

Investing Is Like Building a House

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If you were building a house, would you begin the process by buying the insulation and two-by-fours first? Clearly that's not what builders do. To do so would be a terrific mistake, wouldn't it? Even so, many investors build their investment portfolios by making that very mistake. Instead of following the portfolio creation process carefully, they simply go out and choose a few stocks or mutual funds based upon "tips" they've heard or an article they've read touting "This Year's Ten Best Mutual Funds!"

Does your portfolio have a purpose in your life, or is it simply an outlet for entertainment? If you have enough assets to be able to allocate some of it to an "entertainment account", then you need not create a plan for your investments. However, if you have financial goals you need to achieve with your investment assets, you need a carefully constructed portfolio. Instead of simply buying stocks or mutual funds that sound good, follow the same steps required in building a house:

Planning – Who will live in the house? Answering this question will help you determine the number of bedrooms and bathrooms needed. For your portfolio, ascertain your goals for these assets. Are they long- or short-term? What life situation will these assets hopefully support?

Design – What type of bedrooms are needed? Will the bathrooms need to be connected to bedrooms? Do you need a formal living room? A great room? The investment equivalent to these questions will lead you to determine the appropriate asset allocation. What kind of tolerance do you have for down markets? Do you feel comfortable owning all types of equities, including small companies and international stocks? Your portfolio should be tailored to fit your investment comfort zone, commonly known in the financial arena as your "risk tolerance."

Subcontractors – Who will you hire as experts in the home building process? Unless you are extremely handy, you will probably need a professional electrician, plumber, and roofer to name a few. Investment decisions are similarly complex and unless you make a living choosing stocks and bonds, your best bet is probably to hire mutual fund managers. By investing in mutual funds, you benefit from the fund manager's stock selection expertise while also achieving a broad diversification of stock holdings, a crucial requirement for your long-term portfolio's performance.

Materials – Finally, your subcontractors will purchase the necessary supplies on your behalf. Similarly, the mutual fund manager will analyze a wide range of company stocks or bonds to select the ones that are most likely to achieve the fund's goals. Many do-it-yourself investors complete this step without giving any consideration to the topics above. This is a costly mistake. Not only will you tend to have too much of your portfolio concentrated in a few stocks, but you will not be properly positioned for ALL market directions. A better choice is to let an expert do the legwork of selecting a diversified set of stocks.

If you have followed these steps, you can rest assured that your portfolio is better suited to meet your needs than it would be if you had simply decided to buy a few stocks with the extra cash you have laying around.

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