iShares by BlackRock

3 questions before you build your investment portfolio

Your financial future is not something to be left to chance. It demands a well-constructed, goal-oriented investment portfolio.

In a world of increased market risk, policy uncertainty and an outlook for lower long-term returns across asset classes, how well you build your investment portfolio matters like never before. It can mean the difference between a comfortable or a compromised retirement.

Contrary to common belief, "portfolio construction" is not a simple matter of choosing securities—shares for growth, bonds for income—and assigning some mix of the two. It's important to understand how the various components work together, how they might be expected to perform over a given time horizon, and what risks might be embedded in them. And even that's an oversimplification.

This piece focuses on three questions you should ask yourself as you embark on the process of constructing a portfolio that can address your financial needs and goals.

1. What am I investing for?

Granted, this is a statement of the obvious, but many investors fail to orient their investments by objective. To begin, assess: a) how much you have, b) how much you need at some point in the future, and c) how much your investments need to earn to get you from point A to point B.

The tougher question: Is my objective actually achievable? In other words, is that required rate of return possible given the timeframe and expected market conditions you're working under? Consider: How probable (or improbable) is it, and how much risk might you need to take in order to pursue that return. Ultimately, the answers to these questions will help you understand if your goal is a reasonable one, or if your timeframe or expectations may need to be adjusted.

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2. What type of risk am I able and willing to accept in pursuit of those goals?

In the industry, we often quantify risk as a mathematical concept, such as standard deviation. But we are keenly aware that, for investors, risk is emotional. And that can be hard to plan for.

Often, the framing of risk can make all the difference. Imagine that a $100,000 investment in an asset with an annualised level of volatility of 10% could easily undergo a drawdown of $10,000 in any given year. Assessing your tolerance for risk is probably not about whether 10% volatility feels OK to you. It's about the more tangible question: Can I bear a loss of $10,000 in value at any moment in time?

Equally important: Know the risks you're taking. BlackRock has identified over 2,200 unique risk factors, and has a powerful system to measure any given portfolio's sensitivities to different types of stress scenarios. Nothing removes the emotion from investing, but having confidence in what you've built can sometimes help you to stay the course and not let stressful periods derail the pursuit of your goals.

3. What am I willing to pay in this pursuit?

Portfolio costs come in two categories: fees (transaction costs or management fees) and taxes. Each of these eat into the returns a portfolio generates. That drag is intensified in times of low returns.

Being wise about your cost budget means considering how low-cost exchange-traded funds (ETFs) might work together with high-conviction active strategies. In short: You want to consider where it makes sense to pay more for manager skill and high-conviction ideas vs. gaining broad market exposure with index-tracking investments.

For example, if an active manager has displayed an ability to outperform her benchmark by 1% over time, and you only pay 0.5% extra in fees and taxes in order to achieve that return, then that tradeoff might be worth making if you believe the manager can continue to deliver at that rate. If you can't identify a manager offering this kind of benefit, then it may make more sense to opt for the broad market exposure at a low cost.

While these are three seemingly simple questions, they require hard thought to arrive at meaningful answers around which a productive investment portfolio can be built and oriented. Working with a professional financial adviser can bring objectivity and expertise to the conversation. It might also bring some peace of mind: BlackRock research[1] shows that investors who work with a financial adviser feel more confident and better prepared for their financial future. Your life goals deserve that much. No questions asked.

1 BlackRock Investor Pulse Survey - August 2016.

Want to know more?

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IMPORTANT INFORMATION

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