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Employ a Conservative Portfolio

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What is a conservative portfolio? Is it what you need? This strategy delves into the building blocks used in designing a conservative portfolio, highlights the historical returns and risk profile of each component, and provides you with guidance on developing a conservative portfolio that'll serve you through all economic climates.

Determine Whether a Conservative Portfolio Is Right for You

You should consider a conservative portfolio if the following applies:

- **You need the money in the next five to ten years.** For goals less than five years away, you want to avoid exposure to the markets. The risk of a loss is too high. Instead, use a money market account, CD, or ultra short-term bond fund to finance short-term goals.
- **You're unable to bear much risk.** If you can't accept the consequences of your investments' not producing results in the time period needed, you can't bear much risk. For example, a retiree dependent on investments for essential living expenses can't accept much risk, but one who has covered those living expenses with pensions, Social Security, and/or annuities can afford to take more risk.
- **You're an inexperienced investor.** Almost all people overestimate their ability to handle market volatility. If you don't have much investment experience, start conservatively. You'll be less likely to sell your portfolio when the market drops.
- **You're averse to risk (market volatility).** If dips in your portfolio keep you up at night, stick with a more conservative portfolio. You'll sleep better and be better off than if you were outside your comfort zone.

Although less volatile than a more-aggressive portfolio, a conservative portfolio can still produce negative returns in any given year, or in rarer instances, for more than one year in a row. And of course, the trade-off for lower volatility is lesser returns.

Decide Which Asset Classes to Use

An enormous number of asset classes are available. Many, however, don't belong in a conservative portfolio. Table 48-1 gives examples of the more traditional asset classes for a variety of increasingly complex portfolios. If you're just starting out, stay with the simple portfolio; as your nest egg grows, add additional asset classes as illustrated in the more-complex and complex portfolios.

Table 48-1 Asset Classes for Model Portfolios

Simple Portfolio	*More-Complex Portfolio*	*Complex Portfolio*
Cash	Cash	Cash
Bonds	Short-term bonds	Short-term bonds
U.S. total stock market	Intermediate-term bonds	Intermediate-term bonds
International equity	U.S. large cap	High-yield bonds
	U.S. small cap	Global bonds
	International developed	U.S. large cap value
	Emerging markets	U.S. large cap growth
		Small cap
		International developed
		Emerging markets
		Real estate
		Commodities

Increasing the number of asset classes potentially increases your long-term return while decreasing volatility. After 8 to 12 asset classes, the value of adding additional asset classes actually diminishes. You need to weigh the additional benefit against the increased management complexity.

Know How Much to Allocate to Each Asset Class

The split between fixed income (bonds) and equity (stocks) has the biggest impact on the likely long-term returns and volatility. There's no one right answer, but because the goal is a less volatile portfolio, the range for cash and fixed income should be about 55 to 80 percent. Equity and alternative investments should fill in the remaining 20 to 45 percent.

To further lower volatility, consider swapping riskier asset classes (which have a higher standard deviation) for less-risky asset classes under the broad bond/equity split. For example, use intermediate-term bonds instead of long-term bonds, large-cap stocks instead of small-cap, and so on.

The following table provides data on various asset classes. Use this information to decide how conservative you need or want to be.

Consider breaking your investments into a number of mini-portfolios, each with an allocation suited for that particular time frame and objective. You'll remove much of the stress of trying to fund a number of diverse goals from the same portfolio.

Asset Class	Holding Ranges (%)	Long-Term Historic Returns* Nominal (%)	Long-Term Historic Returns* Real (%)	Standard Deviation** (%)
Fixed Income	**55–80%**			
Cash*	0–10%	6.0	1.4	±2.9
Short-term bonds	20–40%	7.3	2.7	±4.1
Intermediate-term bonds	20–40%	8.0	3.3	±6.5
High-yield bonds	0–5%	9.2	4.8	±9.1
Global bonds (unhedged)	0–5%	8.4	3.7	±6.7
Equity	**20–45%**			
Large cap	10–25%			
Value		10.7	6.1	±15.4
Growth		10.2	5.6	±18.1
Small cap	0–10%	14.3	9.7	±22.2
International developed	5–15%	11.7	7.1	±21.4
Emerging markets	0–3%	11.6	7.0	±28.0
Alternative	**0–6%**			
Real estate investment trusts	0–3%	13.0	8.4	±17.1
Commodities	0–3%	11.7	5.6	±24.2

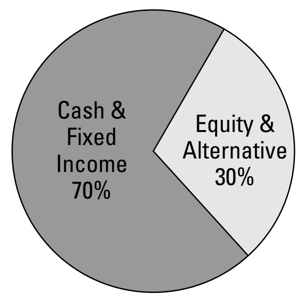
Source: Long-term historic returns and standard deviation figures from MoneyguidePro/PIE Technologies for time period 1972–2007.
**Nominal returns are returns before inflation. Real returns exclude inflation (average 4.63 percent per year for the period 1972–2007.)*

***One standard deviation describes the range that returns will likely fall within two-thirds of the time.*

Finally, here are sample portfolios along with historical performance.

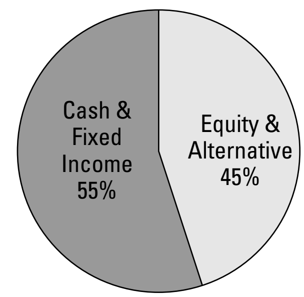
Conservation Portfolios

70% Cash and Fixed Income : 30% Equity and Alternative



Six Asset Class		Twelve Asset Class	
Cash	8%	Cash	8%
Short-term bonds	28%	Short-term bonds	23%
Intermediate-term bonds	34%	Intermediate-term bonds	29%
Large cap	16%	High-yield bonds	5%
Small cap	5%	Global bonds	5%
International	9%	Large cap value	7%
Total	**100%**	Large cap growth	7%
		Small cap	5%
		International developed	5%
		Emerging markets	2%
		Real estate	2%
		Commodities	2%
		Total	**100%**
Expected return	8.7%	Expected return	8.8%
Real return	4.0%	Real return	4.2%
Standard deviation	6.1%	Standard deviation	5.7%

55% Cash and Fixed Income : 45% Equity and Alternative



Six Asset Class		Twelve Asset Class	
Cash	6%	Cash	6%
Short-term bonds	21%	Short-term bonds	16%
Intermediate-term bonds	28%	Intermediate-term bonds	23%
Large cap	25%	High-yield bonds	5%
Small cap	5%	Global bonds	5%
International	15%	Large cap value	11%
Total	**100%**	Large cap growth	10%
		Small cap	5%
		International developed	10%
		Emerging markets	3%
		Real estate	3%
		Commodities	3%
		Total	**100%**
Expected return	9.2%	Expected return	9.4%
Real return	4.6%	Real return	4.8%
Standard deviation	7.9%	Standard deviation	7.2%

Source: Portfolio expected returns and standard deviation figures from Moneyguide Pro/PIE Technologies based on historic performance during the period 1972–2007