

Building a Stress-Free Portfolio: Four Tips for Long-Term Investing

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Discover how to create and maintain a diversified portfolio with minimal effort. Learn about asset allocation funds, target-date funds, and automated contributions for long-term financial success.

By David Shotwell

A lot of portfolio advice I see is sound but would result in portfolios that are too complicated for most people to implement and maintain over the long haul. If you want a portfolio based on sound principles but don't want investing to become your second job, here are some basic rules to follow that will help you get the job done.

1. Risk Levels and Asset Allocation

The first thing to consider when building a portfolio is asset allocation. This really comes down to risk and how much your portfolio should have in stocks, bonds and cash investments. Those categories also have many subcategories. How you combine assets determines your portfolio's risk level, how much it might fluctuate in the short term as well as your potential long-term return. More stock means more volatility but more growth if you stay invested.

A thorough discussion of how to choose an asset allocation and divvy up your portfolio amongst all the various subcategories of stocks and bonds would take a textbook. For right now, just consider how much risk is appropriate for your investment goals. Money you need to spend, or may need to spend, in the next few years requires a conservative asset allocation because, in the short-term, market returns are very volatile. Portfolios that won't be used for ten years or more can be invested primarily in stocks; while they may rise and fall a lot over short periods, over the long-haul markets tend to provide consistent growth.

Your portfolio's timeframe helps determine your portfolio's risk capacity – how much market volatility makes sense. But the other aspect of risk is personal: how much volatility can you take before you give in and sell your investments in a lousy market. The way to

ensure a volatile portfolio's success is to stay invested during the good times and the bad times. Selling investments during downswings, at low prices, is a recipe for disaster. Conservative investors are much better off investing conservatively in the first place and leaving their portfolio alone rather than trying to take risks when the markets seem to be rising and then being conservative when they worry about losses.

2. Diversification

In addition to dividing your portfolio appropriately between different asset types, a well-built portfolio holds enough different stocks and bonds to eliminate the risk that any one company or bond issuer messing up can upset your investment returns. Research differs regarding the appropriate number of different investments it takes to be diversified. Some studies say forty while others suggest a much higher number.

When you invest in stock – any stock – you take on what is known as “systematic risk.” This is the risk associated with the market in general: stocks will rise and fall with economic expectations. As we touched on above, the more you invest in stocks the more risk you take, but also the more your potential reward.

But individual stocks also have a second layer of risk known as “business risk” or non-systemic risk. That is the risk that any one company can make a mistake and hurt their stock price even when the rest of the market is rising. An oil company's tanker can run aground, a pharmaceutical company can fail a clinical trial or an automaker can face a safety recall. Taking on business risk does not increase your expected return.

Diversification removes business risk. Buying many different stocks from different industries insulates your portfolio from the threat posed by any one of them having a catastrophic error. A diversified portfolio will rise and fall with the broad market but no one company can do too much damage.

3. Simplification

A good portfolio is simple enough to manage and maintain for the long run. Modern investment vehicles allow you to diversify and simplify your portfolio. Rather than trying to analyze, purchase and manage a diversified portfolio of individual stocks and bonds, you can easily purchase a handful of diversified mutual funds or exchange traded funds to cover the entire stock and bond markets.

Choosing individual stocks and bonds is difficult, even for professionals. You need to sift through reams of data trying to identify investments that are undervalued, and you need to figure out when to buy them and when to sell them. The data shows that even the

supposedly sophisticated professionals rarely add value above the return of the broad market.

You can further simplify your portfolio by choosing a fund that is designed for one-stop shopping. Asset allocation funds invest in diversified portfolios of stocks and bonds and are designed to target specific risk levels. These funds will usually have their desired risk level or goal right in their name, such as the Conservative Income Fund or Aggressive Growth Fund.

Target date funds take asset allocation funds a step further. These funds have a year in their name, such as “target retirement 2045.” The funds are managed to be appropriate asset allocations for investors planning to retire near that date. The funds become more conservative as that date approaches.

These funds take the guesswork out of the asset allocation and portfolio building process and make decision-making simple. Some advisers are hesitant to recommend asset allocation and target date funds. Sometimes these funds are more expensive than portfolios built from funds that cover individual asset classes, and most of us have our own opinions on how to allocate a portfolio which may not line up exactly with how a mutual fund company builds their allocation funds. However, their simplicity means that beginning investors trying to start on their own are more likely to go ahead and begin investing, and that is better than trying to make the portfolio perfect.

4. Automation

Because human psychology and behavior get in the way, the fewer ongoing decisions you need to make, the better your portfolio will likely be in the long run. Automation makes it much easier to stick with an investment plan. Contributions to company retirement plans are usually automated and come directly from each paycheck, but if you plan to contribute to an IRA, Roth IRA or non-retirement investment account, set your contributions up for automatic transfer. Automate the investment part, too. Have the contributions added automatically to the funds in your portfolio rather than having to make a purchase decision each time. Eliminating the manual decision-making helps ensure that you won't forget to make the transfer and removes the guesswork around timing the transfer and purchase. Pick a day and an amount and forget about it.

If you simplify by using asset allocation funds or target date funds, then you don't need to worry about rebalancing your portfolio. If you build your own asset allocation from individual funds, you will need to rebalance periodically. Rebalancing means returning your portfolio to your original target percentages, selling those that have become overweight and buying those that are underweight. Some 401(k) providers allow you to set up

automatic rebalancing when you choose your investments. This is a great tool, and you should take advantage of it if it is available. So-called robo advisers also offer automatic rebalancing along with asset allocation guidance and, so long as you are mindful of the portfolio costs, can be a good way to get diversification, simplification and automation all at once.

If you must rebalance manually, set a schedule that makes sense to you, log into your portfolio and return the allocation to its original targets. Make rebalancing as automatic as you can.

Pay attention to allocation, diversification, simplification and automation. These four basic principles will get you off to a good start with your portfolio. Notice that what is NOT listed here is almost as important as what is listed. You do not need to sift through piles of economic data to try to time the market. Just get started and stick with your plan. You do NOT need to dig through details about companies or industries. Invest in a broad, diverse portfolio of stocks and bonds using simple asset allocation or target date funds and automate your investments as much as possible.

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David Shotwell, CFP®, is a financial planner with Shotwell Rutter Baer, an independent Registered Investment Advisory firm based in Lansing, Michigan, but with clients all over the country.

Starting his career during a bear market with the collapse of the tech bubble in 2000 and then working with many of the same clients through the financial crisis in 2008 and 2009, gave David a unique perspective into how people relate to their money and view their portfolios in difficult times. He has dedicated his financial planning efforts to helping clients see past the short – term market swings and focus on the big picture, so they can behave in ways that will help them reach both their current and long – term financial goals.
