THE EDUCATED INVESTOR

Fall 2001

Cooking Up the Perfect Portfolio

It's too bad that constructing an investment portfolio isn't more like baking a cake, where a single recipe is followed, predictably resulting in the same just desserts.

In reality, while there are many guidelines, there is no single recipe for everyone. Fortunately, while the recipe may vary, the ingredients from which to choose tend to remain the same.

How do you mix your ingredients to arrive at a recipe to suit your tastes? While each individual step is relatively straightforward, creating the "perfect" portfolio can involve numerous factors, decisions and ongoing maintenance. This special-focus issue of *The Educated Investor* provides an overview of the many ways we add value, helping you to cook up an investment masterpiece instead of just a "stock-du-jour."

What's Inside?

- To Thine Own Self Be True
- Fixing to Invest
- A Defining Moment
- Taxes: The Final Frontier
- Worth Repeating

My Perfect Portfolio

Serving size: One Individual Investor

1. Sift together a liberal measure of stocks:
   - Domestic and international
   - Value, growth, small-cap and large-cap
   - Possible dashes of emerging market stocks and real estate
2. Add several portions of fixed income:
   - Long-term or short-term
   - Taxable or municipal
   - Inflation-hedged (such as TIPs or I Bonds)
   - Cash (as needed)
3. Fold above ingredients gently into a combination of taxable and tax-deferred or tax-sheltered accounts. Consider the following tax-favored flavorings:
   - IRA – Traditional or Roth
   - 401(k), 403(b) and similar retirement plans
   - 529 college tuition plans

To Thine Own Self Be True

The most important decision you must make when building an investment portfolio is how much to allocate to equities (stocks and real estate) versus fixed income. To make that decision, we help you choose an appropriate risk factor based on your ability, willingness and need to take risk. Here are some key questions to consider:

When will you spend these assets? Your time horizon for events for which you are saving (college, retirement, etc.) helps determine your *ability* to own riskier investments. If your investments can simmer untouched for long periods, you can hold more equities than someone who is faced with a more immediate deadline.

How will you react when your portfolio undergoes hardships? What is your risk tolerance? If you can blithely ignore bear markets, your *willingness* to own riskier investments is much higher than if you tend to panic during times of stress.

How are you doing so far? You take on extra risk in exchange for higher expected returns. At the same time, the risk is real, and you may not personally *need* to take it. If your lifestyle would only be modestly improved by seeking higher expected returns, but it would be greatly damaged if your portfolio underperformed your expectations, then you may decide to accept a lower level of risk (and lower expected returns) in exchange for a greater likelihood to achieve the returns you seek.

What is most important to you? Often, you will discover conflicts among the competing guidelines. You might have a long investment horizon and the desire to achieve higher returns, but you may have a low willingness to accept the higher risk. There is no right answer — you must decide what will work best for you.

It's a Small World, After All

Once you've decided how much equity vs. fixed income you wish to hold, you can decide how much to allocate to the various equity asset classes. Again, there is no universal answer, but there are general guidelines. A global diversification among all asset classes is recommended. Don't perceive international investing (including emerging markets) as being "too risky." Instead, consider it in relation to its impact on the overall risk of your portfolio. Studies have demonstrated that adding international equities to a domestic equity portfolio reduced the portfolio's volatility* (a measure of risk), and reduced the risk of loss within the portfolio. Investing globally also protects the US investor from having all investments *and* all "intellectual capital" (such as career, home and lifestyle) invested exclusively in the US.

Spreading the Wealth

We again begin with the crucial role that diversification plays in meeting long-term investment objectives. While the recipe is imprecise, everyone should consider allocating equity investments to each of the five major asset classes: large-cap, small-cap, large-cap value, small-cap value and real estate.

Comparing Apples to Oranges

"Tracking error regret" is a common stumbling block to avoid. While diversification across asset classes is the prudent strategy, once done, it is important to realize that your portfolio probably won't perform like the popular conception of "the market," as represented by common indices like the S&P 500 which is very narrowly focused on the asset class of large-cap stocks. In periods like 1998-1999, when large-cap stocks dominated the performance charts, investors in diversified portfolios ran the risk of wondering why their portfolios were not doing as well as the indices. Of course, the reverse was true in years like 2000 and most of 2001, when value and small-cap stocks were dominating the performance tables.

Things of Value

Value and small-company stocks are riskier investments than their growth and large-company counterparts, with higher *expected* returns as compensation for that risk. Among the common characteristics of value companies are high leverage and high volatility of earnings. To determine how much value and small-cap equity you wish to include in your portfolio, revisit an analysis of your ability, willingness and need to accept risk. Another issue worth consideration is how much risk you already are accepting in your life if your chosen career is affiliated with a value or small firm; or, conversely, how much risk you might be foregoing by having a career affiliated with a large growth company (or by being safely retired from it all).

Get Real (Estate)

The final domestic equity asset class to consider is real estate. Real estate has low correlation to the other domestic equity asset classes, tending to perform well in inflationary environments. It is also highly tied to the economic cycle. Thus investors who should consider tilting toward value and small-cap stocks should also consider including real estate.

Fixing to Invest

While there is much to be said about diversified stock holdings in a portfolio, it's just as important to work with your advisor to ensure that your fixed income investments are equally contributing to your overall portfolio objective.

There are numerous options available for fixed income investing, and new ones seem to open up all the time. These range from cash and its equivalents (CDs, passbook savings accounts, etc.) to more sophisticated and potentially higher-yielding instruments such as Treasury or corporate securities, the latest inflation protected securities or municipal (muni) bonds. Then there's the decision of whether to purchase individual holdings (such as individual Treasury notes or muni bonds) or fixed income mutual funds.

As your investment advisor, we can help you sort through the range of existing and new options to determine which ones make the most sense for you. There are numerous factors we take into account when helping you build the fixed income component of your portfolio. Most critical are the following considerations.

What Do You Wish to Achieve?

Are you holding fixed income mostly to generate regular current income (such as in retirement)? Or does it serve more as your "safety net" to offset the riskier equity portion of your portfolio?

As with equities, you can expect to achieve higher returns by accepting greater risk. Even if risk reduction is your primary objective, we can help you determine when it might make sense to take on modest risk — for example, by investing in individual or fund-based Treasury notes or muni bonds — in exchange for expecting higher long-term returns. We can also help you decide when it *doesn't* make sense to take on risk. For example, we advise against taking on the high risk involved in low-grade investments such as junk bonds; for the same amount of risk, you'd be better off purchasing stocks with their higher expected returns.

We can also explain subtleties such as why the prudent investor will find the greatest risk relative to reward in shorter-term (one- to two-year) Treasury notes, but can wisely invest in longer-term instruments (averaging five-seven years) when selecting municipal bonds. For investors such as retirees, whose primary objective is inflation protection, we can compare the different vehicles available to address this need.

What About Taxes?

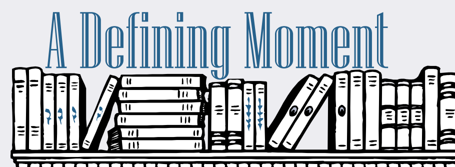
Are you able to hold your fixed income in your taxable or non-taxable accounts? Munis, which enjoy a tax-exempt status, might be an appropriate choice if you are holding your fixed income within your taxable accounts. Less-tax-efficient vehicles such as taxable fixed income mutual funds might be best placed within your tax-sheltered accounts.

At the same time, your tax status may not always be the overriding factor in determining which instruments to select and where they should be placed in your portfolio. For example, you might be in a low tax bracket, or individual muni bonds might not be an appropriate investment for you for other reasons. We can help you determine how to balance tax considerations against other factors affecting your fixed income decisions.

How Large Is Your Portfolio?

Do you have significant or modest amounts to dedicate to fixed-income investing? As with all investments, it is important to achieve as much diversification as is reasonably possible for your fixed income. If your assets are modest, your best choice may be a low-cost mutual fund that can offer significant diversification even with relatively small investments. As your assets grow, you may be in a better position to invest in a collection of individual muni bonds, or in investment-grade corporate or Treasury securities, again depending upon your overall objectives.

In short, there are more ways than ever to save for that rainy day … and more reasons than ever to seek the assistance of your investment advisor.



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* **Volatility** — A measure of how risky you can expect an investment to be, based on the amount it deviates from its long-term average return. Volatility is usually measured by the "standard deviation" of returns. The greater the standard deviation, the greater the volatility. Standard deviation can be for varying time periods (monthly, annually or a customized time frame), and for either specific components of or your entire portfolio. Lower volatility results in higher expected returns over time.

Taxes: The Final Frontier

When all is said and done, there's still those taxes to be paid. Thus an important ingredient with which we can help is how best to locate your holdings among your taxable and tax-deferred/ non-taxable accounts so that your annual tax bill is no higher than it need be.

The easiest account is a Roth IRA. Since all qualifying withdrawals are tax-exempt, we advise you place within that account the asset classes that generate the highest current taxes. Generally, the least tax-efficient equity asset class is real estate. From there, in order, are small-cap value, large-cap value, emerging markets, small-cap and large-cap. The same lessons can apply to other tax-favored accounts such as 401(k)s, 529 college tuition plans or traditional IRAs. You may also want to hold your fixed income in tax-deferred accounts.

In your taxable accounts, we advise you to hold the most tax-efficient equity asset classes — the above in reverse, plus any funds that are specifically designed as tax managed. This assumes that you are invested only in the passive investment vehicles that we recommend. If you must hold "actively managed" funds that attempt to beat market returns by stock selection or market timing, these are typically less tax efficient and thus should be placed in tax-favored accounts.

What if you need to invest within a tax-inefficient asset class but you have no room in your tax-favored accounts? Then you might consider an exchange traded fund (ETF) or tax-managed fund as relatively tax-efficient ways to gain exposure to the desired asset class.

If you want to make sure that every penny saved is a penny earned, we have one more consideration. Foreign stock holdings often entail taxes being withheld at the source. You must then claim a foreign tax credit that you can use against your US taxes. Of course, this credit does you no good if the holding is not in a taxable account. Thus, if you have a choice between holding similar US and international funds in taxable or tax-deferred accounts, place the international fund in the taxable account and the US fund in the tax-deferred.

Renowned investment guru Warren Buffet once made the following quip about investing amidst bull and bear markets: "A rising tide lifts all boats. It's not until the tide goes out that you realize who's swimming naked."[1] By incorporating techniques such as tax management, effective diversification and maximization of your fixed income investments, we can help you swim through the many rises and falls of the market's tide.

[1] Scott West, *Storyselling*

Worth Repeating

Worth Repeating

"We are all swimming on an investment beach roiled by waves of noise. Be very careful you don't mistake a line of rogue waves for the turning of the tide."

William J. Bernstein
Editor, *Efficient Frontier*
www.efficientfrontier.com

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP

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