investing for Major Financial Goals

Setting financial and investment goals

Setting goals is an important part of life in general and financial planning in particular. Investing without knowing what you're trying to achieve is like trying to drive across country without a map or GPS. Your goals and circumstances may change over time, but it's easier to adjust your plan to accommodate those changes than it is to succeed when you don't know what you're working to accomplish. And with any financial goal, the sooner you start saving and investing for it, the easier it may be to amass the amount you'll need to realize it.

Before you actually invest your money, you should spend some time considering and setting your personal financial goals. For example, do you hope to be able to retire, either soon or eventually? Would you like to start your own business? Do you need to pay for your children's college education? Would you like to buy or build a new house? Are you planning a large purchase in the near future?

In addition to thinking about these common financial goals, there are several other questions that can help you develop an appropriate financial plan.

- What is your time horizon? When you will need the money for your goal is a critical factor in determining how to invest for it. In general, though time alone is no guarantee of higher returns, the longer your time horizon, the more risk you may be able to take on with your investments in pursuit of potentially higher rewards. With a longer time horizon, you have more years to try to ride out fluctuations in your investments, and might be able to allot a greater portion of your portfolio to investments such as common stock or real estate. On the other hand, if your time horizon for a particular goal is very short, you may want to concentrate money you plan to use for that purpose in less volatile investment choices, because you have less time to try to recoup any losses.
- What is your emotional and financial tolerance for investment risk? Some investors would forgo the possibility of a large gain if they knew it also involved the possibility of a large loss--even if that meant giving up the opportunity to reach their financial goal. Relatively conservative investments such as Treasury bills, money market accounts, high-quality bonds with short maturities, and other similar investments can help reassure such risk-averse investors. Other investors are more willing to take greater risk in pursuit of potentially higher returns. Your financial resources also can affect your risk tolerance. If a substantial loss would mean serious financial hardship, you may not be able to be as aggressive as another investor with a significantly greater financial ability to cope with a setback. Bear in mind that your time horizon (as discussed above) also influences your risk tolerance. Also, all investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful.
- What are your liquidity needs? Liquidity refers to how quickly an investment can be converted into cash. For example, real estate tends not to be very liquid, since it can take a long time to sell. Publicly traded stock tends to be relatively liquid, though you might suffer a loss if you need to sell when the market is down. Cash and cash alternatives, such as money market accounts, are extremely liquid (though some cash alternatives may be more liquid than others). Money you plan to use soon should be kept fairly liquid.

Your answers to all of these questions will help you determine your investment goals. In general, there are three major investment goals: growth, income, and stability or protection of your investment capital. Having growth as your primary goal means focusing on increasing the value of your initial investment, generally through capital appreciation. Income means

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receiving regular payments over a period of time--for example, from stock dividends or interest on bonds. Stability (sometimes referred to as capital preservation) as an investment goal means trying to ensure that your initial investment doesn't drop in value. Any investment typically focuses on at least one (and sometimes more than one) of these fundamental investment goals. Most investors like to have some combination of all three.

Investing for retirement

Without some planning, the odds of achieving the retirement lifestyle you hope for drop significantly. Even if you plan never to retire, you'll need to invest so that you're better able to handle any unexpected obstacles and setbacks that could otherwise derail your later years.

One of the biggest decisions you'll face with saving and investing for retirement is how best to take advantage of the variety of tax-advantaged retirement vehicles available. The tax advantages offered by employer sponsored retirement plans (such as 401(k)s) and individual retirement accounts (such as IRAs and Roth IRAs) can make a substantial difference in the nest egg your savings eventually produce. It's important to remember that these plans are not investments in themselves; they are just vehicles in which you hold various investments.

Even though such vehicles offer substantial tax benefits, there is a role for taxable savings as well. There are limits on the amounts you can contribute to a tax-advantaged retirement plan or IRA. Also, long-term capital gains and qualified dividends are taxed at rates that are typically lower than ordinary income rates, and municipal bonds generally aren't taxed at the federal level; it may or may not make sense to hold these in a tax-advantaged account. Annuities also can have their own tax advantages. With proper planning and expert advice on your own tax situation, you may be able to maximize the benefits of both tax-advantaged and taxable accounts.

If you're investing for a retirement that's many years away, you may be able to hold a greater proportion of stocks than bonds or cash alternatives. The closer you are to retiring, the greater weight you should probably give to income-producing investments such as bonds and certificates of deposit (CDs). Some investments are designed to make it very easy to invest for a specific time horizon. For example, lifecycle or target-date mutual funds combine stocks, bonds, and cash alternatives in proportions geared toward a specific date, generally becoming more conservative as the target date approaches. (Before investing in any mutual fund, carefully consider its investment objectives, risks, charges, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.)

Investing to produce income in your retirement years may be very different from investing to accumulate a retirement nest egg. In addition to providing ongoing income to live on, your portfolio will have to address several other considerations:

How to keep pace with inflation. Bonds are the traditional backbone of retirement income, but it's likely you'll also need to keep a portion of your portfolio in investments that can keep pace with inflation. Even if you think your income will cover your expenses when you retire, remember that the cost of everyday items like food and gasoline will likely continue to rise over what could be a lengthy retirement.

How to achieve a sustainable withdrawal rate. You'll need to invest so that your nest egg will last long enough to cover your retirement years.

How to balance the need for security with the need for flexibility. Some potential choices, such as annuities, are designed to provide a guaranteed income for life (subject to the claims-paying ability of the issuer), but they may or may not offer flexibility to cope with changes in your circumstances. Other options may have fewer constraints but provide highly variable returns that might mean greater uncertainty about the income you can expect.

None of these decisions are either/or choices. Successful retirement investing generally involves selecting specific investments and retirement accounts targeted at different investment goals, combining them in a mix targeted to your own situation, and adjusting those choices over time as your circumstances change.

Investing for education

Whether you're saving for a child's education or planning to return to school yourself, paying tuition costs definitely requires forethought--and the sooner the better. With college costs typically rising faster than the rate of inflation, getting an early start and making the most of your savings can make an enormous difference in reducing or eliminating any post-graduation debt burden.

There is a wide variety of college saving and investing options. There are many factors to take into account when contemplating how to pay tuition costs. Among the questions you'll need to consider are:

How will any investments affect your potential eligibility for financial aid? Because eligibility is based on a family's ability to pay, your strategy for saving can positively or negatively affect eligibility for loans and scholarships.

What tax advantages does a particular college savings option offer? Deferring or eliminating tax liability may help your savings grow faster.

Who should own the investment account? In some cases, you may be better off taxwise to set up the portfolio in your child's name; in other cases, it makes sense for a parent to retain the account.

Investing for a large purchase

Some purchases are large enough that they require months or years of planning and saving. If you're renting an apartment, you may long for the day when you can put a down payment on a home of your own. Or you might have your eye on a new automobile to replace one that's seen better days. Or perhaps you'd like to have a vacation home that you could rent out when you're not using it. In some cases, even a major appliance can be expensive enough that you need to give some thought to how you'll pay for it.

With all such purchases, your time horizon is particularly critical. For a purchase that's six months away, you probably can't afford to be as aggressive as you might for one that's several years off; your priority for that money would be on assets aimed at capital preservation, such as CDs, money market accounts, and other cash alternatives.

However, consider also the potential downside risk of not achieving your financial goal. If you're saving for your first home, you'll want to make sure the money for the down payment is available at the time of purchase; a loss at the wrong time could cripple your plans and cause major inconvenience. By contrast, if the timing of your purchase isn't critical, or you wouldn't suffer greatly if your dream didn't come true, you might be willing and able to take greater risk with that portion of your investments.

Investing if you're starting a business

Even if you plan to finance your startup from outside sources, it's highly likely that some of your capital will go into the endeavor--either directly, by investing cash in it, or indirectly, by investing time and effort that might otherwise be used to generate cash flow in other ways. Before starting or buying a business, determine how much of your resources you can afford to invest in it. Devoting your entire net worth to a new business because you feel it's a good investment could subject your family to short-term cash flow problems or excessive financial risk. In general, the greater the percentage of your net worth that is tied up in the business, the more conservative you should be with any other investments.

As a business owner, you'll want to make sure you have an adequate cash reserve to tide you over lean periods and help manage cash flow. That money should be invested with an eye to accessibility and safety of principal rather than returns.

Investing to increase your net worth

If you've adequately addressed all your time-sensitive financial goals, you may still want to put any remaining money in investments that could potentially increase your net worth. If you don't have any specific time frame, it can be more difficult to know how to choose investments. It may be worth considering setting guidelines for an annual rate of return you'd like to achieve, then setting an appropriate asset allocation designed to help you achieve it. (Remember, though, that asset allocation can't guarantee you'll reach that target return, or even make a profit; it also can't eliminate the risk of loss.) You also could simply invest based on an arbitrary time frame you'd like to target, and adjust your investing strategy as circumstances or the markets dictate.

In general, if your sole objective is to increase your net worth, you'll likely focus on growth-oriented investments. However, even with this money, you may also want to include other investments that can help moderate the volatility of your portfolio, such as bonds, stocks that pay dividends, or cash alternatives.

You may also need to consider the impact of taxes; in higher tax brackets, tax efficiency can substantially affect your net return and over the long term, your net worth. If you are in a very high tax bracket, you may want to consider investing in tax-free municipal securities and/or stock mutual funds that are tax efficient (i.e., the portfolio is managed so it does not produce many taxable gains). If your goal in increasing your net worth is to leave a bequest to loved ones or a favorite charity, you also may find it useful to investigate specific estate planning techniques that can help you minimize estate shrinkage, manage your tax liability, and potentially increase the amount you leave to any heirs.