SMART INVESTING: IT'S REALL

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Begin With the Basics

START AN EMERGENCY FUND AND LAUNCH A RETIREMENT PLAN.

The most frustrating part of launching an investing program is likely to be that you've got a lot of goals but practically no money to address them. Worse, investment companies are often unwelcoming to those with hundreds, rather than hundreds of thousands, in assets. After all, the fees on small accounts would barely buy a broker a cup of coffee or cover the cost of mailing a prospectus.

The good news is that all of your goals can be addressed over time—as long as you take them one at a time. And, thanks to automation, you can choose from a growing number of inexpensive options that let you invest small amounts in either individual stocks or mutual funds.

Let's start with strategy. You'd be wise to address two goals first—your emergency account (which will keep you from having to move back in with Mom and Dad in case of a financial upset) and your retirement account.

Retirement, you say? Can't that wait? Not if you have access to a Roth IRA or an employer-provided 401(k) plan that offers matching contributions. Contributions to a 401(k) or similar plan are taken before taxes—as if you never earned the money. That reduces your tax bill and makes it easier to afford to save. Better yet, many employers match your contribution at a rate of 25 to 100 cents on the dollar (up to certain amounts), turbocharging your return. Contributions to Roth IRAs are not deductible, but the money is tax-free when it's pulled out at retirement.

In addition, both Roth IRAs and 401(k) plans allow penalty-free access to at least part of your savings, under the right circumstances. That means you can use some of your long-term retirement savings to finance shorter-term goals, such as buying a house or financing college. In the meantime, you don't have to pay taxes on the investment earnings, so your money grows faster.

Once you have an emergency fund established, aim to set aside 10% of your income in a retirement plan (even a smaller amount will give you a head start). Then you can begin saving for other goals, such as travel, college tuition or buying a house.

Historical Returns

THE GOOD, THE BAD AND THE UGLY

As the numbers make clear, stocks have gained the most over the long haul but have wide swings in any given year. Cash is at the opposite extreme. Bonds are in the middle.

Asset class	Long-term return*	Best return (year)	Worst return (year)
U.S. stocks	9.9%	54.0% (1933)	−43.3% (1931)
Long-term U.S. government bonds	5.7	40.4 (1982)	−14.9 (2009)
Cash (30-day Treasury bills)	3.6	14.7 (1981)	0.0 (1938, 1939, 1940, 2011)

*Annualized. Long-term returns are from December 31, 1925, through August 31, 2012. SOURCE: © 2012 Morningstar Inc.

Realize that if you marry, your emergency needs are likely to change—but not double. If you've both got emergency accounts, pull out part of the emergency money and reinvest it to meet longer-term joint goals.

Now for the practical side of the equation: Where can you invest small amounts without paying outsize fees?

If you want to buy individual stocks, your best bets are **SHAREBUILDER** and **TD AMERITRADE.** With ShareBuilder, you can buy individual stocks and exchange-traded funds for as little as $4 per trade. The brokerage has no investment minimums. TD Ameritrade also has no investment minimums and charges $9.99 per trade. In addition, it lets you buy and sell more than 100 ETFs without commissions. (For our latest brokerage rankings, see "The Best of the Online Brokers," on page 38.)

MOTIF INVESTING allows you to buy baskets of stocks related to a single theme, such as companies that pander to pets or ones that are working on biotechnology breakthroughs. The commission is $9.95 to buy a "motif," or full basket of stocks, and $4.95 to buy or sell a single share. You can invest as little as $250.

FOLIO INVESTING does much the same thing as Motif, but it creates portfolios around investing styles, such as small-company stocks and packages that own stocks and bonds, rather than themes. Its basic plan charges $4 per stock (and most portfolios include at least a dozen), or you can buy the "unlimited plan," which costs $29 per month for as much trading as you want.

If you want to buy a single mutual fund, consider **VANGUARD STAR (SYMBOL VGSTX)**. It owns a balanced portfolio of other Vanguard funds that invest in both U.S. and foreign stocks and bonds. Star's annual fee is a modest 0.34%, and its minimum investment is just $1,000. Or check out the small-account portfolio, at right.

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Divvy Up Your Assets

MATCH YOUR INVESTMENTS WITH YOUR GOALS.

The term *asset allocation* is enough to strike fear (or provoke boredom) among many investors. But that's because they may be thinking about asset allocation all wrong.

Consider it a dating game between your goals and your money. Match a goal to the right type of investment and the couple will live happily ever after. And, of course, so will you, because you'll have the amount of money you need, when you need it, to finance the things that are precious to you. Let's take this matchup step-by-step.

DREAM THE DREAM

What do you want? A house? A car? Annual vacations in exotic locales? Or just enough money to handle emergencies and send your kids to college, and time to spend with your grandkids when you're older? Make a list and put it in the order of what's most important to you.

MAKE A TIMELINE

Put an expected date of arrival next to each goal. For instance, the need for your emergency fund is immediate, but your teen's college money won't be needed for, say, four or five years. When will you start tapping your retirement money? How long do you expect to need it in retirement?

ESTIMATE THE COSTS

Some goals are easy to put a price tag on—the value of a new car, for example, or an emergency fund big enough to cover about six months of your living expenses. Other long-term goals, such as college for the kids and a comfortable retirement, are trickier to quantify. But the good news is that the numbers don't have to be precise. Even getting in the ballpark will help.

For college, go with your best guess given your child's wishes and prospects

The Ultra-Simple Choice

60%	Vanguard Total World Stock Index (VTWSX)
40%	Vanguard Total Bond Market Index (VBMFX)

You'll own almost 4,000 stocks from around the globe and a slice of the entire U.S. investment-grade bond market with these two mutual funds. Even better, annual expenses for this mix come in at a modest 0.33%. This portfolio is suitable for anyone, provided you adjust the allocation to each fund to suit your needs.

For Small Accounts

33%	Amana Income (AMANX)
33%	Homestead Small-Company Stock (HSCSX)
33%	Schwab International Index (SWISX)

If you're just starting out and have little scratch to spare, this portfolio is for you. Each fund has a low initial minimum, and the portfolio requires just $1,500 to assemble. With no bonds in the mix and a generous helping of foreign and small-company stocks, it is suitable for someone with a long time horizon. Note: The Amana fund invests according to Islamic principles.

and what you're willing to pay. Two-year community colleges charge about $2,900 a year. The current average annual cost to attend a public university is $17,131 (see "How to Retire Rich," Oct.), and that rises to $38,589 at a private school.

Kiplinger.com can help with the retirement math. Go to kiplinger.com/tools/retirement-savings-calculator.html for our calculator. Not only will it tell you how much your current nest egg is likely to be worth at retirement, it will also estimate how much you should save each month to hit your goal in the future.

KNOW YOUR ASSETS

You wouldn't try to fix up two friends who had nothing in common with each other. You likewise can't match your goals to the right assets without knowing a little about them. Here are the basic characteristics of different asset classes.

Cash investments. Money in bank accounts, money market funds and short-term Treasuries and certificates of deposit are all about safety. They don't pay much, but they're there when you need them. They're ideal for emergency money and short-term goals.

Income investments. Longer-term CDs and corporate and government bonds can serve two purposes. They can provide regular income while earning a higher return than cash investments, or they can be matched to mature at the same time as your goals. For instance, buying a high-quality bond that matures the same year your child goes to college gives you a fairly high degree of certainty about how much you'll have to address that goal.

Growth investments. U.S. and foreign stocks are ideal for long-term goals because, while subject to violent short-term swings in value, they usually return much more than the inflation rate over time. That makes them a great match for your retirement savings plan.

Inflation investments. Commodities and Treasury inflation-protected securities are worth owning to guard against the ravages of inflation. Putting 5% to 10% of your money in TIPS and commodities should provide insurance against runaway prices.

MATCH THEM UP

Take the money you determined that you'd need when you estimated the costs for each goal, and match it with the right asset. For emergency money, pick among the cash investments; for medium-term goals, choose among the income investments; for long-term goals, feed your monthly savings into a variety of growth investments and inflation hedges. That diversity helps stabilize your overall nest egg because some investments will increase in value while others fall.

Also realize that as you get closer to long-term goals, such as retirement, a portion of your savings will slide into the "medium-term goal" category. Start shifting a portion of those assets into income-oriented investments as you get about ten years from the goal.

ETFs for Income

30%	Vanguard Dividend Appreciation (VIG)
20%	PowerShares International Dividend Achievers (PID)
20%	SPDR Barclays Capital High Yield Bond (JNK)
30%	Pimco Total Return (BOND)

This mix of 50% stocks and 50% bonds yields a handsome 3.1% and is suitable for investors seeking an income-centric portfolio using exchange-traded funds. However, this blend will rise and fall with the overall stock market and is not appropriate for investors who cannot withstand significant fluctuations.

ETFs for Long-Term Growth

30%	iShares S&P 500 Index (IVV)
25%	iShares Russell 2000 Value Index (IWN)
30%	Vanguard MSCI Emerging Markets (VWO)
15%	SPDR Dow Jones REIT (RWR)

With this portfolio, you'll own a slug of small-company and emerging-markets stocks, plus a dose of U.S. real estate stocks as a substitute for bonds. Consider this package if you have a long time horizon and a high tolerance for risk. You can buy all of these ETFs without commissions at TD Ameritrade (see "The Best of the Online Brokers," on page 38).

A Kiplinger 25 Package

25%	Fidelity Contrafund (FCNTX)
15%	Akre Focus (AKREX)
10%	Harbor International (HIINX)
10%	T. Rowe Price Emerging Markets Stock (PRMSX)
40%	Harbor Bond Institutional (HABDX)

This portfolio, which uses only funds that are in the Kiplinger 25, provides access to some of the world's greatest managers while offering plenty of diversification (see page 48 for the entire Kiplinger 25). A healthy helping of bonds should provide ballast in a market storm.

Fund Basics

THREE STRATEGIES FOR SIMPLE INVESTING

» Buy on a Schedule

Do you invest in a 401(k) plan each month? Then, even if you've never heard the term *dollar-cost averaging,* you're using this smart strategy to make yourself rich. It's especially well-suited for funds.

When you dollar-cost average, you invest a set amount of money on a regular basis, regardless of whether prices are up or down. This approach forces you to buy more of a security when it's cheap. How so? If you're investing $1,000 a month, in months when prices have fallen you'll buy more shares of a fund or a stock. When a particular security rises in price, the same $1,000 buys fewer shares. Over time, your costs average out (the logic behind the term) but you get additional shares when prices have fallen.

Investing regularly has important psychological benefits. When stock prices in particular are down—that is, when stocks are on sale—the air is thick with gloom and investors are often reluctant to buy, sale or no sale. And if you use an averaging strategy with a lump sum, it prevents you from investing all of your money at once at what could turn out to be an inopportune moment. If you see the value of your assets plunge, you could be tempted to sell at a loss and vow never to invest again.

» Index to Cut Costs

Not everyone loves the notion of poring over corporate balance sheets to find good investments. And thanks to index funds, you don't need to. Index funds buy every stock or bond that's part of a given index and hold those assets indefinitely.

Because an index fund doesn't have to pay managers and analysts to study securities, the funds are cheap. The typical domestic index fund charges just 0.71% of assets in fees each year (and some charge less than 0.1%), compared with 1.41% for the average actively managed U.S. stock fund, according to Morningstar. And because the funds do little buying and selling, trading costs are low, too.

Primarily because of their expense advantage, the performance of index funds is competitive with the best actively managed mutual funds. In fact, over the long haul, index funds beat most comparable actively run funds, although managed funds prevail from time to time.

You can find index funds for nearly every category of stock and bond. You'll find index funds in both the mutual fund format and among exchange-traded funds. Just pick the index you want to mirror and buy the cheapest fund that copies that benchmark.

To be sure, a few actively managed funds consistently outperform the rest. The Kiplinger 25 includes actively managed funds that we think are good enough to overcome their expense disadvantage and outpace their index rivals over the long term. But if you don't want to monitor managers and prefer to spend a minimal amount of time selecting funds, then you'll love index funds.

» Pick Your Target

If you crave simplicity, you'll love target-date funds. Used primarily for retirement accounts, target funds divvy up your assets among stocks, bonds, cash and, sometimes, commodities based solely on the date that you're likely to need your money.

Because you probably have more than one goal, you shouldn't consider a target fund to be a one-fund answer to all of your investment needs. Your portfolio should also include a cash account for your emergency money, and maybe a 529 plan for college savings. If you have other near-term goals, such as buying a house or a car, you'll need to set aside money in appropriate investments for those goals, too. But for retirement savings, a target fund can be a simple, set-it-and-forget-it option.

Where should you go for target funds? We like the offerings of all three of the nation's biggest no-load fund companies—Fidelity, T. Rowe Price and Vanguard. But each approaches asset allocation somewhat differently.

Price is the most aggressive, holding roughly 55% of assets in stocks at the target date. The reason: Price managers think the biggest risk to investors isn't market volatility but rather the chance that you might run out of money before you run out of breath. Price believes that growth investments—namely, stocks—are more likely than income investments to beat the rate of inflation over time, so these funds remain relatively stock-heavy—about 30% to 40% of the portfolio—throughout retirement. Vanguard and Fidelity both have about half of their target funds' assets in stocks at retirement, but both shift you into bond-heavy income funds after a set number of years post-retirement—seven in the case of Vanguard, 15 in the case of Fidelity.

The right mix for you will depend on your investment style. If you're conservative, pick Vanguard; if you're aggressive, choose Price; if you're in the middle, go with Fidelity.

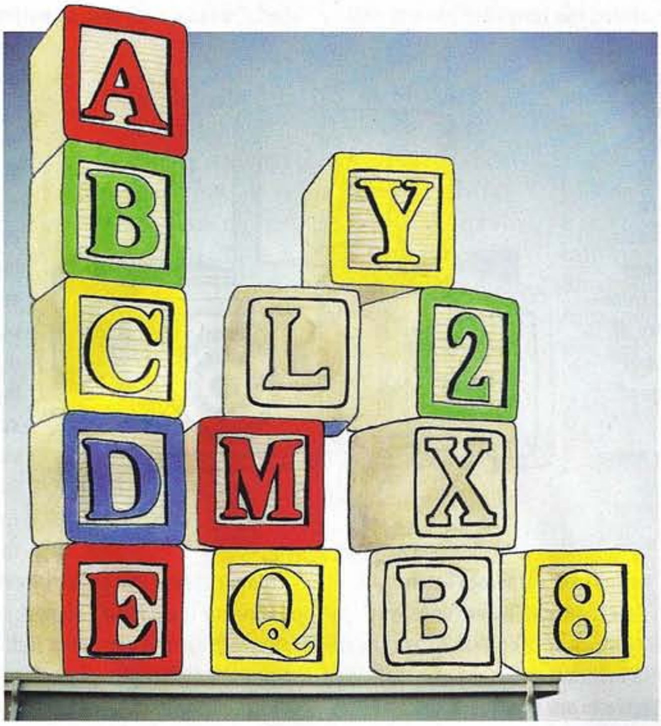
KipTip

Declutter Your Portfolio

Does your portfolio look a bit like your junk drawer, with all sorts of odds and ends that don't seem to fit with anything else? Does tax season take on nightmarish qualities when you try to pull together dozens of disparate investment statements to calculate gains and losses? Then it's time to declutter your portfolio, making it smart, simple and easy to manage.

First figure out what you have. The simplest way to do that is to pull out a notebook and make a grid to show the name of each stock, bond or fund you own and the amount you have invested in it. With funds, you'll also want to note the fees they charge and where they fit on a style grid. That is, do they invest in the stocks of large, undervalued companies or small, fast-growing ones? Treasury bonds or "junk" bonds? Finally, note whether you've got a gain or loss in the holding.

An easy way to research the funds is to go to Morningstar.com. Just plug in each fund's symbol and click on "portfolio." That will bring up a pie chart showing the types of assets the fund owns and where those assets fit on a style grid. That will help you determine whether your portfolio is diversified or you simply have a lot of funds that own roughly the same things.



When you've gone through all the funds in your portfolio, add up the assets by category. What percentage of your assets is in, say, stocks of big U.S. firms? What percentage is in foreign stocks, bonds, real estate and so on? How does this reality compare with what you want to own? (If you're not sure, check our primer on asset allocation, on page 31.)

Your final move is to consolidate and shift assets into a handful of investments that reflect your goals. Ideally, you want just a few investments that provide wide diversification without a lot of fuss (check out our sample portfolios for a few ideas).

All of this shifting will have no impact on what you owe Uncle Sam if it's done inside a tax-deferred account. But if some of your investments are in taxable accounts, decluttering could trigger a tax bite. Selling generates capital losses or gains, so this is where you should refer back to your notations of profit and loss on each holding. The ideal move is to shift assets by matching those that have gains with those that have losses. If you have more losses than gains, you can use the excess losses to offset gains in future years. But if your investments are all in the black, you'll want to see just how big the tax bill might be if you sell.

If the tax hit looks onerous, you have two options: Restructure slowly, over the course of a few years, so you never push yourself into a higher tax bracket or get hit with the alternative minimum tax, which can punish people in high-tax states, such as California. Or you can hold on to your most profitable investment and structure the rest of your portfolio around that, so you won't have to sell the security that's likely to generate the biggest taxable gain.

3

Rejigger Regularly

REBALANCE TO KEEP THE RIGHT INVESTMENT MIX.

Now that you're an asset-allocation whiz, you'll occasionally need to "rebalance" your portfolio to keep the proportions where you want them. That's because various investments increase and decrease at different speeds and at different times. And, of course, your goals could change from year to year, too.

Figure on spending one hour each year reviewing your goals and adjusting your asset mix when market conditions—or your life—throw the portfolio out of whack. Say, for instance, you decided that you need to have 25% of your assets in bonds and 75% in stocks. Then bonds go crazy while stocks wilt, and you find yourself with 35% in bonds and 65% in stocks. In that case, sell enough of your bonds and buy enough stocks to restore the right mix. Or, if you're investing regularly, you can rebalance by simply directing new investments into stocks rather than bonds until you reach the proper balance.

If you have a very large portfolio and are an active investor, it might make sense to rebalance more frequently—say, once a quarter or once every six months. However, if you have to sell assets to rebalance and your money is in a taxable account, you may get stuck with a tax bill. So don't overdo it. Better yet, do the bulk of your rebalancing in tax-deferred accounts, such as IRAs. ■