#49

Employ a Moderate Portfolio

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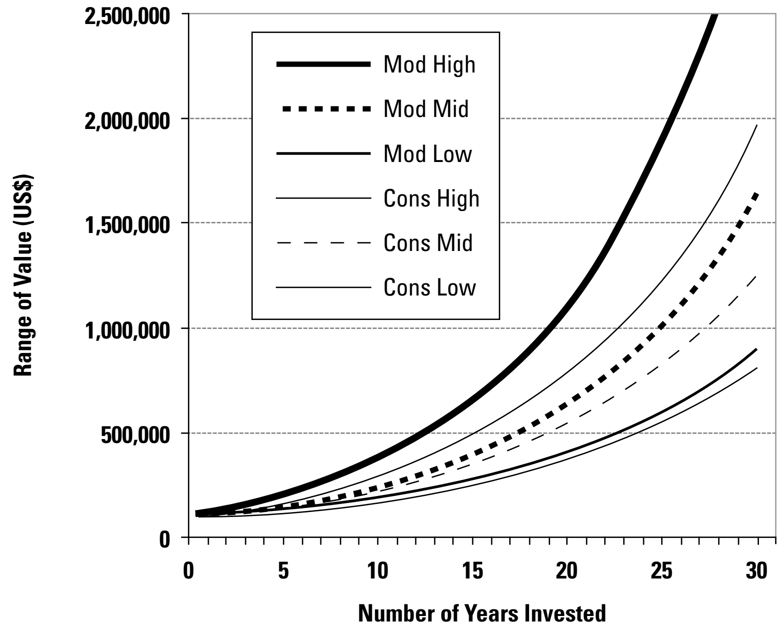
The moderate portfolio shifts up the risk, volatility, and return scale when compared with the conservative portfolio, including perhaps more years of loss and an increased chance of multi-year losses. The reward for bearing more risk is the increased chance of a higher long-term return when compared with the conservative portfolio (refer to Strategy #48). The difference between an expected return of 9.94 percent for a moderate portfolio and 8.96 percent for a more conservative one may not look like much, but it can really add up. Figure 49-1 shows the range of possible values that $100,000 invested in a moderate and conservative portfolio may earn over time. In the long term, the moderate portfolio's expected or *mid value* is higher than that of the more conservative portfolio, and the potential range of values is wider.

Choose to Create a Moderate Portfolio

A moderate portfolio is appropriate if you meet the following criteria:

- **You won't need the money for about ten years.** In general, the longer time horizon allows you to add more equity and other risky assets, which should increase your long-term return. With a longer time frame, extreme up and down years tend to cancel each other out, and your return will trend much closer to the expected long-run return.
- **You have increased ability to bear risk.** Someone in his 20s or 30s with decades of earnings ahead of him — and not dependent on income from the portfolio — can afford more risk in search of a higher return than a retiree with her working years behind her. Similarly, a retiree with adequate health and long-term care insurance and a hefty retirement pension can bear more risk than a retiree dependant on his portfolio to fund essential expenses.
- **You can tolerate a moderate amount of market volatility.** You already have some experience in the market and are comfortable with some volatility, but you're unwilling to accept the more extreme movements that come with a more aggressive portfolio. For example, a moderate portfolio with an expected annual long-term return of 9.6 percent may be expected to return between 1.8 and 17.4 percent two-thirds of the time.

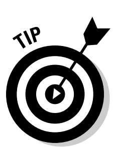


Expected range of values for a Moderate Portfolio with an expected return of 9.94% per year and standard deviation of 10.10% and a Conservative Portfolio with expected return of 8.96% per year and standard deviation of 7.02%, assuming returns are log normally distributed. Portfolios are expected to earn above the lower boundary 90% of the time and below the upper boundary 90% of the time.

Figure 49-1: Range of possible ending-portfolio values, moderate versus conservative.

Construct a Moderate Portfolio

Building a moderate portfolio follows the same process as constructing the conservative portfolio. You use the same asset classes for the level of portfolio complexity you prefer (see Strategy #48); only the weightings change.



Keeping equity and alternative investments in the 45-to-65-percent range, and cash and fixed income investments in the 35-to-55-percent range, is a good idea.

The same steps apply as with the conservative portfolio:

1. **Keep the overall split between equity and fixed income within the ranges for a moderate portfolio as specified in the following table.**

2. **Balance the number of asset classes with the size of your portfolio and your ability to manage it.**

   Having more than 8 to 12 isn't necessary.

3. **Allocate funds to the various asset classes within the ranges indicated in the table, depending on how much risk you're willing to take in the attempt to earn a higher return.**

   REMEMBER

   Focus on overall portfolio performance. By design, you'll always have some asset classes in your portfolio doing better than others. The impact of having some investments zigging while others are zagging lowers overall portfolio volatility and potentially increases portfolio return. (See Strategy #40 for more on diversification.)

4. **Choose one or two mutual funds for each asset class, depending on the size of your portfolio.**

   TIP

   If most active fund managers have trouble beating the market or their respective benchmarks in a one-year period, what chance do they have of beating their benchmark over longer periods? And what chance do you have of choosing that manager ahead of time? By choosing passively managed funds (index funds and exchange-traded funds) over actively managed ones, you may improve your chances of earning the market return over the long run. See Strategies #21 and #23 for details.

5. **Rebalance periodically back to your target allocation.**

   In volatile markets in particular, ensure you don't stray too far from your target weightings. This may mean you have to sell assets that are doing well and buy those that are doing poorly, but you'll be well positioned when the market recovers because you've bought low and sold high along the way.

The following table gives suggested asset class percentages.

Asset Class	Holding Ranges (%)	L/Term Historic Returns Nominal (%)	Real (%)	Standard Dev (%)
Fixed Income	**35-55%**			
Cash^	0-10%	6.0	1.4	±2.9
Short Term Bonds	15-25%	7.3	2.7	±4.1
Intermediate Term Bonds	15-25%	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 and Alternative	**45-65%**			
Large cap	20-40%			
Value		10.7	6.1	±15.4
Growth		10.2	5.6	±18.1
Small cap	5-10%	14.3	9.7	±22.2
International developed	5-20%	11.7	7.1	±21.4
Emerging markets	0-5%	11.6	7.0	±28.0
Real estate	0-5%	13.0	8.4	±17.1
Commodities	0-3%	11.7	5.6	±24.2

^ Cash allocation is needed for portfolios where you'll be making withdrawals. L/T historic returns and standard deviation figures from Moneyguide Pro/PIE Technologies, 1972-2007. Real returns based on long term US inflation of 4.63%

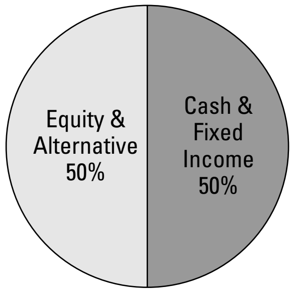
Note the Historical Performance of Moderate Portfolios

We provide two examples of moderate portfolios. The first portfolio illustrates a moderately conservative allocation using both 6 and 12 asset classes, and the second example shows the same historical results for a portfolio that has more opportunity for growth. The key statistics are shown on the bottom line — you want the highest return with the lowest amount of volatility (as measured by standard deviation) for your personal comfort level.

Note that the additional asset classes in the more complex portfolio result in a higher expected return and lower standard deviation in both cases, although the simple portfolio captures most of the benefits of diversification.

Moderate Portfolios

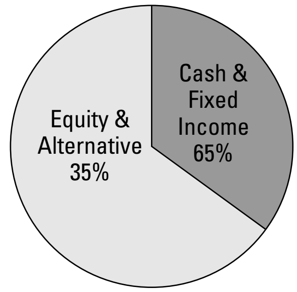
50% Equity and Alternative : 50% Cash and Fixed Income



Six Asset Class	
Cash	6%
S/T Bonds	19%
Int Bonds	25%
Large Cap	31%
Small Cap	7%
Int'l	12%
Total	**100%**
Exp Rtn	9.4%
Real Rtn	4.8%
Std Dev	8.3%

Twelve Asset Class	
Cash	6%
S/T Bonds	15%
I/T Bonds	21%
High Yield	4%
Glbl Bonds	4%
Lg Value	14%
Lg Growth	11%
Small Cap	7%
Int'l Dev	9%
Emg Mkts	3%
REITs	3%
Cmmdities	3%
Total	**100%**
Exp Rtn	9.6%
Real Rtn	5.0%
Std Dev	7.8%

65% Equity and Alternative : 35% Cash and Fixed Income



Six Asset Class	
Cash	5%
S/T Bonds	12%
Int Bonds	18%
Large Cap	40%
Small Cap	10%
Int'l	15%
Total	**100%**
Exp Rtn	10.0%
Real Rtn	5.4%
Std Dev	10.7%

Twelve Asset Class	
Cash	5%
S/T Bonds	9%
I/T Bonds	15%
High Yield	3%
Glbl Bonds	3%
Lg Value	17%
Lg Growth	16%
Small Cap	10%
Int'l Dev	10%
Emg Mkts	3%
REITs	4%
Cmmdities	3%
Total	**100%**
Exp Rtn	10.2%
Real Rtn	5.6%
Std Dev	9.9%

^ Portfolio expected returns and standard deviation figures from MoneyguidePro/PIE -Technologies, based on historic returns from 1972-2007