Introduction

You will probably live to [at least age 90](), and probably longer. If you stop working at about age 65, you will need income for at least 25 years, and probably longer -- possibly much longer. You cannot possibly fund this retirement through your savings. You must get your money to grow, and the only way to do that is in stock investments. In retirement, your investments will be a source of income to you, either through capital gains and dividends or through selling off assets over time.

Your investments will grow much faster if you reinvest any capital gains and dividends. If you try to use your investments as a source of income *now*, you will compromise their long term growth, and you run the risk of running out of money in retirement.

For this reason, I strongly recommend you design a portfolio for *growth*, not income. You should decide how much of your income you need to live your life -- for travel, furniture, books, entertainment and so on, and come up with a figure for how much you can set aside for investments each month. And then use that amount to build a balanced portfolio.

A balanced portfolio is one that has coverage across all the major classes - large cap, mid cap and small cap (and for older investors, bonds). An unbalanced portfolio is one that has *only* large caps, or only small caps, and so on. The consensus among professional investors is that a balanced portfolio will outperform an unbalanced one over time.

Setting up a balanced portfolio is simple. I will explain how you can do this, in easy steps. It may take you several years, but this is OK.

About Allocation Plan

The first thing you need is an asset allocation plan. This is a statement of how much of your assets you want in each major class -- large caps, mid caps, small caps. For a young investor the portfolio should be tilted toward small caps, because these have the most growth potential.

Your allocation plan should become more conservative (more large caps, more bonds) over time.

The Three Keys to Wealth-Building

Building wealth through mutual fund investing means pursuing three keys:

- Asset allocation
- Investing expenses
- Tax efficiency

Asset allocation means having a plan, and choosing investments that implement that plan. Investing expenses means avoiding things like **brokerage fees** and **loads** (or ‘sales charges’). Tax efficiency means maxing out your 401(k), or IRA, or both.

Sample Allocation Plan

For you I recommend this allocation plan:

Large Cap	25%
Mid Cap	25%
Small Cap	50%

Figure 1 Allocation Plan for Young Investor

Note An important consideration is how much money should be domestic (US-based) funds, and how much international funds. I recommend keeping at least one-third of each sector in international. However, to keep things simple I am omitting this entire topic. Once you have a balanced portfolio set up you can give more thought to this.

Growth versus Value versus Index

Broadly stated, every fund follows one of three strategies: Growth, Value, or Index.

Growth and *Value* funds put more effort into research, so they cost you more, but in theory they can deliver better results over time. Whether they do or not, and how consistently, is open to debate.

Index funds concentrate on keeping fund expenses down, the idea being that when the fund does make money, you get to keep more of it, thus erasing any advantage Growth and Value may have.

An index strategy is the best option for most investors, and I recommend this to you.

Active vs Passive management

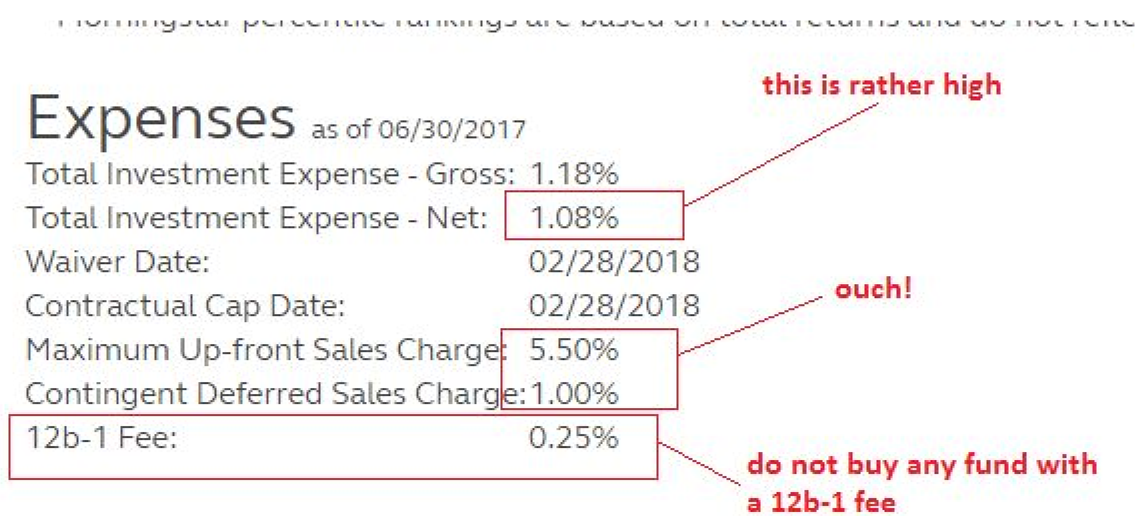
You will come across the terms *actively managed* and *passively managed*. The difference is, more or less, the difference between Growth and Value, and Index. Growth and Value funds use active investing, where they do a lot of research to identify stocks that will suit their strategy. Index funds use passive management that keeps research costs down.

Passively managed funds have lower - usually much lower -- expenses. All the funds I will recommend to you are passively managed.

Current State

Right now you have $40K available to invest, and $16K in your 401(k). 100% of your 401(k) is in Principal LifeTime 2040 Fund (A) (PTDAX). (Actually it's in the 2045 fund, but I don't see that on the web site.) PTDAX is a large-cap index fund.

PTDAX is a rather expensive fund:



Note A 12b-1 fee is a marketing fee. This is money you pay to help advertise the fund. Sometimes this is acceptable, but as a general rule you should avoid buying any fund that has a 12b-1.

However, I do not recommend selling out of this fund. It would cost you money (deferred sales charges) to do so, and anyway there simply aren't any better choices in your 401(k). As a large cap fund, it has a place in your strategy. Keep it, and I will recommend some other things you should do in addition to it.

Right now your asset allocation looks like this:

	Target	Actual
Large Cap	25%	100%
Mid Cap	25%	0%

Small Cap	50%	0%

Your job as an investor is to put new money in whatever sectors are below their asset allocation targets, while taking full advantage of tax shelters, and keeping investing expenses down. For you, that means adding new money to mid caps or small caps, or both, because these are both below target.

So the question is, how to do that. I think the thing for you to do next is open an IRA.

About IRAs

An IRA is an *individual retirement arrangement*. It's a tax shelter available to almost everyone. There are two kinds of IRA: the *traditional* and the *Roth*. For you I recommend the traditional.

Steps to set up a balanced portfolio

I have set of steps for you to take, in order, and some of them on specific dates, using the $40K you have on hand.

Step	Date	$ Remaining to allocate
1 Open IRA and max it out for 2017	Now	$34500
2 Set aside 2019 IRA contribution	Now	$29000
3 Set aside 2020 IRA contribution	Now	$23500
4 Open small cap taxable account	Now	$5500
5 Max out your IRA for 2018	1/1/2018	$0
6 Take IRA deduction for 2017	2018	
7 Max out your IRA for 2019	1/1/2019	
8 Max out your IRA for 2020	1/1/2020	

Step 1: Open a traditional IRA

When: Now

1. Go to https://investor.vanguard.com/home/ and select **Investing** | **Open an account**.

2. Select **Traditional IRA**, and follow the prompts.

When you have your IRA open, put $5500 in Vanguard Small-Cap Growth Index Fund Investor Shares (VISGX) for the 2017 tax year.

Note This is the maximum amount you can put in your IRA for one year.

Let's look at the expenses for VISGX compared to your large cap fund PTDAX:

	PTDAX	VISGX
Expense ratio	1.08%	0.19%
Front end load	5.50%	none
Back end load	1.00%	none
12b-1 fee	0.25%	none

VISGX is much cheaper, which means, all other things being equal, you make more money over the long term.

Your asset allocation is now:

	Target	$$	Actual
Large Cap	25%	$16000	74%
Mid Cap	25%		0%
Small Cap	50%	$5500	26%

Step 2: Set aside your 2019 IRA contribution

When: Now

Open an 18-month CD at your favorite financial institution and deposit $5500. Set the CD to deposit into your bank account upon maturity. When this CD matures, use it to max out your IRA for 2019 (step 7). The idea here is that the CD should mature on or near January 1 2019.

Step 3: Set aside your 2020 IRA contribution

When: Now

Open an 2-year CD at your favorite financial institution and deposit $5500. Set the CD to deposit into your bank account upon maturity. When this CD matures, use it to max out your IRA for 2020 (step 8). The idea here is that the CD should mature on or near January 1 2020.

Step 4: Open a taxable Small Cap fund

When: Now

Log in to vanguard.com and click on **Open An Account**. Open a taxable account (not an IRA this time), and put $18,000 in Vanguard Small-Cap Growth Index Fund Admiral (VSGAX).

Note This is a different flavor of the same fund you opened your IRA with in step 1. Because you are investing at least $10K, you get *Admiral shares*, which have lower expenses.

Note In the future, when the VISGX shares in your IRA reach $10K, Vanguard will convert them to Admiral shares for you.

Your asset allocation is now:

	Target	$$	Actual
Large Cap	25%	$16000	40%
Mid Cap	25%		0%
Small Cap	50%	$23500	60%

Step 5: Max out your IRA for 2018

When: January 1, 2018

On January 1, log into Vanguard.com, open your IRA account, and add Vanguard Mid-Cap Growth Index Fund Investor Shares (VMGIX), and contribute the maximum, $5500, for the 2018 year.

Like all Vanguard funds, VMGIX is cheap:

- Expense ratio: 0.19%
- No loads
- No 12b-1 fee

Your asset allocation is now:

	Target	$$	Actual
Large Cap	25%	$16000	35%
Mid Cap	25%	$5500	12%
Small Cap	50%	$23500	53%

Note To keep things simple I'm ignoring growth that may occur in your investments, and showing only the amounts invested.

Step 6: Take the IRA deduction for 2017

When: Spring 2018

When you fill out your Federal taxes next year, fill out the IRA worksheet and take the IRA deduction. You should be able to deduct some portion of your IRA deduction, and you may be able to deduct all of it. If you were not already getting a tax refund, you may get one, and if you were already due one, you will get a larger one.

Note If you get a tax refund, it's a good idea to put the money in the taxable fund you opened in step 4.

Step 7: Max out your IRA for 2019

When: Spring 2019

When the CD you opened in step 2 matures, put the money in your IRA. This will max out your contribution for the year. Put the money in whatever asset class is below target.

Here I will assume you put it in mid caps. Your asset allocation is now:

	Target	$$	Actual
Large Cap	25%	$16000	31%

Mid Cap	25%	$11000	22%
Small Cap	50%	$23500	47%

Step 8: Max out your IRA for 2020

When: Spring 2019

When the CD you opened in step 2 matures, put the money in your IRA. This will max out your contribution for the year. Put the money in whatever asset class is below target.

Note The IRA contribution limit may increase in the future.

Here I will assume you put half in mid caps, and half in small caps. Your allocation is now:

	Target	$$	Actual
Large Cap	25%	$16000	28%
Mid Cap	25%	$13750	25%
Small Cap	50%	$26250	47%

Summary

You have achieved the three keys to wealth-building:

- You have a balanced allocation plan, and you have implemented that plan (allocation)
- You have opened an IRA and maxed it out (tax efficiency)
- You have avoided brokerage fees and loads (investing expenses)

Next Step: Create a Google Docs spreadsheet with a more detailed view into your asset allocation. More about how to do that, later.