You CAN Heal Your Portfolio: Asset Allocation & Diversification

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1)**<u>You CAN Heal the Damage in Your Portfolio.</u>**

If you are like most people your portfolio probably falls into one of two categories:

<u>The Abandoned Portfolio</u>
-All your money is either in cash, money market funds, savings accounts or CD's. This is either because you bailed on all your holdings or because you are a new investor and haven't started yet.

<u>The Paralysis Portfolio</u>
-Most of your money is concentrated in a few **securities**, either stocks or mutual funds that have performed very poorly. You've left everything as is for one or more of the following reasons: fear of making more mistakes, avoidance of complexity, uncertainty, lack of confidence, or lack of knowledge of how to fix this problem.

Do you recognize yourself in either of these scenarios? Even if you don't fit neatly into one of these profiles, you probably have elements of one or both of them. Either way, this tutorial will help educate you and provide a roadmap for healing the damage and for getting back on track towards achieving your financial goals.

(perhaps it will make sense to have certain words hyperlinked to a definition – I have boldfaced ones I think might make sense.)

2) **Where you are today.**

Neither the Abandoned Portfolio nor the Paralysis Portfolio has performed well over the last 3 years.

2 Examples:

The Abandoned Portfolio
(insert pie chart: 100% Cash)
3 Year Return: 2%

The Paralysis Portfolio
(insert pie chart:

Stock A	5%
Stock b	15%
Stock C	20%
Mut fund D	25%
Mut Fund E	30%
Cash	5%)

3 year return –50%

3) **Why am I in this situation?**

The first problem is that most of us don’t want to examine our portfolio. We know the news is bad and we’d rather address it “some other time.” We certainly have enough in our lives to keep us busy while we wait for the market and our portfolios to come back. This is not the best course of action. Why?

> The Abandoned Portfolio will never “recover.” In fact it won’t even keep pace with inflation so your real return over time will be negative. Inflation erodes the value of your money faster than savings rates can pay you interest.
>
> The Paralysis Portfolio is like an old junk car that you used to drive down a mountain. “Just waiting” is not going to make that old car ready to drive you back to the top. It will need a tune up, replacement of some parts, and perhaps a complete overhaul of the engine.

The second problem is that when we do look at the damage or the paltry return in our portfolio we despair thinking that the problem is so big that we couldn’t possibly fix it.

4) **<u>So, is there hope?</u>**

Yes! But there is no magic bullet.

You will need a plan and you will need to implement that plan.
Implementing will take a combination of faith, courage, discipline and time to heal your portfolio.

Faith, you will get from education that asset allocation principles work.
Courage, you will get when you sell some of your underperforming investments. –Wait till you see how good you feel afterwards!
Discipline, you will get by scheduling in your calendar the review of your portfolio at least yearly.
Time, we don't have a lot of control over, however by evaluating how much time you have and incorporating it into your plan, you will be able to attain optimum success.

Remember taking any action is better than "just waiting." And this tutorial will demonstrate that it is not that difficult to do.

5) Can I get back to where I was? And beyond?

Yes – if you have a long enough time horizon and have a disciplined approach to asset allocation. Even if you don't have a long enough time horizon to get back to where you were, you can achieve a better result than you have today.

The strategy & tactics to get you there is fairly easy.

The most difficult part is having the courage and motivation to take the first step and to stay disciplined over time. Both the good times and the bad times will test your discipline to this approach. It is important to stick with your asset allocation when you are discouraged in the bad times, and when you are tempted by high-flying stories in the good times.

6) **<u>OK, so how do I do this?</u>**

Asset Allocation and Diversification.

You’ve probably heard these terms before. Maybe you’re thinking this sounds too simple. The simplest strategies are often the best ones. Complexity and degree of difficulty to implement does not necessarily correlate with better results. They usually correlate with procrastination. Keep it simple, take action, stay disciplined and you will see positive results.

Before showing you how to use these two concepts it is important to understand their definition and why they work.

7) What is Asset Allocation and Why use it?

Asset Allocation is finding the right mix of foreign and domestic assets classes: stocks, bonds and cash for your portfolio.

The reason to use asset allocation is because of the findings of Gary Brinson, a money manager and author of finance, and also the findings of modern portfolio theory. Brinson's study analyzed a group of pension fund managers to determine what was the cause of the differences in their results. What he found is that over 90% of their differences could be explained by the asset allocation they chose. This meant that both security selection and market timing accounted for less than 10% of their differences. Here's a notable tidbit that will should instill some confidence:

> If over the past 10 or 20 years you had held a portfolio of 25% of the following **indices**: large US stocks, small US stocks, foreign stocks and high quality US bonds, you would have outperformed over 90% of all professional money managers and with significantly less risk.[1]

What could be easier than picking four index funds, investing equal amounts in each, and letting them sit for 10 years?

[1] http://www.efficientfrontier.com/aa/index.shtml

8) **How do you get the "right mix?"**

You will need to examine your personal Investment Profile. This includes the following:

Your risk tolerance – how you feel about potential fluctuations in your portfolio and how much you can financially withstand.
Your time horizon – how much time you have before you will need the money that you are investing.
Your goals – what do you want your money to do for you? (retirement, home, large purchase, education, etc)
Your income, job status and tax bracket – how much savings you should have as opposed to investments, and what type of fixed income securities should you invest in.

9) **Investment Profile: Finding your "right mix" – Goals**

This worksheet is to help you begin to get a feel for what you would like your money to do. Going through the exercise will help you understand your timeframes for different goals.

After inputting all the information you'll be able to printout a consolidated Goal Sheet that will provide motivation for you to have discipline in your investing process. It will also serve as a reminder to keep you on track.

1. What do you want money to do for you? (check all that apply)
2. Buy things, security, home, retirement, travel, other__________________

3. What do you think is a realistic annual return on your overall investments?______%

4. What is your outlook on the economy and the stockmarket over the following time periods?
   1 year _____% (your projected annualized stock market return)
   2-5 years _____% (your projected annualized stock market return)
   5-10 years _____% (your projected annualized stock market return)
   10-20 years _____% (your projected annualized stock market return)

5. What are some of the major purchases you would like to buy in the future?

Item	Amount	When
(bigger) House, Car, Stereo, Boat, etc		1 year, 5yrs

6. What are some of the life event expenses that you anticipate

Event	Cost	When
Marriage, personal education, children's education, healthcare for parents, travel/vacations etc		

Here is your Goal Worksheet. You may print this now or print it later with your other printouts.

(output: printable summary of answers to the above questions)

10) **Investment Profile: Finding your "right mix" – Risk Tolerance**

How do you discover what your risk tolerance is? It is certainly more art than exact science, however by answering some questions you can get a gauge on it. It is also important to keep in mind that it is a moving target depending on the changes occurring in your life, such as job status, marriage, financial needs, etc.

Risk Tolerance Quiz (we can discuss how this will equate into points towards an asset allocation mix. Also we can discuss what should be the default value if a field is left blank. Maybe we make it so that they have to fill in something.)

1. How much do you currently have in your portfolio or in cash for investing?
   $__________

2. How much of your money will you need in the short term? (less than 1 year)
   $__________

3. For the rest of your money, when will you need the money?
   1-3 years, 3-5 years, 5-10 years, 10-15 years, 20 years +

4. I plan to spend this money over the following time period:
   1-3 years, 3-5 years, 5-10 years, 10-15 years, 20 years +

5. What are your monthly expenses? (fill in amount) $_________________/month

6. What is your income level? (choose a level or fill in exact amount)
   <$20,000, $20-$30k, $31-50k, $51-75k, $76-100k, $100-150k, $150k+

7. What is your tax bracket? (Choose one)

Tax Brackets—2002 Taxable Income

Joint return	Single taxpayer	Rate
$0–$12,000	$0–$6,000	10.0%
12,000–46,700	6,000–27,950	15.0
46,700–112,850	27,950–67,700	27.0
112,850–171,950	67,700–141,250	30.0
171,950–307,050	141,250–307,050	35.0
307,050 and up	307,050 and up	38.6

8. What is the status of your job? (Gauge of layoff potential)
   Very secure, Secure, Somewhat Secure, Not Secure, Layoff is likely

9. How do you feel about investing? (choose one)
   Scary, I'm cautious, I'm comfortable yet cautious, I'm comfortable with fluctuations, I like to take risks

10. My investing knowledge and experience level is:
    No knowledge, beginner, good experience, very good, very experienced.

11. Review the following hypothetical portfolios. Which one would you be most comfortable with considering both the potential upside and potential downside.

One Year Return

(add column here that would show what the participant's portfolio value would be with these returns, given the input from the first question)

Investment Plan	Average Annualized	Best Case Scenario	Worst Case Scenario
Plan A	7%	16%	-6%
Plan B	9 %	25%	-12%
Plan C	10%	34%	-18%
Plan D	11%	43%	-24%
Plan E	12%	50%	-28%

Here is your suggested Asset Allocation according to your Investor Profile:

(demonstrate pie chart and line item asset allocation percentages & dollar amounts based on the amount of $$ the participant typed into the questionnaire.)

Below you will see the other asset allocation models. If you feel that you would like to be either more conservative or more aggressive, you can choose one of these models below instead.

(display the other model names with radio buttons next to each so the participant can override the suggested model and choose their own.)

Asset Allocation Results: (these will all have pie charts and line item breakdown of percentages) (only display pie chart etc for the selected model. All others just show the name)

Short Term

Large Company Stock	0%
Small Company Stock	0%
International Stocks	0%
Fixed Income	40%
Cash	60%

Conservative

Large Company Stock	15%
Small Company Stock	0%
International Stocks	5%
Fixed Income	50%
Cash	30%

Moderately Conservative

Large Company Stock	20%
Small Company Stock	10%
International Stocks	10%
Fixed Income	40%
Cash	20%

Moderate

Large Company Stock	20%
Small Company Stock	15%
International Stocks	15%
Fixed Income	35%
Cash	15%

Moderately Aggressive

Large Company Stock	30%
Small Company Stock	25%
International Stocks	25%
Fixed Income	15%
Cash	5%

Aggressive

Large Company Stock	40%
Small Company Stock	30%
International Stocks	25%
Fixed Income	0%
Cash	5%

11) **<u>What about Diversification: What is it and how do I use it to my advantage?</u>**

Diversification is having a broad mix of securities in each of the **asset classes** in which you invest. It also means having a broad coverage of all the different **sectors** of our economy.

How broad is broad enough? Generally speaking, broader is better for spreading out risk, but a good guideline is to have a minimum of 25 securities per asset class. The easiest way to achieve this is through mutual funds.

Why use diversification? Simply put, if you have a small number of securities in your portfolio and if one of those securities performs poorly its impact on your portfolio is felt more strongly than if you had a greater number of holdings. The same is true with sectors of the economy. The less securities you have the more one of them will impact your overall results.

12) **<u>How do I take this knowledge to recover my portfolio?</u>**

<u>Mentally</u>

Before you implement, it is important to get your mental resolve strengthened. Don't torture yourself with getting back to where you were. Focus on where you are today and what you can realistically achieve.

Your goals should be based on what you have to work with –both amount of money and length of time - and also based on realistic expected returns.

Remember, the vehicle that took you down the mountain will not likely be able to bring you back up the mountain. And any vehicle you choose, even the "right mix," will take longer to go up than it did to come down.

<u>Implementation</u>

Next we'll embark on a strategy to take asset allocation and diversification principles and break it down into tactics you can implement.

13) **<u>Healing the Abandoned Portfolio- Implementation</u>**

This one is easy.

Take the cash that you have to invest and allocate it in the following manner to each of the asset classes.

Here is the Asset Allocation you chose based on your Investment Profile:

(display the pie chart and line item asset class percentage breakdown here. This is from what the participant chose earlier in the tutorial.)

Next we’ll show you how to plug mutual funds into your target asset allocation.

14) **Using Mutual Funds for Diversification**

Mutual Funds will automatically give you the diversification that you need in each asset class. As mentioned earlier, you should have at least 25 securities in the each of the asset classes as well as good sector coverage in order to achieve proper diversification. Since most mutual funds own at least 25 stocks and/or bonds per fund, you can establish a high level of diversification easily.

Trying to do this on your own with individual stocks and bonds is a full time job. It can be done, but just like taking your car to a mechanic, it is often more efficient and effective to let the experts handle this for you.

15)**<u>Plugging Mutual Funds into your Asset Allocation</u>**

Asset Class	Percent of your Portfolio (this will come from their allocation)	Type and Style of Mutual Funds to Use*	Percent of that Asset Class	Dollar Amount (this will be calculated based upon the $$ amt they plugged in earlier)
Large Company Stock		Index Fund Value Fund	50% 50%	
Small Company Stock		Growth Fund Value Fund	50% 50%	
International Stocks		International Fund OR International Fund of Funds	100%	
Fixed Income		Med/Long Term Bond Fund Short Term Bong Fund	50% 50%**	
Cash		Taxable MMF OR Municipal MMF***	100%	

You can use Morningstar or another mutual fund ranking service for choosing the mutual funds to plug into your target asset allocation.

Choose 4 or 5 star funds according to asset class, **type** and **style** as indicated above. The last column above is the amount that you should invest in each fund. Choose the funds and take action to invest today! Don’t delay!

* If you have less than $15,000 approximately and find it difficult to meet the fund minimums, or if you have difficulty choosing mutual funds, you can stick with an Index Fund in each category or a Fund of Funds for each asset class or all asset classes combined.

** If you are more conservative you can weight the Med/Long Term Bond Fund as low as 0% of your portfolio. Also, if you feel that you are more conservative you can stick to either US Treasury or US Gov’t Agency Bond funds, forgoing Corporate Bond Funds.

*** Use Municipal MMF when you are in the highest tax bracket or when the return is better than a taxable MMF. To calculate which MMF is better for you:

Take the Muni MMF Rate divided by (1-your tax rate-expressed as a decimal). If the result is larger than the Taxable MMF rate then you should use the Muni MMF. If it is lower than the Taxable MMF then use the Taxable MMF

<u>Example:</u>
Taxable MMF Rate: 4.0%
Muni MMF Rate: 2.75%
Your tax bracket: 38.6%

Calculation: 2.75/(1-0.386)=4.23% This is your tax equivalent rate and since it is higher than the Taxable MMF rate of 4.0%, you should use the Muni MMF.

16) **<u>Healing the Paralysis Portfolio</u>**

To illustrate how to heal the Paralysis Portfolio, let's take a look at a hypothetical example.

Example Portfolio

Security	Present Value	3 year performance	% of Portfolio	Value 3 years ago
Large Stock A	$1000	-80%	5%	$5000
Large Stock B	$3000	-75%	15%	$12,000
Small Stock C	$4000	-50%	20%	$8000
Large Stock Mutual Fund	$5000	-20%	25%	$6250
Small Stock Mutual Fund	$6000	-30%	30%	$8570
Cash	$1000	+5%	5%	$950
Totals	$20,000	-49%	100%	$40,770

Does this look familiar? If it does, you are not alone. The big cloud over your head is "how can I ever get back to $40,000?" In this case, although the drop was approximately 50% in value, it will take a return of 100% to get back to where you were. It's no wonder you feel paralyzed.

A lot of us think that since our portfolio holdings were once "at the top of the mountain" that we can use them to get back there. Betting on just these 5 securities is not the most prudent way to regain that market value.

Let's keep moving forward. There's good news around the corner.

17) **How long will it take to reach my goals?**

Let's take a look at a couple scenarios:

If you set a goal of 8% per year, and if you simply invest your $20,000, it would take you close to 10 years to get back to $40,000.
However if you contribute $100 per month in this scenario, it will take less than 6 years.

Enter in your own scenario to see what your timeframe might look like.
(Insert investment return calculator)

The important thing is to select a reasonable rate of return as a goal. In your Investment Profile you chose (____x%___) as a reasonable return. (fill in from Invst Profile) The return you choose determines the amount of risk you will need to assume. You must also choose the correct vehicles to get you to your goal. You will want to choose a vehicle, in this case a well diversified portfolio, that will get you to your goal in a reasonable amount of time.

18) **Exactly How do I fix the Paralysis Portfolio?**

There are two main tasks you must consider: Selling and Buying.

First, we’ll look at Selling. The goal of selling is to reallocate asset class percentages and also to remove under-performing securities.

Second, we’ll look at Buying. The goal of buying is also for reallocating to your target asset allocation. In addition it will serve the purpose of fortifying your portfolio, fixing the engine of the vehicle that brought you down the mountain.

19) **<u>Selling in your portfolio</u>**

<u>Stocks</u>
Sell all shares of any stock that you wouldn’t buy today. Let it go financially and emotionally. And take advantage of the the loss on your taxes.

Of the stocks you still have faith in, reduce them to no more than 5-10% of your overall portfolio combined. So if you have 3 stocks you still like, their total combined market value should be no more than 5-10% of your total portfolio.

<u>Mutual Funds</u>
Sell all shares of the funds that have underperformed their market benchmark for 3 years or more. If you are working with Morningstar for choosing mutual funds, you can sell any that are at 3 stars or below.

For the funds that are still performing well relative to their benchmark, sell only the portion necessary to bring your portfolio in line with your target asset allocation.

20) **<u>Buying for your Portfolio</u>**

Plugging in Mutual Funds into your Asset Allocation

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21) **<u>Congratulations!</u>**

You’ve completed the tutorial on how to heal your portfolio!

Now, you need to Take Action!!

Here is your roadmap:

(display all their previous inputs and outputs)

Choose what you need to sell and choose what you want to buy. Do it today. Take that first step. And stay on course. You should reevaluate your portfolio at least 1-2 times per year or whenever you have a major life event occur where your goals and financial situation changes. Schedule it into your calendar today!

Good luck and enjoy the rewards!