

Build a Needs-Based Retirement Portfolio

My upcoming book, 30-Minute Money Solutions, provides step-by-step guidance on completing 36 separate financial-planning tasks, each in a half hour or less. The book is designed to help investors who are newer in their investing careers, but it also tackles topics that are important for retirees and pre-retirees. The following, on how to build a retirement portfolio driven by your income needs, is an excerpt from the book.

The e-mails poured in throughout 2008 and continued into 2009. During the economic crisis and the worst bear market since the Great Depression, retirees were seeking hand-holding and guidance about what to do next.

There was Oscar, who was concerned about what would happen if his pension—which he had counted on for income during retirement—failed. How could he check up on the health of his pension, and would his retirement savings cover the shortfall in his income if his pension plan did run into problems?

I also heard from Diane—and other grown children of aging parents. An overly high stock weighting had reduced her 85-year-old mom's portfolio down to a dangerously low level, and she was trying to make sure the assets would last throughout her mother's lifetime.

And then there were Bob and Janet. Bob had moved most of the couple's assets into cash late in the bear market. That had helped them avoid a further drubbing when the market continued to sell off in early 2009, but with stocks roaring back, they found themselves in a quandary: Was it time to get back in? And if not now, when?

No doubt about it, the recent bear market tested the portfolio strategies (and nerves) of nearly all retirees, even those who were in relatively good shape at the outset and especially those who weren't.

It also demonstrated how much more challenging today's retirement landscape is than it was a few decades ago. Not only did many individuals retire with the luxury of a pension, but interest rates were substantially higher than they are today; in the 1970s, you could earn a double-digit yield with very limited risk. Now, however, most individuals are in charge of building and managing part or all of their retirement portfolios, and they're confronting wimpy yields to boot. Many retirees still cling to the notion of being able to live solely off the yield generated by their portfolios, but that's become unrealistic except for the very well-off. Whereas not invading their principal may have been a key challenge for affluent retirees a few decades ago, the key challenge for most retirees today is to not deplete their nest eggs.

So, where do you begin to create an in-retirement portfolio that will provide you with the right combination of income, stability, and growth—one that will help you navigate varying market conditions without

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Christine Benz,
Director of Personal Finance

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prompting you to change course midstream? Ideally, your in-retirement portfolio will not only be effective and suit your needs, it will also be low-stress and low-maintenance. Those are important attributes for your investment portfolio whatever your life stage, but especially so during retirement, when you've no doubt got better things to do than fret about your investment results.

The first step in the retirement portfolio planning process is determining whether you have enough assets to retire and how much you can safely take out each month and each year without running out of money. You also need to examine the impact that different asset allocations would have on withdrawal rates and the potential for asset depletion. Various online tools, including Morningstar.com's Asset Allocator and T. Rowe Price's Retirement Income Calculator, can help you with those tasks.

Once you've culled that information, you can then turn your attention to the nitty-gritty of selecting specific investments for your in-retirement portfolio.

To create an in-retirement portfolio, you'll need:

- ▶ An estimate of your income from all sources (other than your investment portfolio) during retirement.
- ▶ An estimate of your in-retirement spending needs.
- ▶ Morningstar's Instant X-Ray tool, available on the Tools tab of Morningstar.com.

Start the Clock

Step 1

First, make sure you have an adequate cash cushion in place. Every retiree should have two to five years' worth of living expenses set aside in highly liquid (that is, checking, savings, money market, CD) investments at all times.

If you're receiving income from other certain sources—such as Social Security—you can reduce the amount accordingly. For example, say your annual living expenses are \$60,000 a year but you bring in half of that in income: \$24,000 in Social Security and

another \$6,000 from a small pension. If that's the case, the amount of assets you should keep in cash should range between \$60,000 (\$30,000 x 2 years) and \$150,000 (\$30,000 x 5 years).

In general, if you're confident in your portfolio's ability to last throughout your retirement, you can keep closer to five years' worth of living expenses in these highly liquid accounts. (After all, you shouldn't take risks if you don't need to.) If you're less confident and can't afford to keep such a big chunk of your portfolio tied up in low-returning investments, your cash holdings may stay at the low end of this range.

Step 2

The next step is to arrive at an appropriate asset allocation. There aren't any one-size-fits-all solutions for retirees. Age and the number of years you expect to be retired are big swing factors, of course: Generally speaking, having a longer time horizon will make you better-equipped to tolerate, and regroup from, stock market losses. The size of your portfolio and what other sources of income you'll be able to rely on during retirement also play roles in whether your retirement portfolio tilts toward equities or bonds, or balances the two. For example, an individual whose pension covers most of his living expenses and is mainly investing to leave money behind for his children and grandchildren can hold a lot more in stocks than one who's entirely reliant on his portfolio for income.

It's important to view asset allocation through the lens of your own situation: your optimal withdrawal rate, the number of years you expect to be retired, and your willingness to tolerate the possibility of falling short. You can tinker with each of these factors to help identify an appropriate asset allocation given your own inputs.

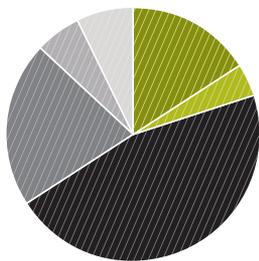
I've also provided some sample in-retirement portfolio allocations in the figures on Page 3. You'll notice that all of them include at least some stock exposure—including foreign stocks. Long gone are the days when retirees could get by with all-bond portfolios: Long life spans and paltry bond yields mean that even conservative retirees need the appreciation potential

Model Portfolio Allocations for Retirees

Sample allocations for three different in-retirement time horizons. If your risk tolerance is moderate, you'll want your portfolio to fall between the extremes for a given time horizon.

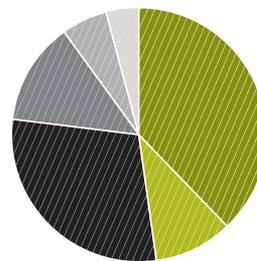
In-Retirement Portfolios: 10-Year Time Horizon

Conservative



▲ U.S. Stock	16%
▲ Foreign Stock	4%
▲ Bond (ex TIPS)	46%
▲ TIPS	21%
▲ Commodities	6%
▲ Cash	7%

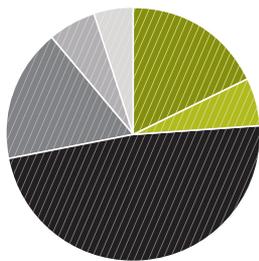
Aggressive



▲ U.S. Stock	38%
▲ Foreign Stock	10%
▲ Bond (ex TIPS)	29%
▲ TIPS	13%
▲ Commodities	6%
▲ Cash	4%

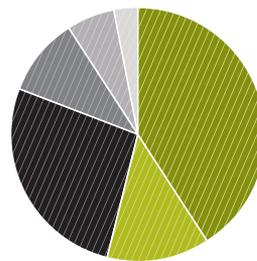
In-Retirement Portfolios: 15-Year Time Horizon

Conservative



▲ U.S. Stock	18%
▲ Foreign Stock	6%
▲ Bond (ex TIPS)	48%
▲ TIPS	17%
▲ Commodities	6%
▲ Cash	5%

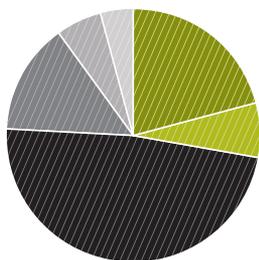
Aggressive



▲ U.S. Stock	41%
▲ Foreign Stock	13%
▲ Bond (ex TIPS)	27%
▲ TIPS	10%
▲ Commodities	6%
▲ Cash	3%

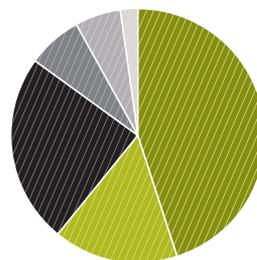
In-Retirement Portfolios: 20-Year Time Horizon

Conservative

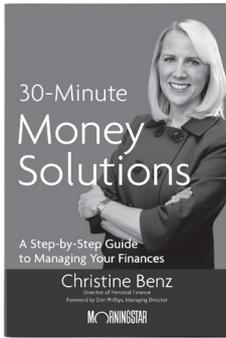


▲ U.S. Stock	21%
▲ Foreign Stock	7%
▲ Bond (ex TIPS)	48%
▲ TIPS	14%
▲ Commodities	6%
▲ Cash	4%

Aggressive



▲ U.S. Stock	45%
▲ Foreign Stock	16%
▲ Bond (ex TIPS)	24%
▲ TIPS	7%
▲ Commodities	6%
▲ Cash	2%

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of stocks in their portfolios. But don't go overboard. If you have stocks in your portfolio, you'll need at least a 10-year time horizon for that money. For example, say you have a \$1 million retirement portfolio and \$350,000 (35 percent) of that pool is in stocks. The remaining \$650,000 in bonds and cash should be enough to cover your living expenses over the next 10 years.

Step 3

Once you've found an appropriate asset allocation, take a look at your current stock/bond/cash mix to determine where you need to make changes in your existing mix—if at all. If you don't know your current asset allocation, use Morningstar.com's Instant X-Ray tool to help you find it. Simply enter the tickers for each of your holdings, then click Show Instant X-Ray. Compare that asset allocation with the target you identified in the preceding step.

Step 4

Once you've determined the asset classes you'll be adding to and subtracting from, it's time to select individual securities for the job. Choosing individual holdings for an in-retirement portfolio isn't radically different from selecting securities for a pre-retirement portfolio. You'll want to make sure you have a good balance of investment styles, such as small and large stocks and bonds of varying credit qualities and maturities.

The portfolios on Page 5 include some of Morningstar's favorite in-retirement mutual fund holdings, both stock and bond. Most of these funds have somewhat conservative personalities—for growth-stock exposure, for example, I prefer a mild, high-quality-oriented fund like **Jensen Portfolio JENSX** over a more aggressively positioned growth fund like **Fidelity Growth Company FDGRX**.

You'll also notice that all the portfolios include inflation-fighting investments. That's because as you add fixed-rate investments like bonds and bond funds to your portfolio, inflation will gobble up more and more of your purchasing power.

Step 5

As you craft your retirement portfolio, look for opportunities to streamline. It's easier to monitor a compact portfolio. By taking care to reduce your number of holdings early in your retirement years, you'll greatly reduce your oversight responsibilities. If you have multiple IRAs, for example, consider consolidating them into a single account. And while many retired individuals buy individual stocks and bonds, mutual funds and exchange-traded funds allow for less ongoing oversight, which can be particularly valuable later in your retirement years. You may also consider anchoring your portfolio with broadly diversified broad-market index funds and ETFs; these investments give you a lot of diversification in a single shot.

Step 6

Once you've set a course for your in-retirement portfolio, revise your investment policy statement to reflect your current goals, asset allocation policy, individual investment parameters, and monitoring criteria. Doing so will provide you with a template for managing your in-retirement portfolio on an ongoing basis and help ensure that you won't make changes to your portfolio that you'll later regret. Be sure that your investment policy statement specifies guidelines that your portfolio should have two to five years' worth of living expenses in highly liquid assets at all times.

Next Steps

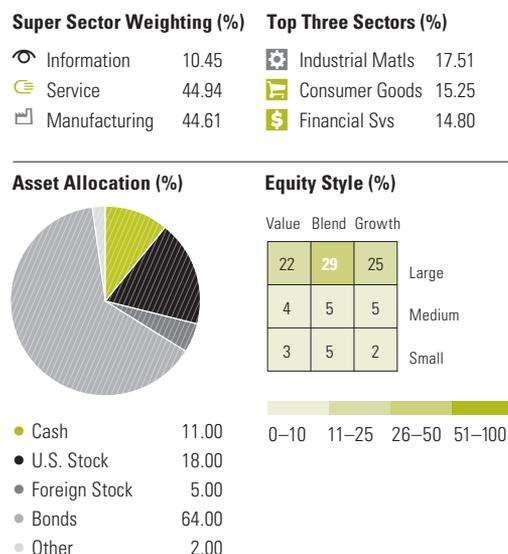
- ▶ The portfolios provided on Page 5 feature plain vanilla bond and stock mutual funds because they tend to be the most cost-effective building blocks for retiree portfolios. However, retirees often look to other securities—notably annuities—for their in-retirement portfolios. Single-premium immediate annuities can be a cost-effective way to make sure you receive a steady paycheck, but your payout will tend to ebb and flow based on prevailing interest rates. With current rates exceptionally low, it may pay to wait until rates head back up before committing to an annuity.
- ▶ If your retirement portfolio has taken a big hit over the past few years, don't try to make up lost ground by using an asset allocation that's too aggressive

given your age and life stage. It's reasonable to modestly increase your stock weighting relative to the targets that you've identified, but do so judiciously. For example, you might hold 45 percent in stocks even though your target is 40 percent, but you shouldn't nudge your equity weighting as high as 60 percent.

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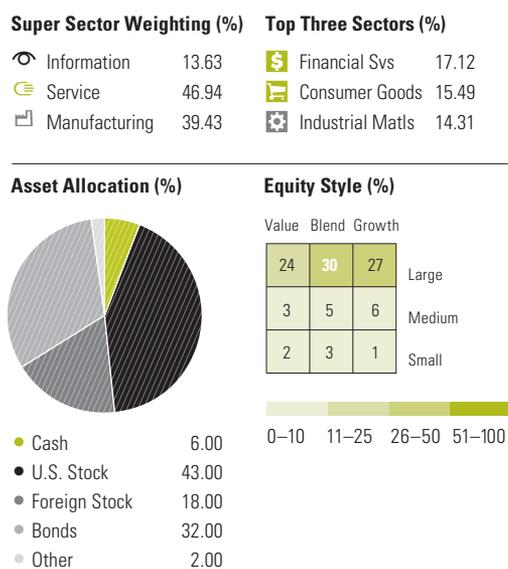
Conservative Portfolio: 10-Year Time Horizon

Fund Name	Star Rating	Category/ Industry	Holding Value (%)	Expense Ratio (%)
Dodge & Cox Income DODIX	★★★★	CI	30	0.43
T. Rowe Price Short-Term Bond PRWBX	★★★★	CS	10	0.55
Vanguard Inflation-Protected Securities VIPSX	★★★★	IP	21	0.20
Loomis Sayles Bond LSBRX	★★★	MU	5	0.94
Vanguard Dividend Growth VDIGX	★★★★★	LB	10	0.36
Jensen JENSX	★★★★★	LG	5	0.86
Royce Total Return RYTRX	★★★	SB	5	1.12
Harbor Commodity Real Return HACMX	N/A	Comdties	7	0.94
Harbor International HIINX	★★★★★	FV	4	0.72
Cash	N/A	N/A	3	N/A
Total			100%	



Aggressive Portfolio: 20-Year Time Horizon

Fund Name	Star Rating	Category/ Industry	Holding Value (%)	Expense Ratio (%)
Dodge & Cox Income DODIX	★★★★	CI	15	0.43
T. Rowe Price Short-Term Bond PRWBX	★★★★	CS	3	0.55
Vanguard Inflation-Protected Securities VIPSX	★★★★	IP	7	0.20
Loomis Sayles Bond LSBRX	★★★	MU	7	0.94
Vanguard Dividend Growth VDIGX	★★★★★	LB	17	0.36
Jensen JENSX	★★★★★	LG	15	0.86
Vanguard Total Stock Market Index VTSMX	★★★	LB	7	0.16
Royce Total Return RYTRX	★★★	SB	7	1.12
Harbor Commodity Real Return HACMX	N/A	Comdties	6	0.94
Artisan International ARTIX	★★★★	FG	16	1.22
Total			100%	



Categories

- CI Intermediate Bond
- FG Foreign Large Growth
- IP Inflation-Protected Bond
- LG Large Growth
- SB Small Blend
- CS Short-Term Bond
- FV Foreign Large Value
- LB Large Blend
- MU Multisector Bond

Where to Invest in 2010 (and Where Not To)

Investment Insights | Christine Benz

The year 2009 brought a tremendous rally, with even subpar-performing stock funds gaining more than 20% and many bond funds posting double-digit gains. But the huge runup in security prices has left a lot of investors wondering “What now?” If you have a portion of your portfolio sitting in cash and need to deploy those assets, or if you’ve rebalanced and are searching for a worthy repository for your money, here’s your guide to what still has upside potential.

Don’t get me wrong: The market’s rebound last year was more than welcome. But as I was preparing to fund my IRA in 2009’s closing days, I had to stop and think: What the heck should I invest in?

A year ago at this time, there were screaming buys all over the place, not just in stocks but in just about anything that wasn’t a gilt-edged Treasury or money under the mattress. Long-closed mutual funds like **Sequoia** SEQUX were flinging open their doors because their managers were finding so much to invest in, and none other than Warren Buffett penned an editorial in *The New York Times*, arguing that U.S. stocks looked cheap.

Since then, however, nearly everything that was down in 2008 has run way up, with junk bonds, emerging markets, commodities, technology, and real estate leading the charge. Even investments that have lagged on a relative basis, such as high-quality stocks and stock funds, posted respectable absolute returns of 20% or better in 2009.

Given the velocity and magnitude of the market recovery—and how much good economic news has already been priced in—it’s safe to say that the markets aren’t likely to be as rewarding in the year ahead as they were in the one in the rearview mirror. So if you’re putting money to work in stocks or bonds right now, either by adding cash or through rebalancing, you’ll have to work harder to identify

those securities that still offer good upside potential. It goes without saying that you’ll want to avoid the rookie mistake of simply buying whatever is on last year’s leader’s list or adding to your portfolio’s biggest winners. By the same token, you’ll also want to avoid the trap that many investors fell into last year when they shunned stocks. Bond funds saw inflows of more than \$300 billion in 2009, whereas inflows into stock funds were barely positive, cementing the view that fund flows can be a contrarian indicator.

What follows is a survey of where the market opportunities are—and are not—right now. To help compile this list, I turned to various Morningstar tools and also surveyed my analyst colleagues for their opinions and to gather intelligence about what they’re hearing from top fund managers.

Quality (Still) Looks Cheap

Stocks have come a long way over the past nine months. When the market touched bottom on March 9, 2009, the stocks in Morningstar’s coverage universe were, in aggregate, trading at a roughly 40% discount to our analysts’ estimate of their fair values. By late 2009, that discount had largely disappeared, and the roughly 1,700 stocks in our analysts’ coverage universe were trading right in line with our analysts’ estimates of their fair values.

Using Morningstar.com’s ETF Valuation Quickrank paints a somewhat more encouraging picture: Broad

market indexes such as the S&P 500 and the MSCI Broad Market Index (which encompasses more small- and mid-cap stocks than appear in the S&P 500) were trading at a roughly 10% discount to our analysts' estimates of the fair value of their underlying holdings toward the end of December. That leaves room for some upside, but it also means our analysts don't think the market, in aggregate, is screamingly cheap.

“According to our stock analysts, high-quality large-cap companies have looked inexpensive on both an absolute and relative level for a while now, and that trend has been magnified.”

Once you look beyond the total market lens, however, it's not difficult to identify pockets of value. According to our stock analysts, higher-quality large-cap companies have looked inexpensive on both an absolute and relative level for a while now, and that trend has been magnified by the past year's market events. As the financial crisis receded, investors flocked to risky assets, bidding up shares of highly leveraged and cyclical companies and leading to what was widely characterized as a "low-quality" rally for much of 2009. As a result of investors' newfound risk tolerance, stable mega-cap companies, including many dividend-payers with sustainable competitive advantages and solid balance sheets, have fared less well and appear to offer better relative value than smaller, riskier companies. (For the quant geeks among you, that helps explain why our analysts' whole coverage universe is trading at a richer level than the broad U.S. market indexes. The former is a simple average of 1,700 companies and is not weighted by market capitalization, unlike the indexes. When our analysts think small stocks are looking pricey relative to large, as they do now, the market-cap-weighted indexes would appear to offer better value.) The large-cap value square of the Morningstar Style Box currently has the highest percentage of companies trading below our analysts' estimate of fair value.

A similar valuation disparity exists among foreign stocks. While foreign stocks, in aggregate, are trading closer to our analysts' estimate of their fair value than are domestic, foreign blue chips appear to be trading inexpensively alongside smaller caps.

Of course, there's no guarantee that the past year's low-quality rally won't have legs, particularly if the economy strengthens beyond current expectations. But for those of you reworking your stock portfolios in the wake of 2009, Morningstar's valuation analysis would point to one obvious trade: Take money off the table in risky assets and add to high-quality mega-caps.

The good news is that you probably already have the latter type of exposure in your portfolio. A plain-vanilla S&P 500 index fund has such companies in spades, and mega-cap-focused offerings such as **iShares S&P 100 Index OEF** or **Bridgeway Blue Chip 35 Index BRLIX** provide even more targeted exposure to high-quality blue-chip companies. I'm also a fan of **Vanguard Dividend Appreciation**, an index of companies with a history of dividend growth; it's available in both traditional index VDAIX and exchange-traded fund VIG formats. Among active funds that invest heavily in wide-moat blue-chip companies, a few of my favorites include **T. Rowe Price Equity Income PRFDX**, **Vanguard Dividend Growth VDIGX**, **Jensen Portfolio JENSX**, and **Dreyfus Appreciation DGAGX**. Favorite foreign-stock funds with a heavy dose of high-quality mega-caps include **Dodge & Cox International Stock DODFX**, **Artio International Equity II JETAX**, and total international index funds such as **Vanguard Total International Stock Index VGTSX**.

Financials and Health Care Beckon

A handful of sectors also appear to be reasonably valued relative to the market as a whole. As of late December, the companies our analysts cover in both the financials and health-care sectors were, in aggregate, trading below their estimates of fair value. Based on the headlines, it's easy to see why investors would demand a discount to hold firms in either downtrodden sector. Financial-services companies' troubles have been well chronicled. Health-care

stocks, meanwhile, have suffered from the one-two punch of patent expirations for key drugmakers and worries that government-led reform could crimp the industry's lush profit margins. Uncertainty could hang over both areas for a while, but our analysts think the stocks look fairly cheap. **Health Care Select SPDR XLV**, a mega-cap-focused ETF, was trading nearly 20% below our analysts' estimate of the fair value of its holdings as of the end of December. Nearly all of the financials ETFs were trading at similarly large, if not wider, discounts.

“In aggregate, small and mid-caps across the style spectrum appear to be fairly valued to slightly overvalued currently.”

As regular readers know, I'm not a fan of sector-specific funds and ETFs because they're usually redundant with other holdings in investor portfolios. Nonetheless, it's possible to add to your holdings in these sectors by bolstering your position in a diversified fund that emphasizes one or both of these unloved areas. Fund Analyst Pick **Fairholme Fund FAIRX** is a terrific fund, and manager Bruce Berkowitz added aggressively to both areas over the past year. **Dodge & Cox Stock DODGX**, Vanguard Dividend Growth, Vanguard Dividend Appreciation, and Jensen Portfolio all have an overweighting in health-care stocks currently. Among funds that emphasize financials, T. Rowe Price Equity Income, **Selected American Shares SLADX**, and **Vanguard Wellington VWELX** stand out as favorites.

Stocks to Consider Trimming

So if high-quality mega-caps, health care, and financials are worthwhile destinations for new equity money, what are the areas to consider trimming? In aggregate, small and mid-caps across the style spectrum appear to be fairly valued to slightly overvalued currently. Among sectors with the highest valuation levels, per Morningstar's equity analyst team, are computer software, computer hardware, and utilities. Foreign small caps and emerging-markets names—particularly those from the so-called BRIC countries (Brazil, Russia, India, and China)—also appear richly

valued versus large-cap developed-markets names. All of the aforementioned areas, with the exception of utilities, soared over the past year, as investors cheered improving global economic conditions. And should global growth continue to improve, these higher-risk names will no doubt continue to perform better than stable blue chips. Thus, I'm not suggesting you eliminate these holdings entirely, but rather consider taking chips off the table in the interest of reducing your portfolio's risk level.

Bonds: Don't Get Too Fancy

Just as investors lavished attention on risky stocks in 2009, improving economic conditions led bond investors to embrace higher-risk bonds last year. The typical junk-bond fund in Morningstar's database gained more than 40% in 2009, more than nearly all of the equity-fund categories. (File that stat away for future reference: Coming out of a recession, a junk-bond fund may give your portfolio just as much oomph as holding stocks.) Emerging-markets and bank-loan funds also posted scorching gains.

Investors shouldn't expect a repeat performance. Although investment-grade corporate, lower-quality corporate, nonagency mortgage-backed, and municipal bonds were like a coiled spring in late 2008, the yield spreads between those securities and government bonds have narrowed considerably over the past year. (The current yield differential between corporate bonds and governments is still above average, but not by a lot.) Thus, you're simply not getting paid as much to assume those risks as you were a year ago. In fact, Morningstar fixed-income fund specialist Miriam Sjoblom says that many diversified bond fund managers have recently been trimming riskier parts of their portfolio, calling them fairly valued.

That said, government bonds carry risks of their own. While the Fed has indicated an inclination to hold interest rates way down for the foreseeable future, it has also indicated that it will move to quash inflation as soon as it appears. In a rising interest-rate environment, government bonds, particularly those with long durations, will tend to be among the most vulnerable.

So how should you navigate this potentially treacherous terrain? A good starting point, given shrunken yield spreads, would be to trim your holdings in high-risk fixed-income securities, including junk bonds, bank loans, and emerging markets. I'd argue it's also time to take the money and run if you own a high-yield municipal offering.

In terms of where to put new money to work, it's an especially good time to delegate your decision-making to a pro, given all of the uncertainty in the bond market right now. Opt for a skilled manager with a wide-ranging, flexible mandate; most such funds land in Morningstar's intermediate-term bond category. Regular readers know my favorites in this area: **Harbor Bond HABDX**, **Metropolitan West Total Return Bond MWTRX**, and **Dodge & Cox Income DODIX**. For those willing to tolerate much more risk with a small sleeve of their fixed-income portfolio, I remain a fan of **Loomis Sayles Bond LSBRX**. Not only is management highly experienced, but the fund's flexible mandate and value-conscious approach give it an opportunity to succeed in varying market conditions.

And while municipal bonds enjoyed a very strong year in 2009, investors in higher tax brackets should still explore whether they're better off in munis than in a taxable bond fund of comparable average credit quality. (The Tax-Equivalent Yield tab on Morningstar's Bond Calculator, found on the Tools tab of Morningstar.com, is a good way to compare two bonds or bond funds.) Morningstar's fixed-income analyst team remains as bullish as ever on Fidelity's municipal-bond fund lineup, thanks to the funds' restrained approach and low costs. **Fidelity Tax-Free Bond FTABX** is a particular favorite. Owing to its high-quality approach, that fund struggled in relative terms in 2009's risk-tolerant market. But now that riskier parts of the muni market have rallied, it may be time to consider a more restrained offering like this one. Even though muni yields are near historic lows, the possibility of higher taxes to come makes them look even more attractive on a tax-equivalent basis. ■■■

Top Picks for 2010 and Beyond

Name	Category	Star Rating	Expense Ratio (%)	Comment
Vanguard Dividend Appreciation ETF VIG	LB	★★★★★	0.24	Yield isn't high, but has high % of wide-moat firms.
T. Rowe Price Equity Income PRFDX	LV	★★★★	0.69	Stalwart rarely tops charts, but is consistently solid.
Vanguard Dividend Growth VDIGX	LV	★★★★★	0.36	Actively managed fund focuses on stable companies.
Jensen Portfolio JENSX	LG	★★★★★	0.86	Consistently scores as one of widest-moat funds.
Fairholme Fund FAIRX	LB	★★★★★	1.01	Solid play on unloved financials, health-care stocks.
Selected American Shares SLADX	LB	★★★	0.56	Blue-chip fund has long-standing financials focus.
Vanguard Wellington VWELX	MA	★★★★★	0.29	Cautious contrarian mixes bonds and value-priced stocks.
Dodge & Cox International Stock DODFX	FB	★★★	0.64	Heavy emphasis on mega-caps as well as emerging markets.
Artio International Equity II JETAX	FB	★★★★	1.21	Weak relative performance in 2008, but solid management.
Vanguard Total International Stock Index VGTSX	FB	★★★★	0.34	Emphasizes developed markets, but also owns emerging.
Harbor Bond HABDX	CI	★★★★★	0.55	One of the cheapest ways to access PIMCO kingpin Bill Gross.
Metropolitan West Total Return Bond MWTRX	CI	★★★★★	0.65	Flexible strategy, experienced management are strong suits.
Dodge & Cox Income DODIX	CI	★★★★	0.43	Dodge's bargain-hunting approach works on bond side, too.
Loomis Sayles Bond LSBRX	MU	★★★	0.94	Limit aggressive fund to small slice of your portfolio.
Fidelity Tax-Free Bond FTABX	ML	★★★★★	0.22	After big muni rally, fund's high-quality focus is appealing.

Can You Be Too Streamlined?

Portfolio Makeover | Christine Benz

I'm always preaching the merits of a streamlined portfolio. You can achieve adequate asset-class and style diversification with a limited number of holdings, and that, in turn, helps reduce the amount of oversight you're responsible for. Winnowing down a portfolio is particularly valuable for retirees, who usually have better things to do with their time than keeping track of a long list of stocks, bonds, and funds.

As I surveyed Nancy Masterson's holdings, however, I began to wonder whether a portfolio can be too compact. Nancy, a 62-year-old former administrator at a public university, has built a solid nest egg of more than \$800,000, but it's spread across just four holdings and a cash stake. She wrote seeking guidance on whether her portfolio's allocation is adequate, and she's also trying to gauge whether her portfolio can support her goal of withdrawing \$40,000 per year. She's currently living on her pension and Social Security, and hasn't yet begun tapping her investment portfolio to fund her living expenses. However, she'd like to begin enjoying the fruits of her working years soon. Traveling overseas is her main dream for her retirement, and she'll need to tap her assets to do so.

The Before Portfolio

Like most retirees, Nancy's retirement portfolio consists of several different sleeves. The biggest piece is her IRA portfolio, composed of assets rolled over from her former employer's 403(b) plan. (A 403(b) is a plan offered to employees of educational and not-for-profit institutions; in many respects it's similar to a 401(k)). In it, Nancy has just two holdings:

Vanguard Total Bond Market Index VBTLX and **Vanguard Total Stock Market Index** VTSAX. Nancy also holds Vanguard Total Stock Market Index and **Vanguard Total International Stock Index** VGTSX in her taxable account. Vanguard Total Bond Market Index is the sole holding in her variable annuity, and she holds a tiny position in **Vanguard Star** VGSTX in

a Roth IRA. Nancy also has a sizable cash stake. Her current asset allocation for the total portfolio consists of roughly one third each in stocks, bonds, and cash.

The After Portfolio

Because Nancy's broad index-fund holdings are all hyperdiversified, her portfolio isn't missing anything major. However, I'd like to see her add a small position in inflation-fighting investments, notably Treasury Inflation-Protected Securities. And while her all-index-fund portfolio is inexpensive and effective, she could also give her bond portfolio more oomph by de-emphasizing the Total Bond Market Index, which is heavy on ultra-low-yielding U.S. government bonds, and putting some assets into a fund that holds more in corporate and nongovernment mortgage-backed bonds. Government bonds have underperformed other bond-market sectors over the past nine months, and that trend is apt to persist, particularly if interest rates trend up. (Government bonds tend to be more sensitive to interest-rate changes than other types of bonds.)

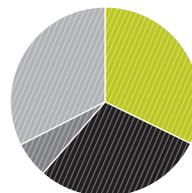
My bigger concern is that Nancy's goal of withdrawing \$40,000 per year from her portfolio is too aggressive given her young age and her fairly mild asset mix. There are a couple of different remedies she could consider. One would be to calibrate her withdrawals based on her actual needs—for example, she might withdraw \$45,000 in a heavy travel year and reduce that amount to \$25,000 the following year. Nancy could also consider giving her portfolio a slightly more aggressive look. For example, she could increase her portfolio's stock position slightly, and also increase her foreign stake as a percentage of her equity portfolio. Her cash stake is on the high side given her current cash needs, so Nancy could move a portion into stocks and bonds. These changes definitely make Nancy's portfolio more aggressive, so she'll need to weigh that heightened risk potential against her desire to generate higher returns. ■■■

Nancy's Portfolio: Before

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Vanguard Total Bond Mrkt Indx Adm VBTIX	★★★★	CI	295,000	0.11
Vanguard Total Stock Mrkt Indx Adm VTSAX	★★★	LB	236,000	0.08
Vanguard STAR VGSTX	★★★★	MA	2,685	0.32
Vanguard Total Interntl Stck Mrkt Indx VGTSX	★★★★	FB	47,000	0.34
Cash	N/A	N/A	250,000	
Total			830,685	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	21.17	Financial	17.67
Service	41.26	Industrial Matls	11.91
Manufacturing	37.58	Healthcare	11.26

Asset Allocation (%)



- Cash 32.00
- U.S. Stock 29.00
- Foreign Stock 6.00
- Bonds 32.00
- Other 0.00

Equity Style (%)

Value	Blend	Growth	
25	26	24	Large
6	6	6	Medium
2	2	2	Small

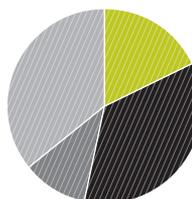
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Nancy's Portfolio: After

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Vanguard Total Bond Mrkt Indx Adm VBTIX	★★★★	CI	35,000	0.11
Vanguard Total Stock Mrkt Indx VTSMX	★★★	LB	300,000	0.16
Vanguard Total Interntl Stck Mrkt Indx VGTSX	★★★★	FB	85,000	0.34
Vanguard Inflation-Protected Securities VIPSX	★★★★	IP	85,000	0.20
Vanguard Short-Term Invstmt-Grd VFSTX	★★★★	CS	75,000	0.21
Vanguard Intermediate-Trm Invstmt-Grd VFICX	★★★★	CI	100,000	0.21
Vanguard High-Yield Corporate VVHEX	★★★	HY	25,000	0.27
Vanguard STAR VGSTX	★★★★	MA	2,685	0.32
Cash	N/A	N/A	123,000	N/A
Total			830,685	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	20.64	Financial	18.20
Service	41.22	Industrial Matls	12.18
Manufacturing	38.15	Consumer Goods	11.19

Asset Allocation (%)



- Cash 18.00
- U.S. Stock 36.00
- Foreign Stock 11.00
- Bonds 36.00
- Other 0.00

Equity Style (%)

Value	Blend	Growth	
26	26	24	Large
6	6	6	Medium
2	2	2	Small

0-10 11-25 26-50 51-100

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Categories

CI	Intermediate Bond	IP	Inflation-Protected Bond
CS	Short-Term Bond	LB	Large Blend
FB	Foreign Large Blend	MA	Moderate Allocation
HY	High Yield Bond		

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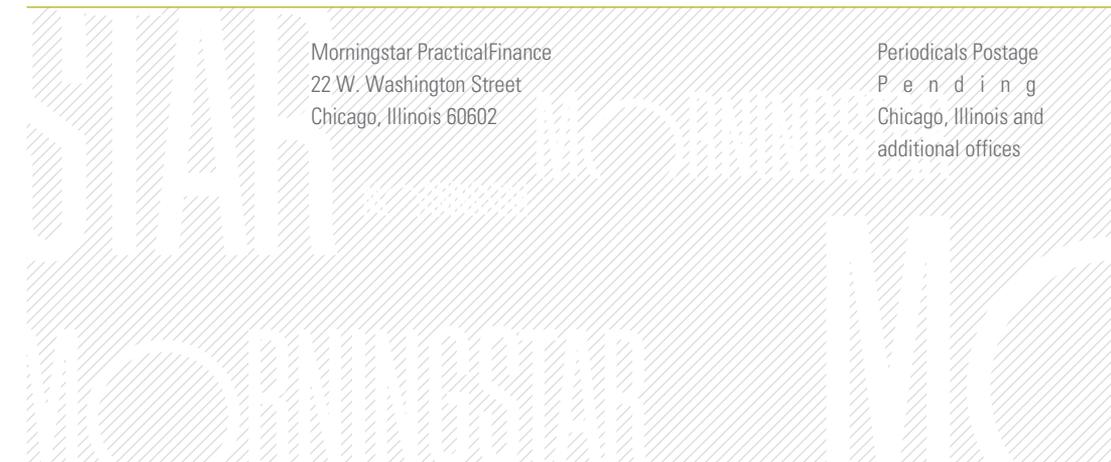
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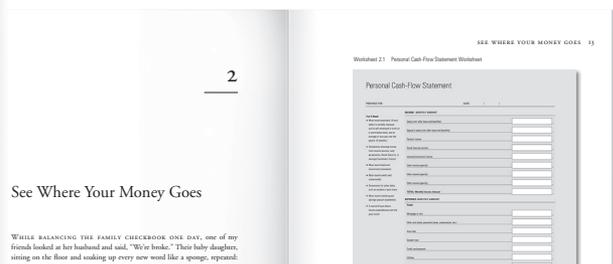
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