Building a Balanced Investment Portfolio

In some ways, financial planning sounds pretty straightforward. If you spend less than you earn and invest the difference, you'll ultimately have money for your major goals: college for your kids, comfortable retirement for yourself and your spouse, an inheritance for your loved ones.

Getting from here to there, though, may not be that simple. If you invest your savings wisely, you'll have an excellent chance of meeting all those goals, but poor investing can make all your savings a waste of time. Many people now probably wish they had enjoyed a few good vacations rather than lose huge amounts of money in the Internet bubble of the late 1990s.

Understand the distinction between saving and investing. Saving involves putting money into cash equivalents—safe low-yielding instruments that can be easily converted into spending money, like bank accounts and money-market funds. Investing is putting your money into more risky vehicles, such as bonds and stocks, which have the potential to achieve much higher returns over the long term.

How can you invest profitably instead of poorly? There are no guarantees, but your chances are better if you know what you're doing. Just as you go through medical school and residency before going into practice, so you should learn about investing before deciding how to invest.

To start, you should differentiate between saving and investing. Generally, saving indicates putting money into cash equivalents. These are very safe instruments that can be easily converted into spending money. Examples include bank accounts, Treasury bills and money-market funds.

With cash equivalents you probably won't lose money, so

they're considered low-risk. On the other hand, you probably won't make a lot of money from your cash holdings. If you earn, say, 3 percent from a bank account, you will probably net 2 percent or less after paying income taxes. That may not be enough to keep up with inflation and won't enable you to build wealth.

> **According to** Ibbotson Associates, a Chicago-based investment research firm, cash has returned less than 4 percent a year over the past 80 years, while corporate bonds have returned around 6 percent a year. The stocks of large corporations during that time period have returned over 10 percent.

Therefore, you should hold some money in cash equivalents but direct most of the money you don't spend into investments. While investing does expose you to some risk, it will provide the potential to achieve much higher returns over the long term.

As a step up from cash equivalents, you can invest in bonds—securities representing loans made to companies or government agencies. When you invest in bonds, you'll get interest that is usually (but not always) greater than the interest from cash equivalents. As a group, bonds are riskier than cash equivalents; you take those risks when you seek the potentially higher returns of bonds.

If you are interested in bonds, there are some terms that you should understand:

- **Maturity.** The date when a bond is scheduled to come due. In 2006, for instance, a bond that will be redeemed in 2016 is said to have a 10-year maturity.

Generally, long-term bonds will offer higher yields than short-term bonds. On the other hand, long-term bonds will lose more value when interest rates are rising.

"When we are concerned that interest rates might rise, we trim our holdings of long-term bonds and go shorter-term," says Marc Singer of Singer Xenos Wealth Management in Coral Gables, Fla. "There's less risk with shorter-term maturities."

- **Yield.** The yield of a financial instrument is the amount of money to be made per year by investing in that instrument. For instance, a bond that promises an interest rate of 4 percent per year has a 4-percent yield.

- **Yield curve.** A graph showing various yields at different maturities of bonds. Generally, this curve shows yields increasing at longer maturities, so a 10-year-bond, for example, usually will have a higher yield than a two-year bond.

However, in recent months, the yield curve has been flatter and at times inverted, with the two-year Treasury note carrying a higher yield than the 10-year and recently reintroduced 30-year Treasury bonds. When short-term yields are higher than long-term yields, there is no reason to take on the additional risk of the long maturity. An inverted yield curve can be a signal that rocky economic times are ahead.

- **Credit quality.** Bonds are rated for credit quality by several rating agencies based on an analysis of the issuer's financial condition and management, economic and debt characteristics and the specific revenue sources securing the bond. U.S. Treasury securities, which are backed by the full faith and credit of the government, carry the highest credit quality, while so-called junk bonds are below investment-grade and are considered speculative. Bonds with lower credit ratings pay higher interest commensurate with the higher risk.

Similarly, stocks (ownership shares of corporations) are riskier than bonds but may have higher returns. According to Ibbotson Associates, a Chicago-based investment research firm, cash has returned less than 4 percent a year over the past 80 years, while corporate bonds have returned around 6 percent a year. The stocks of large corporations during that time period have returned over 10 percent. Over long time periods, going from 4 percent or 6 percent to 10 percent a year can make a huge difference in the wealth you accumulate.

Just as bonds pay interest, many stocks pay dividends to their investors. These dividends are distributions of corporate profits to shareholders. The total return from stocks will consist of any dividends paid plus any appreciation in the price of the stocks you hold.

However, just as stocks can benefit from long-term appreciation, so can they fall in price. In 2000-2002, when Internet stocks came crashing down, many other types of stocks fell as well. Major stock market averages declined sharply, and many investors saw years of gains evaporate in a relatively short time.

Wise Wealth Building

After going over the fundamentals, the obvious question is how an investor can maximize returns while holding down risks. "To be a winner, you need a game plan," says Femi Shote, managing director of Asset Harvest Group, a financial planning and investment advisory firm in McLean, Va. "When it comes to investing, the game plan is called asset allocation."

How can you put together your asset-allocation plan?

- **Divide the world into asset classes.** Start with stocks, bonds and cash, as described above. Other popular asset classes include real estate (for investment, in addition to your home) and commodities such as oil, gold, timber, etc.

"Most of my clients hold 20 percent to 40 percent of their portfolios in bonds," says Mr. Singer. By adding bonds to a portfolio that's heavy on stocks, you can dampen the year-to-year swings while sacrificing a bit of potential long-term returns.

- **Subdivide the asset classes.** Companies that issue stock come in all shapes and sizes. You need to divide up your stock allocation among different types of stocks, says Mr. Shote. "That means small-company stocks as well as large companies, plus foreign stocks as well as companies based in the U.S.," he says. "You also should be sure your stocks cover all kinds of industries, from banks to healthcare to technology."

Many investment professionals class stocks by market capitalization—the total value of a company's stock, which is equal to the number of shares times the price per share.

A "small-cap" stock might have less than $1 billion in market capitalization while a "large-cap" stock might have many billions of dollars worth of shares outstanding.

Of course, it may not be easy to invest in, say, small companies from all around the world. Fortunately, there are mutual funds you can use to help fill in your asset allocation.

Just as you should hold a mix of stocks, the same is true for bonds. "If a client has a 40-percent fixed-income allocation, for example, we might hold 10 percent in each of four categories," says Mr. Singer. "Besides investment-grade corporate bonds, we're also using high-yield bonds, foreign bonds and TIPS." TIPS—Treasury Inflation-Protected Securities—are bonds that are issued by the Federal government and that pay a higher yield

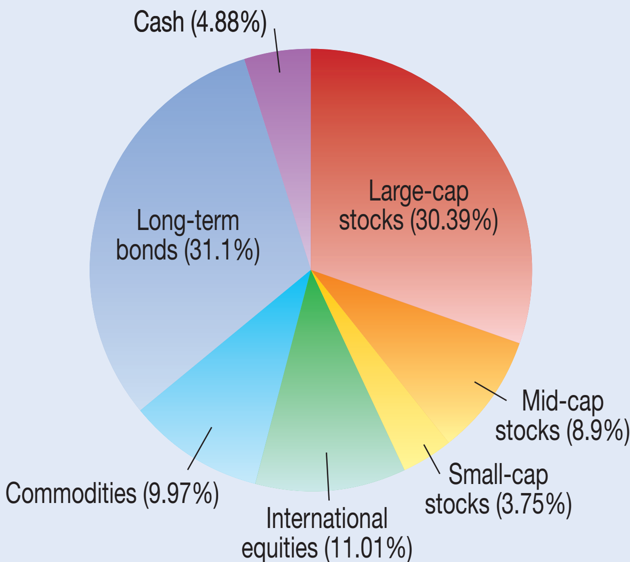
if inflation rises.

Mr. Singer says that his firm now projects returns to investors at 7 percent to 9 percent per year, from a diversified portfolio. "With a target of 7 percent to 9 percent," he says, "holding Treasury bills may drag down the entire portfolio and make it harder to reach the objective. TIPS are likely to produce a higher return. In today's environment, we fight for every half-point of return."

The other three categories of bonds have less interest-rate risk than corporate bonds, according to Mr. Singer. "In high-yield bonds [also known as junk bonds] you have economic risk. When

Sample Asset Allocation

The chart shows the asset allocation recently reflected in the Ibbotson Moderate Asset Allocation Total Return Index. The index reflects an optimized strategic asset allocation model with a moderate risk level.



Source: Ibbotson Associates.

the economy is strong, the high-yield market may deliver higher returns than investment-grade bonds. Our foreign bonds are mainly from Europe, where interest rates are higher. If European countries lower their rates, which is a possibility, those bonds will appreciate."

For many physicians, municipal bonds also may be appealing. If you buy a bond issued by a corporation, the interest will be taxed as high as 35 percent. However, municipal bonds pay interest that may not be taxed at all.

In 2000–2002, U.S. stocks suffered through a vicious bear market. If you were loaded up on stocks, especially technology stocks, you might have lost most of your money. However, if you had bonds and cash as well as stocks, your portfolio would have had smaller losses or even gains those years.

Municipal bonds, issued by states, cities and various local government agencies, pay interest that is exempt from Federal income tax in most cases. If you buy $100,000 worth of municipal bonds and collect $4,000 in interest this year, you probably will owe nothing to the Internal Revenue Service. You might owe income tax on that $4,000 in interest to your home state. However, if you buy municipal bonds issued within your home state, you may owe no income tax at all.

■ **Find assets that don't all act the same way.** As mentioned, you'll need stocks in your portfolio because they can produce superior returns. However, there are times when stocks drop.

Therefore, you should include some asset classes that can play defense: bonds and cash, for example. "They might not produce spectacular gains," says Mr. Shote, "but they can hold down your losses in bad years for stocks."

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The same is true of real estate and commodities; they don't always move in the same direction as U.S. stocks, so they can help your overall investment returns in weak years.

■ **Keep your balance.** This may be the most difficult part of

asset allocation. Once you have set your asset allocations, you should maintain your portfolio at those levels.

Suppose, for example, you think that large-company stocks of U.S. companies should make up 30 percent of your portfolio. Say those stocks enjoy a few years of big gains so that they now make up 40 percent of your total investments.

In this situation, you should sell enough of those stocks to get down to your 30 percent allocation. The money you raise by selling these stocks can be invested in assets that haven't performed well, perhaps bonds or real estate or foreign stocks.

Is this easier to say than to do? Probably. In the late 1990s, technology stocks had a huge run so that most portfolios were overbalanced. Many investors kept those stocks and bought even more; those investors were the ones who were hit the hardest when the tech-stock bubble burst, while investors who re-balanced regularly did much better.

By following the fundamentals of asset allocation, you can have an investment plan that includes offense and defense. Such a plan will increase your chances of coming out a winner, season after season.

Focus on Mutual Funds

Some types of assets, such as small-company foreign stocks, are not easy to buy directly. You can, though, buy a mutual fund that invests in many small companies based outside the U.S.

The same is true in the bond market. "Although I will buy individual bonds for some clients with large portfolios," says Mr. Singer, "I often invest through bond funds. Some bond fund managers have done a good job." That is, they've delivered the current income and downside protection that investors want from their bonds.

Indeed, many mutual funds tend to follow specific investment objectives, narrowing the universe of securities they might buy. Investors can hold a mix of these funds, in various asset classes, to reduce risk.

To make the most of mutual-fund investing, you should understand how funds fit into various asset classes. Starting with domestic stocks, funds are sliced into those focusing on large-capitalization ("large-cap"), mid-cap and small-cap stocks. That

is, a fund is a large-cap if it tends to invest in companies like GE and Microsoft; it's a mid-cap if its holdings are non-giants such as Fisher Scientific and Countrywide Financial; it's a small-cap if it buys obscure names such as P.F. Chang's China Bistro or Penn National Gaming.

According to Morningstar, the average U.S. diversified stock fund has an expense ratio of 1.48 percent—you pay $14.80 in fees each year to manage $1,000 of your money. Those averages range from 1.35 percent for large-blend funds (a category dominated by cost-efficient index funds) to 1.70 percent for research-intensive small-cap growth funds.

Next, funds are diced by investment style. Those seeking overlooked bargains are value funds, which generally invest heavily in financial firms and industrial producers. Others position themselves as growth funds, which target companies in industries such as technology and telecommunications where earnings growth may be extraordinary. Still other funds combine value and growth stocks so they're known as "blend" or "core" funds.

The bottom line is that most domestic stock funds fall into one of nine categories, from large-cap value to mid-cap blend to small-cap growth. Similar classification takes place among international funds while bond funds have their own categories, depending on the quality and the maturity of their holdings.

Why go through all this trouble? Because different asset classes act differently during certain market conditions. If you had only a large-cap growth fund, you would have done very well during the late 1990s but miserably in the last few years. A portfolio including some value funds wouldn't have done as well in 1998 and 1999 but would have held up much better since then. Indeed, through 2005, large-cap growth funds have lost more than 3 percent per year for the prior five years, according to Morningstar, a Chicago-based investment research firm, while small-cap value funds have earned 13.5 percent a year.

To hold down the risk of being in the wrong place at the wrong time, therefore, you may want large-, mid- and small-cap blend funds, for example, or you may choose to put together a mix of growth and value funds, of various market capitalizations. You also may wish to include international and fixed-income funds

among your holdings.

Still, Morningstar lists hundreds of large-cap growth funds. How can you choose among them, and among the funds in all the categories on your list? Following are some criteria to consider:

- **Historic performance.** The key is how a fund has done within its particular asset class.
- **Consistent performance.** A fund's one- and three-year record will show how it has done recently while a five- or even a 10-year record will give you an idea of how a fund can perform in good as well as bad times.
- **Volatility.** Depending on your tolerance for risk, you may pre-

Fund Category Performance

	1 year	3 year	5 year
Domestic Stock Funds			
Small Growth	17.13%	25.70%	4.10%
Small Blend	16.21	27.76	10.88
Small Value	14.30	27.77	13.62
Mid-Cap Growth	17.66	23.67	2.21
Mid-Cap Blend	14.87	24.68	8.75
Mid-Cap Value	13.13	24.93	9.90
Large Value	9.65	19.28	4.53
Large Blend	9.861	7.27	1.41
Large Growth	11.91	16.55	–1.89
International Stock Funds			
Foreign Small/Mid Value	19.92%	34.11%	14.19%
Foreign Small/Mid Growth	26.88	37.31	10.20
Foreign Large Value	16.71	28.07	9.27
Foreign Large Growth	20.54	25.68	4.18
Foreign Large Blend	18.95	25.44	4.84
Fixed-Income Funds			
High Yield Bond	3.32%	12.06%	6.16%
Short-Term Bond	1.60	1.90	3.58
Intermediate-Term Bond	1.38	3.52	5.04
Long-Term Bond	1.20	6.19	6.78

Data as of 2/17/06. Returns are simple averages.

Source: Morningstar.

fer to give up some potential upside by investing in a fund that hasn't dropped as much during down years.

- **Management.** If a fund has a good record, you need to see that the people managing the fund now are the ones responsible for that good record, for the past several years. If management is relatively new, look for a record of having successfully managed a fund elsewhere.
- **Expense ratio.** Over the long term, a low expense ratio can make a major difference in your return. According to Morningstar, the average U.S. diversified stock fund has an expense ratio of 1.48 percent—you pay $14.80 in fees each year to manage $1,000 of your money. Those averages range from 1.35 percent for large-blend funds (a category dominated by cost-efficient index funds) to 1.70 percent for research-intensive small-cap growth funds.

Within each category, moreover, expenses can vary widely. Among the small-cap growth funds rated five stars by Morningstar, expense ratios range from 1.01 percent for the $2 billion Buffalo Small Cap Fund to 2.19 percent for Wasatch Micro Cap Fund, which seeks out the smallest of small companies. Most top-rated small-cap growth funds, it should be noted, have

'Quant' Funds Take Emotion Out of Investing

There is another alternative to investing in a managed fund or an index fund: invest in a fund that relies heavily on quantitative techniques, which take the emotion out of the investment process.

Quantitative money managers don't spend their time meeting with company management or dialing in to analysts' conference calls. Instead, they seek factors that have some ability to predict stock market performance and then invest in companies where those factors are present. Such factors may include relative strength (how well a stock has done recently vs. other stocks), insider trading trends, earnings momentum and revised earnings estimates.

Some "quant" funds have performed extremely well. Bridgeway's Ultra-Small Company Fund, for example, has returned nearly 40 percent a year for the past three years and over 22 percent a year for the past 10 years. Besides Bridgeway, other fund families known for quant investing include N/I Numeric Investors, Hennessy Funds and Bogle

expense ratios below the category average.

Low expenses can be especially important in international funds, where expense ratios tend to be high, and in fixed-income funds. According to Morningstar, the average fixed-income fund now yields around 4 percent. With yields at such levels, paying 1 percent or more each year to a manager will take a sizable bite from your total return.

Playing the Averages

When you invest in an actively managed mutual fund, you're hoping for returns that outpace market benchmarks, such as the Standard & Poor's 500, which is composed of the 500 largest U.S. corporations by market capitalization. Another approach, though, is to invest in an index fund—one that tracks a popular stock market average. With an S&P 500 index fund, for example, you can be confident of good performance in a year when large-cap stocks do well.

"Index funds do not require as much research and should have low fees," says David John Marotta, president of Marotta Asset Management in Charlottesville, Va. Indeed, the Vanguard 500 Index fund has an expense ratio of only 0.18 percent, according

Funds. According to one study, a group of 68 popular quant funds gained 60 percent in a recent five-year period while the S&P 500 Index went down by 1 percent.

"At the end of the day, most managers use quantitative data in their screening process," says Clark Blackman, chief investment officer of Investec Advisory Group in Houston. "It's a matter of degree how much they rely on the data when they make investment decisions and how much they use other inputs, such as interviews with company management."

Thus, if you hold a diversified portfolio of funds, you may choose to own some that use quantitative methods, along with funds that take a more personal approach. Just because a fund has a "quant" label won't automatically make it a winner. "I like the idea that quantitative investing can help to diversify a portfolio," says Mr. Blackman. "However, I don't think a money manager's technique is as important as the firm's performance record, its reputation for integrity, and its history of building a strong organization."

to Morningstar, while the average U.S. stock fund has an expense ratio of 1.48 percent. The higher a fund's expense ratio, the better it has to perform, just to break even with a low-cost fund.

Another index-fund advantage is low turnover. Especially in large-cap indexes, where few changes occur, managers seldom have to sell a stock and buy another. "Mutual-fund turnover is harmful," Mr. Marotta asserts. "A study by Morningstar found that high-turnover funds generated lower returns than low-turnover funds. In some categories the difference was as much as a couple of percentage points per year."

There are index funds that track mid-cap, small-cap, international and even sector indexes. If investing in index funds can provide broad market participation, low costs and tax-efficiency, why invest in any other type of fund? The case against index funds is that they're, well, index funds. They perform as the index does, no better and no worse.

High turnover hurts performance because this activity incurs trading costs, which are passed through to investors. High-turnover funds may realize taxable gains, which also are passed through. On the other hand, low-turnover index funds tend to be tax-efficient.

For example, Morningstar reports that Vanguard 500 Index Fund returned 9 percent a year, pre-tax, for the 10 years through 2005, and a top bracket investor would have lost about 0.58 percent a year to income taxes, winding up with an after-tax return of around 8.42 percent. By contrast, the average large-cap stock fund lost about 1.25 points a year to income taxes.

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Again, take Vanguard's 500 Index Fund. The index it tracks, the S&P 500, is a "capitalization-weighted" index, meaning that it's a trend follower. As certain types of stocks gain in popularity, and their prices increase, they make up a larger portion of the index.

In the late 1990s, the S&P 500 became heavily weighted in technology and telecommunications stocks. The index (and the index fund) soared in those years. When the tech-telecom bubble burst, the S&P 500 index collapsed, despite the fact that stocks in sectors such as finance, energy, industrial materials, healthcare and real estate held up reasonably well. In the past five years, for example, 57 percent of all diversified U.S. stock funds topped the S&P 500 index.

Mutual Fund 'Loads'—From A to C

For any type of a mutual fund, there are "no-loads" that allow you to invest without paying a sales charge. However, if you depend upon an adviser to help you select funds, you probably will pay some kind of a commission or fee.

In such cases, your adviser should explain that load funds have differing types of commissions. "Many funds offer A, B and C shares," says Marc Singer of Singer Xenos Wealth Management in Coral Gables, Fla. "A shares are the traditional load fund—you might invest $10,000 and have $9,600 in your account, after a 4-percent load."

B shares have what Mr. Singer calls a "hidden" load. "If you invest $10,000, you'll see $10,000 in your account," he says, "but if you withdraw money shortly, you'll have to pay a surrender charge." Depending on the fund, the surrender charge might be 4 percent within one year, 3 percent within two years, and so on.

The same fund also may have C shares. "Those are pay-as-you-go," says Mr. Singer. "You start out with the full $10,000 but you pay an extra 1 percent per year, which goes to the adviser. Some investors might be better off with the C shares because the adviser gets less upfront but more in the future. This may help keep your adviser interested in you."

When you go into a load fund, your adviser should explain the different types of shares and suggest which one would be best for you, depending on how long you intend to hold the fund. "What's more," says Mr. Singer, "at the end of five years the adviser might recommend moving from B shares to A shares, which have lower expenses."

Your adviser also may counsel you to move from one fund to another. "If you can switch to a new fund within the same family, you may avoid another sales charge," says Mr. Singer, "and your adviser should let you know that."

One way to avoid such poor performance is to diversify. Rather than rely solely on an S&P 500 index fund, you might add a small-cap index fund to your portfolio. Just as small-company stocks have outperformed the blue chips during the past several years, so small-cap index funds have done better than large-cap index funds.

Keep in mind also that actively managed funds often do not outperform index funds over the long term, according to a study published in the February 2006 issue of the Journal of Financial Planning. Thomas P. McGuigan, president of Beyond Tomorrow Strategic Advisors in Guilford, Conn., examined the performance of actively managed large- and mid-cap domestic stock funds against a passive strategy during a 20-year period from 1983 to 2003.

The study found that some managed funds outperformed the index for short periods; for example, 55 percent of large-cap funds did better versus an index fund over a five-year period. But as the time period lengthened, active managers were less likely to outperform the index fund. For 10-year periods only a quarter of the funds outpaced the index, and over 20 years, the percentage of funds that outperformed the index fund fell to 10.59 percent.

The bottom line? If you want your mutual fund manager to use judgment on your behalf, and you're confident you can pick managers with good judgment, go with active management. Otherwise, buy low-cost, tax-efficient index funds and put your faith in picking the right asset classes rather than the right stocks.

Low-Cost Exchange-Traded Funds

In recent years, exchange-traded funds (ETFs) have emerged as alternatives to mutual funds. As the name suggests, these are funds that trade on an exchange, like stocks. ETF prices are updated with each trade, throughout the day, so they are unlikely to be involved in the questionable practices, such as after-hours trading, with which many mutual funds have been charged. "With ETFs, investors can see what's being done," says Mark Wilson, a financial planner with Tarbox Group, in Newport Beach, Calif.

ETFs are index funds, meaning that they track a particular index. Because the managers are not involved in stock-picking,

index funds tend to have low costs, and that's especially true for index ETFs. The average expense ratio for ETFs is about half the average for index equity mutual funds.

Although they are index funds, ETFs are not limited to familiar indexes such as the S&P 500. There are some 200 ETFs, tracking indexes that might reflect a particular industry segment, such as iShares Goldman Sachs Networking Index Fund, or an area of the world, such as streetTRACKS Dow Jones EURO STOXX 50.

ETFs may be ideal for taxable accounts because they help investors avoid a trap into which mutual-fund investors may fall. Mutual funds must distribute any net trading gains to their investors. If those mutual funds are held in a taxable account, investors may wind up a given year owing large amounts of tax even if they chose to reinvest those capital-gain distributions.

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ETFs, though, are structured to minimize such unwanted distributions to investors. This ETF advantage is most helpful if the shares are held in a taxable account, where any capital-gain distributions would be subject to income tax each year.

"Not only do ETFs offer more advantages in taxable accounts, they're also better suited to investors who can make large purchases," says Mr. Wilson. "Brokerage fees can significantly reduce the benefits of ETFs for small investors." Because ETFs are traded like stocks, you must pay a brokerage commission each time you buy and sell. Even a modest commission paid to a discount broker can take a chunk out of your potential return from a small order.

Whether you're making large or small investments, there may be good reasons for investing in ETFs. "Most investors mainly have big names in their portfolios," says Tom Lydon, president of Global Trends Investments in Newport Beach, Calif. "ETFs offer you a chance to buy small- and mid-cap stocks very simply, without doing a lot of research." Mr. Lydon

points out that ETFs also allow investors to invest easily in attractive foreign markets.

Altogether, says Mr. Lydon, ETFs offer investors not only low costs and tax efficiency, but also the ability to invest in a wide variety of assets. "I could not have said that a few years ago, but that's definitely true today."

Taxing Topics

ETFs are not the only investments that can affect your income tax bill. In fact, all your investments should be made with the tax code in mind. "You shouldn't focus simply on the return you expect to receive," says Mr. Shote. "Instead, make sure you understand what you'll wind up with, after all the taxes have been paid."

One key point to keep in mind is that not all investment income is created equal. There are actually two kinds, with different tax treatments:

- **Ordinary income.** When you put your money into the bank, the interest you receive is considered "ordinary income." The same is true for many other kinds of investment income, such as the interest you receive from most bonds and bond funds.

Ordinary investment income is added to the rest of your income and taxed at your highest rate. For some physicians, that may mean the top 35-percent rate, as well as any state or local income tax.

- **Capital gains.** When you sell a stock at a profit, that income is taxed as a capital gain. If you've held the stock for more than a year, any profit is a long-term capital gain. (The same is true for mutual funds that invest in stocks.)

Under Federal tax law, long-term capital gains enjoy special privileges. There is no tax at all as long as you don't take your gains. With bonds and bank accounts, you'll owe tax every year.

Suppose, for example, you put $10,000 into a bank account. Even if you let the interest go right back into the account, without touching it, you'll owe tax on that interest each year, possibly at a top 35-percent rate.

On the other hand, suppose you put that same $10,000 into a recommended stock. That stock might go up to $11,000, $12,000, even $20,000 or $25,000. No matter how much it

grows, you'll owe no tax as long as you keep from cashing in your investment. (Dividends are taxable income, but they currently are taxed at only 15 percent.)

At some point, you may decide to sell that stock. If the value has increased from $10,000 to $25,000, for example, you'll have a $15,000 gain. If you held the shares for more than one year, the gain is long term, which means it is taxed at a lower rate than ordinary income. Currently, the long-term capital gains tax rate is 15 percent. In this example, with a $15,000 gain, you'd owe only $2,250 (15 percent of $15,000) to the IRS.

Low taxation is one reason why many sophisticated financial advisers recommend stocks and stock funds.

> **"Don't think that a loss** is 'just a paper loss' as long as you don't sell the security," says Diahann Lassus, president of Lassus Wherley & Associates in New Providence, N.J. "Taking these losses can help you to pay less tax in the future while you'll still be in about the same position, in terms of your portfolio."

Unfortunately, not all stocks and stock funds move up in price. Some will fall, perhaps steeply. "In some cases, it makes sense to take capital losses now for tax savings you can claim this year, and perhaps far into the future," says Diahann Lassus of Lassus Wherley & Associates, a wealth management firm in New Providence, N.J.

Under the tax code, up to $3,000 worth of net capital losses may be deducted each year. Excess losses may be carried forward indefinitely. Thus, you should make sure you have at least $3,000 worth of net losses each year.

Suppose, for example, you tally your trades for the year-to-date in December and discover you have $20,000 worth of net gains so far. You should take at least $23,000 worth of losses by the last trading date of the year.

With net capital losses of $3,000, you'll be entitled to a $3,000 deduction on your tax return. In a 35-percent Federal tax bracket, that will save you $1,050 in tax. "In addition," says Ms. Lassus, "a net capital loss reduces your adjusted gross income (AGI), which may provide other tax savings elsewhere on your return." You may enjoy state and local tax savings, too.

"When you make these calculations, don't forget that capital-

gains distributions from mutual funds must be included," says Ms. Lassus. "Such payouts are taxable unless the funds are in a tax-deferred retirement account."

If you sell a stock or mutual fund for a year-end tax loss, you can't immediately buy back the same security. If you do, the loss will be disallowed under the wash-sale rules.

Here are some alternatives:

- **Wait at least 31 days and then buy back the security you sold.** However, you may miss a price rise during that time.
- **Buy a security that's similar but not substantially the same.** "For example," says Ms. Lassus, "you can sell one growth fund at a loss and buy another growth fund right away."

What's more, you may choose to accumulate net losses in excess of $3,000. "Excess losses can be used against other gains, now or in the future," says Ms. Lassus.

Suppose, for example, you have $20,000 worth of net capital gains for the year, as above. Instead of taking $23,000 worth of losses by year end, you liquidate all your loss positions and wind up with a $40,000 net loss for the year.

In addition to a $3,000 deductible loss for this year, you'll have $37,000 worth of excess capital losses. That $37,000 worth of net capital losses can be used to offset capital gains from other investments, such as real estate or hedge funds.

"Losses you can't use right away can be 'banked' for the future," says Ms. Lassus. Later, you may be able to take $37,000 worth of capital gains, tax-free, because of those offsetting losses.

"Perhaps most important," concludes Ms. Lassus, "don't think that a loss is 'just a paper loss' as long as you don't sell the security. Taking these losses can help you to pay less tax in the future while you'll still be in about the same position, in terms of your portfolio."

The Price of Advice

If you invest exclusively in mutual funds, you can work directly with no-load fund companies and avoid paying sales charges. If you buy or sell individual stocks, though, you'll have to use a broker. Again, this requires you to make some choices.

"I'm dumbfounded at the mistakes made by many people,"

says Stewart Welch III, who is a planner in Birmingham, Ala. "They use a full-service broker while they're do-it-yourself investors. They should use a discount broker instead, and save on the cost of commissions."

Full-service brokers are the traditional, long-established Wall Street firms such as Merrill Lynch and Smith Barney. At such firms, you'll either pay an asset-management fee or you'll pay a sales commission every time you buy or sell a security. Although commissions vary by firm and by the type of trade, you can pay 2 percent or more of the value of a transaction. For example, you might pay over $400 to buy or sell $16,000 worth of stock.

Charging super-low prices for on-line trading is a common practice among brokers these days. You'll usually pay more if you phone in your order, especially if you need to talk to a broker. That's the basic rule: the more service you require from a brokerage firm, the more you'll pay.

Mutual-fund investors, too, may be welcome at full-service firms. You'll pay a sales "load" at some point—when you buy, when you sell or on an annual basis. In some cases, you'll be urged to buy a full-service firm's own mutual fund, so the firm can collect asset-management fees as well.

"If you do your own research and make your own trading decisions, you don't need to pay those kinds of commissions," says Mr. Welch. "Use a discount broker and lower your costs."

As the expression suggests, discount brokers charge lower rates than full-service firms. Jerry Wade, a financial planner in Minneapolis, says his firm works with discount brokers Schwab and TD Waterhouse."They provide a broad level of research and tools for both advisers and retail clients," Mr. Wade says.

Mr. Wade differentiates these discount brokers from deep discounters. The latter, also known as "basic" (rather than "premium") discounters, includes Ameritrade and First Trade. Typically, discount brokers charge about half as much as you'd pay at a full-service firm while deep discounters charge half what you'd pay a discounter, or even less.

With all of these brokerage firms, you need to look at the fine print of their regular commission schedules and their special deals. So-called "free trading," for example, may be limited to

trades you handle yourself over the Internet. In fact, charging super-low prices for on-line trading is a common practice among brokers these days. You'll usually pay more if you phone in your order, especially if you need to talk to a broker.

That's the basic rule: the more service you require from a brokerage firm, the more you'll pay. In fact, at a full-service firm these days, you won't be dealing with a "broker." Instead, you'll probably be assigned a "financial adviser" or "financial consultant" who'll make an effort to know about your personal circumstances and then suggest techniques for college planning, retirement planning, estate planning, etc. These advisers will vary, in terms of skill and sincerity, but some of them can provide valuable assistance.

On the other hand, you may feel capable of making your own investment decisions without the assistance of a financial adviser. If so, you can cut your trading costs sharply by setting up an account with a discounter, especially if you're willing to do most of your investing on-line.

Going beyond the advertised perks, though, you need to determine your actual costs. Is there a flat fee or a per-share fee or a cost based on the size of the trade? Will you face extra fees for limit orders, transfers, insurance, administration charges or late payments? Get an idea of how much you'll really pay, with your investment patterns, in order to see which discounter can offer you the best price.

Programs Link Fees to Assets

Most brokerage firms, as well as many financial planners, now offer fee-based programs in which you pay so much per year, regardless of how often you trade. Typically, these programs charge from 1 percent to 3 percent per year, based on the size of your portfolio. With a $500,000 portfolio, for example, you might pay $10,000 per year (2 percent) for advice on asset allocation as well as selections of stocks, bonds and mutual funds.

If your account goes up to, say, $600,000, the fee you pay would escalate to $12,000; if your portfolio shrinks to $400,000, though, your fee would drop to $8,000. With these programs, at least, the incentives work in your favor: your adviser stands to share in your losses as well as your gains.

"Finding a low cost is important," says Mr. Welch, "but the lowest-cost broker might not be the best one for you. You also should look at other factors, such as the quality of service and the statements you receive."

Suppose, for example, you place an order to buy 100 shares of a given stock through a discounter. You should get a rapid confirmation that the order was placed exactly as you requested, at the price that was in effect at the time. You should also see easy-to-read periodic statements, so that you can keep track of your holdings and be able to provide the required information to your tax preparer.

Indeed, the issue of retirement planning may give physicians another reason to seek discounters who provide high levels of service. Many doctors sponsor retirement plans, for themselves as well as for their employees, and handle the investing of money within the plan.

"You have a fiduciary responsibility as plan sponsor," says Mr. Welch. "Therefore, you need to be sure that all of the rules are being followed. The larger discounters may have a 'deeper bench,' with more personnel who are familiar with retirement plans." These firms also may be able to help you roll over your retirement account to an individual retirement account when it's time for such a transaction.

Some discounters offer IRAs as well as mutual funds, banking services such as checking accounts, mortgages and so on. Nevertheless, they're not full-service brokers. If you're looking for a relationship with a broker, someone who can help you pick stocks or mutual funds and various other financial products, you may be better off with a full-service firm. However, if you're a do-it-yourself investor, there's no reason to pay a broker for advice you don't need.

"One of my clients formerly had a broker who made a recommendation for the education account of the client's son," recalls Melissa Hammel, managing partner at Hammel Financial Advisory Group in Brentwood, Tenn. "This was a few years ago, and the broker recommended a high-tech mutual fund. 'The child is young,' the broker said, 'so he can handle the risk.'"

As it turned out, the fund lost money in the tech-stock crash. "The broker never suggested any action to correct the problem," says Ms. Hammel, "and a big chunk of the account was lost."

The lesson, according to Ms. Hammel, is to "watch out for greed, which can lead to an unbalanced portfolio." Regardless of whether you think a particular investment is going to produce spectacular results, don't overload in one stock or one sector.

"Even with a youngster and a relatively long time horizon," she says, "you need balance in your investment plan." Holding a high-tech fund wouldn't have been so bad, for example, if it had been mixed with financial stocks, healthcare stocks, real estate stocks, etc.

A larger lesson, though, may be that following your broker's advice can be dangerous to your wealth. There are thousands of brokers across the U.S. (many of whom now refer to themselves as financial advisers or financial consultants), and they include countless hardworking, thoughtful individuals. Some brokers, however, are more concerned with their own finances than with yours. In some cases, a broker may see a busy doctor as an easy sell for whatever investment his firm is pushing that week.

Stock tips aren't the only sales pitch that should make you wary. Many brokers conduct "seminars" that are supposed to educate you about a vital topic, such as retirement or estate planning. Often, though, these seminars are meant to sell rather than educate. The more expensive the dinner, the more skeptical you should be.

Thus, you might hear about "excellent opportunities" from your own broker as well as from brokers seeking new clients. "Brokers may approach investors with the idea of quick money, which can be very dangerous," says Michael Booker, founding principal at Financial Synergies Asset Management in Houston. "A broker will tell you that money can be made rapidly, without inordinate risk. A stock might be about to take off, for example. This type of claim is easy to sell because people want to believe it."

Mr. Booker suggests keeping in mind the classic saying: "If it sounds too good to be true, it probably is." After all, if a broker absolutely knew that a stock was going to increase by 50 percent in a few weeks or months, why would he tell you about it? He'd be investing all of his own money, borrowing against his house, urging his parents to buy the stock, etc. He probably wouldn't call you, especially if you're not already a client.

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What sorts of investments are you likely to hear about, over the phone or over a “free” meal? Ms. Hammel says that brokers may be pitching hedge funds, which are unregulated investment partnerships, and commodity funds. “A lot of people are predicting that the stock market will generate single-digit returns for the next few years. Therefore, some investors are interested in hedge funds and commodity funds, which might return sizable profits, good years or bad,” she says.

Historically, hedge funds “hedged” their bets by going both “long” and “short” on stocks. They would invest in some companies, betting that those stocks would rise, while selling other companies short, so they could make money if those stocks fell. Although many different types of strategies are used by hedge funds, they retain the ability to go long and short, and thus make money in all types of markets, by shrewd selections. Similarly, commodity funds can go long or short on just about anything, from interest rates to precious metals.

However, hedge and commodity funds vary tremendously from one to another, and they tend to have high fees. “A high-quality hedge fund or commodity fund might be appropriate for a small piece of your portfolio,” says Ms. Hammel, “but I would not have a large allocation to this type of alternative investment.”

Also, in these low-yield times, brokers may call you to tout investments that offer ample amounts of current income. “Annuities may be sold on the basis of a high yield,” says Mr. Booker, “but those yields might be in place for only a short time, so you should ask about the longer term. Annuities may pay high fees to the brokers who sell them. When you invest, find out how people are getting paid and how much.”

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