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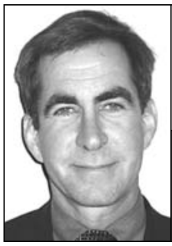
Wealth and risk – what portfolio mix is right for you?

Capitalism is a beautiful thing – it says that if you take a smart risk with your money, you should expect a positive real return. This column will help you explore what amount of risk is right for you in constructing your personal investment portfolio.

Are you a risk taker or does the thought of losing money scare you? Asset allocation is



Personal Finance

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one of the most critical choices an investor has to make regarding their portfolio. In its simplest form, a risk embracing investor might put 80 percent of his or her portfolio into stocks and 20 percent into bonds and cash while a risk adverse investor might do the opposite. Contrary to popular belief, the investor's risk profile is not based solely on the investor's willingness to take risk. It should be based on two factors:

1. Willingness to take risk: If the investor loses sleep every time the market drops 10 percent, then clearly there is a low tolerance for risk. Conversely, an investor willing to put more in the stock market after a 50 percent decline has a very high risk tolerance. There are countless surveys to measure your willingness to take risk, but all have one serious shortfall in that they are theoretical. It's one thing to say you'd hold on if your portfolio lost half its value but, in reality, most investors get nervous and sell near the bottom.

2. Need to take risk: Many investors have a very high risk tolerance but have little need to take risk. If your goal is to live comfortably and you have sufficient funds to live to age 130, then there is no need to put most of your assets into the stock market. On the other hand, a person who wants to retire in five years who has only a $50,000 money market account has a strong need to take risk because his retirement goal is guaranteed to fail with that current strategy.

Risk: Don't confuse the improbable with the impossible.

Let's review the three major asset classes – cash, bonds and stocks.

Cash: This has the lowest amount of risk, especially if it is held at a financial institution guaranteed by the FDIC. Naturally, lower risk means lower return and you are virtually guaranteed to earn less than inflation, especially after taxes. If you have substantial amounts of cash, don't let it sit there earning 0.5 percent or less. There are institutions paying 2.2 percent or more that give you complete liquidity and are backed by the FDIC. This is low hanging fruit, so put on those overalls and get picking.

Bonds: This class has more risk than cash but generally less than stocks. Bonds are usually a nice shock-absorber for your portfolio because bonds and stocks often move in the opposite direction. Bonds with long durations (similar to long maturities) pay more than short-term bonds and have higher interest rate risks. Similarly, those with lower credit quality pay more than U.S. Government bonds. If your goal is to use bonds to mitigate risk, then I suggest sticking to bonds or bond funds with a two- to five-year duration and high quality credit issuers. Finally, consider certificates of deposits (CDs) as part of your portfolio. Under certain conditions, they are backed by the FDIC and some allow you to withdraw the funds with minimal early withdrawal penalties.

Stocks: In the "no guts – no glory" department, this is the riskiest class, which historically has paid the highest return. Yet during the great depression, stocks lost about 88 percent of their value. It's true that times are very different today but don't be lulled into a false sense of security that the same thing couldn't happen again. While it's not likely, don't confuse the improbable with the impossible. Over the long-run, however, stocks have not been that risky as you can see in Table 2. When selecting your stocks, make sure you diversify across:

- The world – both U.S. and foreign
- Company size – small, mid, and large capitalization
- Valuation – growth and value
- Thousands of companies across all sectors

I wish I could tell you in a newspaper column how to choose your asset allocation, but I can only give you a few tidbits of advice:

1. You may be more risk averse than you think. People generally believe they have a higher risk tolerance when the market is hot than after three years of stock losses. That's because feeling the pain is far more powerful than theorizing the pain.

2. Don't believe the experts when they tell you which asset class will do best in the next year. They don't know and following their advice usually only increases risk and decreases return.

3. Within each asset class, make sure you follow the top three rules – diversify, diversify, diversify. Failing to do so increases your risk without one iota of increased expected return. Owning the blue chips Enron, WorldCom, and Qwest did not constitute a diversified stock portfolio. Remember, capitalism rewards for risk taking – not gambling.

4. Get the highest return from each category. Don't settle for a low return on your cash or CDs. Go to sites like www.bankrate.com and seek out the highest paying insured accounts. Within stocks and bonds, keep your costs dirt

ASSET ALLOCATION

ILLUSTRATIVE

WILLINGNESS TO TAKE RISK

		HIGH	LOW
NEED TO TAKE RISK	HIGH	80% Stocks 10% Bonds 10% Cash	60% Stocks 30% Bonds 10% Cash
	LOW	40% Stocks 50% Bonds 10% Cash	10% Stocks 50% Bonds 40% Cash

Note: This is only an example.

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low and your tax efficiency high. This will dramatically increase your expected return, no matter what the market does.

Almost as important as picking your asset allocation is sticking to it. That means you have to periodically rebalance the portfolio. Not only does rebalancing keep your portfolio at your desired risk level, it also gives your expected return a bit of a boost. There is a mathematical explanation for this boost but this column is not about math.

Rebalancing is one of the hardest things for an investor to do, yet it is critical to investing. We all have the emotional drivers of fear and greed, which cause us to enter the stock market after it has been hot and leave the market after it has declined. Disciplined rebalancing, however, causes us to do the opposite – sell the hot asset classes and buy the poor performing ones. When you think about it, it's absolutely a contrarian system that increases your probability of systematically buying low and selling high. It takes a lot of guts, however, to buy stocks after three straight years of losses as occurred in 2000–02.

Make sure you accomplish your rebalancing in a low cost, tax-efficient manner. Mark Patterson, senior tax manager at Stockman, Kast, Ryan & Co. recommends looking at your entire portfolio. Mark says that in order to accomplish tax-efficient rebalancing, "find losses to offset gains and turn to tax-deferred assets such as 401Ks and IRAs. If you must trigger net capital gains to properly rebalance your portfolio, try to make sure your net capital gain is a long-term gain for better tax rates and, as a last resort, you may want to wait until January to sell assets with taxable gains. This deferral to January will defer your tax into 2005 and give you time throughout the year to potentially find some capital losses that can be used to offset this gain."

In conclusion, asset allocation and rebalancing are two relatively simple techniques to help us reach our financial goals. Yet, following these techniques is complicated by our emotions, especially when we receive constant sales pitches to buy hot assets. Be a contrarian and resist those sales pitches. Stick to a focused and disciplined approach that will benefit you rather than Wall Street!

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In the short-run, both stocks and bonds have substantial risks. In the long-run, stocks can actually be less risky than bonds.

REAL (AFTER INFLATION) RETURNS OF STOCKS & BONDS

One Year Performance

	Bonds	Stocks
Best	37.3%	53.3%
Average	2.7%	8.9%
Worst	-19.4%	-37.3%

25 Year Performance

	Bonds	Stocks
Best	6.5%	11.3%
Average	1.7%	6.5%
Worst	-2.2%	2.7%

Source: Charles D. Ellis ñ Winning the Loserís Game, (data from 1901-1997)



	CASH	BONDS	STOCKS
PROs	• *Most stable* • *Most Liquid*	• *Often moves opposite of stocks* • *Can be a shock absorber to stocks*	• *Highest return* • *May be less risky than bonds in long run*
CONs	• *Negative real returns*	• *Can be most risky in long-run*	• *Most risky in short and medium term*
DOs 	• *Earn at least 2%* • *Look for FDIC insurance* • *Consider long-term CDs with low early withdrawal penalty*	• *Buy 2-5 year maturities* • *Stick to quality* • *Consider CDs or paying down mortgage as alternative* • *Put in tax-deferred accounts.* • *Diversify*	• *DIVERSIFY across:* *- Thousands of companies across all sectors* *- US and foreign* *- Size of companies* *- Growth & Value* • *Use low cost index funds and Exchange Traded Funds (ETFs)* • *Use REITS & precious metals funds that have low correlations to the stock market*