



Commonwealth Sense

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Basics of Investing Continued ...

by

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Investing involves the development of a thoughtful and prudent plan. When putting money in the stock or bond markets, an individual knowingly takes on a higher level of risk with the expectation of earning a higher rate of return in order to grow their assets and achieve defined financial goals. Below are some of the key principles to consider when starting an investment plan.

DETERMINING AN APPROPRIATE BROAD ASSET ALLOCATION

Asset allocation is the process of creating a plan to invest in assets or asset classes which best meet the needs and objectives of the investor. Done well, asset allocation is also one of the keystones of a successful investment strategy.

Not only does asset allocation reduce investment risk, it also drives investment return. It has been shown that the majority of a portfolio's returns can be attributed to asset allocation, so careful consideration must be given when determining how a portfolio is distributed across the various asset classes.

Determining what asset allocation is most appropriate for your portfolio depends upon a careful evaluation of your investment goals, return requirements and risk tolerance.

Remember, investing involves the development of a thoughtful and prudent financial plan, and determining the appropriate asset allocation for your individual needs is a crucial element of that plan. It's easy to stay with a long-term investment plan during good times; the hard part is sticking with it through the not-so-good times. What should you do if you are a long-term investor sitting in the midst of a bear market? If you are holding a well-allocated portfolio, the answer is simple - continue to 'stay the course.'

An annual review of your portfolio, including a review of your asset allocation strategy ensures that it is still suitable given changes in your investment goal(s), return requirements or risk tolerance. Additional reviews may be needed if significant life events impact your investment plan.

IMPORTANCE OF REBALANCING

Over time, the asset allocation of your portfolio may be disrupted by market ups and downs. To help manage the impact of these market fluctuations, a Financial Advisor will periodically rebalance your portfolio – bringing asset allocations back into the proportions originally intended through thoughtful execution of buys/sells within your portfolio. This essential account management tool helps maintain a target asset allocation and should keep the portfolio within the appropriate risk tolerance range.

Rebalancing two to four times a year is a reasonable investment standard, but additional rebalancing may be needed during periods of increased market volatility. The act of rebalancing your portfolio should not be confused with trying to time the market. Rather, it is a discipline to maintain your portfolio's unique investment course.



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DANGERS OF ATTEMPTING TO TIME THE MARKET

Market timing involves making “buy” or “sell” investment decisions by attempting to predict future market movements. Individuals who attempt to time the market, and not adhere to an investment plan, run the risk of missing periods of exceptional returns. This practice may have a negative effect on a sound investment strategy. Studies show it is almost impossible to time the market consistently. In addition, unsuccessful market timing can lead to a significant opportunity loss as the example below highlights:

A hypothetical \$1 investment in stocks invested at the beginning of 1990 grew to \$4.84 by year-end 2009. However, that same \$1 investment would have only grown to \$2.04 had it missed the 10 best months of stock returns. One dollar invested in Treasury bills over the 20-year period resulted in an ending wealth value of \$2.12. An unsuccessful market timer, missing the 10 best months of stock returns, would have received a return lower than that of Treasury bills.

Source: Morningstar®

In addition to determining the asset allocation of your portfolio and conducting periodic reviews, it is also important to consider two additional investment factors, compounding and time.

POWER OF COMPOUNDING AND TIME

It is easy to procrastinate when it comes to initiating a long-term investment plan. However, the sooner you begin, and the longer your money is invested, the more likely it is that the plan will succeed -- thanks to the power of compound interest. The key to enhancing returns is the reinvestment of income over time. Returns decline dramatically if dividends or coupon (interest) payments are consumed rather than reinvested. Reinvesting your income enables you to take advantage of a powerful tool: compounding. With compounding, you not only earn income on the principal, but you also earn income on the dividends and coupon payments you reinvest.

Example: Reinvesting vs. non-reinvesting

Growth of a hypothetical \$1,000 investment in stocks:

	Ending value	Compound annual return
With reinvestment:	\$4,843	8.2%
Without reinvestment:	\$3,155	5.9%

Source: Morningstar®

Now, consider the value of time in the market. If you are an investor who does not need to spend dividends or coupon payments, you should consider reinvesting this income in order to maximize the growth of your portfolio over time.

Example: Long-time horizon vs. short-time horizon

Investor A: Began investing in stocks at the beginning of 1990, investing \$2,000 each year for 10 years. After 10 years, Investor A stopped contributing to the portfolio but allowed it to grow for the next 10 years. The \$20,000 outlay grew to \$60,759 by year-end 2009.

Investor B: Postponed investing for 10 years. At the beginning of 2000, Investor B began investing \$4,000 each year in stocks for 10 years. The \$40,000 outlay of Investor B only grew to \$42,118 by year-end 2009. By starting early, and thereby taking advantage of compounding, Investor A accumulated \$18,641 more than Investor B, while still investing \$20,000 less. Source: Morningstar®

Asset allocation, portfolio rebalancing, market timing, compounding and the time value of money are all key investment principles to consider when constructing a financial plan and building an investment portfolio. To help minimize investment risk, grow assets and achieve investment goals, it is important to seek the assistance of an experienced investment professional. If you are ready to learn more about what First Commonwealth Advisors can do for you, please contact one of our Financial Advisors to get the conversation started. You can reach them toll-free at 1-855-ASK-4-FCA or visit us on the web at fcbanking.com.

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