Setting Financial and Investment Goals

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Setting goals is a very important part of life in general and in financial planning in particular. Before you actually invest your money, you should spend some time considering and setting your personal financial goals. For example, do you want to retire early? Would you like to start your own business soon? Do you need to pay for your children's college education? Would you like to buy or build a new house?

Taking time to consider what you want to achieve as a result of your investment process will guide you in determining specific investment goals. For example, your investment goals for money that you're saving for retirement may be different from your goals for money that you're saving for a home down payment. In addition to having investment goals for individual financial needs and desires, you also may have overall investment goals for your entire portfolio. For example, you might try to set up your portfolio so that it averages a certain percentage return over time, or so that it produces a given level of income.

In determining your investment goals, there are several questions that can help you and your financial advisor develop an appropriate financial plan. First, what is your time horizon? Second, what is your investment risk tolerance? Third, what are your liquidity needs? Once you've answered those questions, you can begin to weigh the three primary investment goals--growth, income, and stability or protection of principal--to determine how to select specific investments that are appropriate for your financial plan.

Time horizon, risk tolerance, and liquidity needs

There are three key areas you'll need to consider in setting investment goals. You'll need to think about each one not only in terms of an individual goal, but in terms of your overall finances.

Time horizon

Probably the first question you should ask in setting your investment goals is, "What is my time horizon?" In other words, when will you need the money? Are you investing for your young child's college education, or for your retirement 30 years in the future? Or do you hope to achieve your goal in a shorter time frame? For example, do you want to buy a house in three years, or start your own business in five years? Your time

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horizon for a particular financial goal will have a significant impact on the type of investments you choose to try to achieve it.

The general rule is: The longer your time horizon, the more risky (and potentially more lucrative) investments you can make. Many financial advisors believe that with a longer time horizon, you have more opportunity to ride out fluctuations in your investments. On the other hand, if your time horizon is very short, you may want to concentrate your investments that may offer a lower return but also greater reassurance about whether the money will be there when you need it, because a shorter time frame may not give you enough time to try to recoup any losses.

Risk tolerance

Another factor to consider is your individual risk tolerance. How comfortable are you with the possibility of investment loss, or seeing the value of your investment fluctuate? Many investors would forgo the possibility of a large gain if they knew there was also the possibility of a large loss (these investors are known as risk averse). Other investors, so-called risk seekers, are more willing to take the chance of a large loss if there were also the possibility of a large gain.

It's not always easy to determine where you stand on the spectrum of risk aversion versus risk-seeking, but it's important to try to get an accurate assessment. Risk aversion isn't an either-or proposition; many investors consider themselves risk-seekers until they actually experience a loss that gets too painful. Before making any investment, you should try to get a sense of just what circumstances might cause you to sell an investment if it began to experience a loss. After all, an investing game plan only works if you're able to stick to it, and having an accurate sense of your true risk tolerance will help you develop a plan you can stay with.

Keep in mind that, as noted above, your time horizon can affect your risk tolerance. For example, if you're investing for retirement 30 years from now, you may be more willing to face greater risk in exchange for the potential for a higher return than if you're saving to send your child to college in 4 years.

Liquidity needs

Another question you should ask when setting your investment goals is, "What are my liquidity needs?" Liquidity refers to how quickly an investment can be converted into cash (or the equivalent of cash). Real estate, for example, tends not to be very liquid; it can take a very long time to sell either residential or commercial real estate. Publicly traded stock, on the other hand, 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

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market accounts are extremely liquid (though even here, some types of cash alternatives may be more liquid than others).

Your liquidity needs will affect the type of investments you might choose to meet your goals. For example, if you don't have short-term liquidity needs, you can probably afford to invest in less liquid investments where the potential for gain is much higher than for more liquid investments. However, if you have two children going to college in the next couple of years, you probably don't want all of their tuition money invested in less liquid assets. Like your risk tolerance, your liquidity needs are also related to your time horizon.

When considering your liquidity needs, don't forget to think not just about your liquidity needs for a given financial goal, but your overall liquidity needs. If you have a stable income, excellent job prospects, an emergency cash reserve, and no pressing financial obligations, you may have fewer concerns about liquidity than someone with a family and no emergency fund who works in an industry that's experiencing layoffs.

Investment goals: growth, income, stability

- Once you've determined your financial goals and how your time horizon, risk tolerance, and liquidity needs affect them, it's time to think about how your investments might help you achieve those goals. When considering any investment, you'll need to think about what it offers in terms of three key investment goals:
- Growth: In investing terms, growth (also known as capital appreciation) is an increase in the value of an investment; in other words, you can sell it for more than you paid for it. Your capital is the money you put into an investment initially. If you buy a stock that costs $10 a share and eventually sell the stock for $12 a share, that extra $2 represents capital appreciation, or growth.
- Income: Some investments make periodic payments of interest or dividends. Those payments represent investment income, which can be spent or reinvested. For retirees, income obviously is a key investment goal, but it can be important for other reasons as well. For example, income payments can help offset the impact of the ups and downs of a growth-oriented investment.
- Stability: This is sometimes known as capital preservation or protection of principal. An investment that focuses on stability concentrates less on increasing the value of that investment and more on trying to ensure that it doesn't lose value. If you plan to spend a certain amount of money soon and

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want to make sure the money is there when you need it, stability might be your primary investment goal.

With each individual investment, there is a relationship between growth, income, and stability. The more an investment offers in one of those areas, the more you may have to trade off in terms of the other two. The key to setting investment goals is to tailor each investment to what you want it to do for you.

You may choose to have a single investment goal for a given financial goal, as in the example of making stability a priority for short-term money. Or you may prefer to combine several investments to achieve a balance among stability, income, and growth so that you maximize your overall returns at a level of risk that you're comfortable with and that suits your financial goal or goals.

Additional questions to consider

- How much money do you have to invest?
- What are your sources of investment capital? Do you have a lump sum, or will you be investing regularly and systematically?
- How much profit do you need an investment to generate?
- What is your current income tax bracket?

Once you have identified appropriate financial and investment goals, you can then begin to select individual investments, and think about how to combine all your various goals and investments into an overall portfolio.

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