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Strategies for Enlightened Investors®

8 Point Portfolio Check-Up

This is an excerpt from *The Investing Revolutionaries: How the World's Greatest Investors Take on Wall Street and Win in Any Market*. To order your copy please visit: www.jwafinancialgroup.com.

1) Asset Allocation

The first component to review in your portfolio is the overall allocation of stocks vs. bonds. Generally, in pre-retirement situations, you should have no less than an 80% allocation to stocks. A strong case can be made that in the long term (defined as a 5+ year investment horizon) stocks not only provide a higher expected return, but are actually safer than bonds. If your tolerance for risk is not quite as high, you might reduce equity exposure to 70 or 60%.

If you are already retired, the amount held in short term bonds should be based on a simple formula which uses your annual withdrawal needs times five. The basis of this calculation is based on the fact that the Standard & Poor's 500 Index has not had a four year downturn since the Great Depression. This gives us the confidence to essentially ignore stock market volatility. This five year short term bond portion of your allocation will theoretically get you through most any down market cycle on the equity side with one year to spare. More conservative investors could reasonably use a longer year multiple to make them feel more comfortable. But if you believe the market cycles, then this is not necessary. Keep in mind that even if a five year downturn in equities does occur, it is unlikely that every stock asset class will lose value simultaneously. One or two asset classes typically are headed up even when most are not. (Even during one of the worst bear markets in history from March 2000 to October 2002, the small U.S. value asset class gained 16.1% as represented by the Russell 2000 Value Index). This gives you the opportunity to rebalance periodically which means you will replenish the bond portion of your portfolio with the stock classes that have grown. So even though five years of needed income is recommended, they will likely not be spent down by utilizing this rebalancing technique.

2) International vs. Domestic

A common mistake individual investors make is an under-allocation to foreign equity markets. International exposure for both pre-retirees and retirees should equal somewhere between 25% and 40% of your total equities. Even a 50% allocation of the equity portion of your portfolio to international stocks is not out of the question given the fact that approximately 60% of the total capitalization on the planet now resides outside of the United States. International markets tend to move at a different pace than U.S. markets. In 2006, we saw a good example of this as the MSCI/EAFE Index grew 26.8% with the S&P growing 15.8%. Likewise in 2007, the EAFE grew at more than twice the rate of the S&P at 11.6% vs. 5.5%, and U.S. small caps, came in behind the international index at -1.5% for the year. The weak dollar, which many would usually consider a bad thing, has made for some nice returns overseas in recent years.

3) Fixed Income

In any interest rate environment short term bond mutual funds are called for. Short-term is defined as two years in duration or less. I rarely see any reason for individual investors to go beyond a five year duration with their fixed income allocation. Bonds should be considered a tool to dampen volatility and provide cash flow needs only. Bonds should not be used for interest rate plays in order to try and guess which way the rate is going. It is amazing how much effort is expended in "bond houses" trying to build ladders to the sky with fixed income instruments. They play on the fears many investors have concerning stocks and create other risks that are rarely defined – the main one being inflation risk. Longer term bonds inject unnecessary risk into a portfolio with little or no reward. Remember – use bonds for cash flow and liquidity and let equities provide the long term growth you need.

4) Large Cap vs Small Cap

Another common trend in individual portfolios is the under-allocation to small company stocks. I joke often that if I really had the intestinal fortitude I claim to have, I would put all my money in small cap value and check it every fifteen years or so. (For the fifteen year period from 1993 through 2007 small cap value returned 12.46% annualized). Since 1926, we have seen small cap stocks outpace large caps by approximately 2.0% per year on average. But alas, very few if any humans have the kind of stomach for the intense volatility that comes with those returns, so we super-diversify and win anyway. But in spite of the higher risk, pre-retirees should have somewhere between 30% and 40% of their equity allocation – both domestic and international – in small company stocks. Retirees should likewise maintain 25% to 35% in small companies. The higher risk means higher returns. This is the governing precept of investing.

5) Growth vs Value

There is a perception that "growth" stocks are the place to be because that is precisely the goal of investors – to have their portfolios grow. This "growth" nomenclature does a disservice to investors in that it takes away from the fact that "value" stocks actually outperform growth stocks over the long run.

Perhaps value stocks are not as exciting to talk about as the "go-go" growth stocks with their hot products or services; however, if the objective is to increase value of a portfolio, value stocks fit the bill. You should maintain 50 to 70% of your stock allocation in value stocks with the remaining invested in "blend" asset classes as opposed to a dedicated growth category. The blend will capture enough of the growth companies to satisfy a prudent allocation.

6) Consider Taxes

There are four simple rules to follow when considering taxes in your investment accounts:

1) You should RARELY pay short term capital gains because they are taxed at ordinary income tax rates. If you do, it is likely because your money manager is picking and timing the market – a big bad 'no no.'

2) Use tax-managed mutual funds in taxable accounts when appropriate. The added tax efficiency means a higher return.

3) Bonds should usually be held in tax-deferred accounts as the income they earn is taxed at ordinary income tax rates. Retirees may need to hold some bonds in taxable accounts for cash flow purposes.

4) Use mutual funds with turnover ratios that are generally in the 20 to 40% range. Anything higher once again indicates the presence of those evil twin brothers - Picking and Timing.

7) Assess Fees

The average stock mutual fund fees (expense ratio) for your portfolio should not exceed 0.40%. The average stock fund fee in the marketplace in 2007 was around 1.32%. As you can see there is a great disparity in the mutual fund arena. Emerging market funds and often small cap funds will be somewhat higher because of the transaction fees and less market liquidity. That is why the average expense ratio of all the funds in your portfolio is the correct measurement to use. Bond fund fees should stay below 0.30%. Mutual funds that exceed these parameters are tell-tale of retail funds that use your money to pay for their huge advertising and marketing costs. As a current shareholder of such a fund, why would you care to subsidize their acquisition of new clients by paying higher fees so they can increase their revenue?

8) Assess Your Advisor

1)You should always work with an advisory firm that is independent. This means they are not associated with a "big brother" brokerage firm that looks over their shoulder and markets the hot investment of the week to them and thus to you.

2) They should also be fee only and direct-pay. This means every dollar they make comes directly from you – the client. It also means they do not accept rewards such as exotic vacations or other lavish perks from mutual fund companies or fund custodians. The name at the top of your advisor's paycheck should only be yours.

3) Look for the CFP® marks after their names. This is the highest standard of knowledge and conduct in the financial industry. This qualification makes it more likely that they will be willing to act in a fiduciary manner in the advisory relationship. Get this in writing. This will put a higher standard of accountability on them.

4) Check to see if they use a team approach in their firm. There are extraordinarily talented people in the financial business that you may want to call "your guy" or "your gal." But, time and chance happens to all of us. Their departure from the firm for any variety of reasons including health problems or death could leave you alone. A team approach also allows the ole 'two heads are better than one' to benefit you and your family.

5) Finally, ask the advisor if they use the same strategy for all of their clients. In other words the same type of investments (i.e. asset class passive investing). If the answer is 'yes' then you can have assurance that you would not be getting the "investment of the week" recommendation when your portfolio is invested.