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Imitations Can Mean More Than Flattery

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In general, most people have their own way of doing things. You may enjoy waking up early on Saturday morning before the sun rises, while your colleague finds sleeping in more satisfying. As the popular phrase says: To each his own. However, in the case of successful investors, similarity seems to be the key to success. The following is a list of five practices that the best investors participating in the market today have in common.

■ **Start early.** There is simply no substitute for time. To better understand this fact, let's look at two investors: investor A and investor B. Investor A invests $2,000 in an IRA from age 18 through 31, and then stops investing. Investor B invests $2,000 in an IRA from age 31 through 65. As you can see, investor A contributed to the IRA for only 13 years, while investor B contributed for 34 years. Since investor B contributed to the IRA for 21 more years than investor A, one would probably assume that investor B accumulated more money. But that's not the case.

The contributions made by investor A had 34-plus years to compound, and that's the key. Assuming a 7% annual rate of return for both parties, investor A will have accumulated $485,240 in an IRA by age 65, while investor B will have accumulated $338,546, nearly one third less. In addition, starting early also allows for adjustments in an investment strategy and gives an investor time to regroup if necessary. It also allows for an investor to reap the benefits of at least one true bull market during his or her investment lifetime.

■ **Maximize tax-deferred contributions.** Invest fully in tax-deferred plans, including pension plans, profit-sharing plans, cash-balance plans, Keoghs, and 401(k)s. These amplify the value of compounding, since the untaxed amount is compounded at an accelerated rate. Once tax-deferred plans offered through employment are fully exploited, other avenues for tax deferral or avoidance include annuities and life insurance. With annuities, investments provide a steady flow of cash upon retirement, and will generally be taxed at a lower rate during retirement years. Life insurance investments can be passed on to a spouse or children without tax consequences.

Real estate investments offer depreciation over a 27-year period, and cash flow is protected from taxation. Also, capital gains with investment properties are avoided entirely if the real estate is passed on to a spouse or children through an estate. When making investments inside or outside of tax-protected vehicles, base your decisions on the tax implications. Tax-free government bonds and growth stocks don't need tax protection. Dividend-producing stocks and taxable bonds, however, are best suited for tax-protected plans.

■ **Diversify instruments and investment sectors.** Don't put all your eggs in one basket. If the recent Enron debacle taught investors anything, it's that there are heavy risks associated with not diversifying a portfolio. And it's important that all investors realize that diversification applies both to different investment instruments and different investment sectors. Thorough diversification means diversifying by industry and diversifying through both equities and bonds in various industries.

■ **Protect against downside risk.** It's only human to sidestep thinking about death or disability. Nonetheless, every investment plan should include both life insurance and disability insurance. Life insurance companies are reluctant to underwrite insurance of more than 18 to 20 times income, but for a physician, 30 times income is optimal if it can be obtained. Disability insurance may be even more important, since disability during a working career is 5 to 8 times more likely than death. Finally, gambling is not investing. Investments with significant downside risks, such futures, are best left to specialists.

■ **Set goals, define risk tolerance, and reevaluate often.** Remember to set goals. Goals can include retirement, maintenance of a certain income level for your spouse, education for children, lifestyle enhancements, or an inheritance for heirs. After you set goals, it's imperative that you define your tolerance for risk, taking into account life factors: Do you have children? Are you single or married? How close to retirement are you? These variables impact financial needs and goals. In addition, based on your goals, reevaluate and regroup often. Take profits from high performers to keep a portfolio balanced.

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