How a Model Portfolio Gives an Investor What They Want

By Steve Juetten, CFP®
April 2011

Introduction to Model Portfolio Investing

Investors want many things – high return and low risk, low taxes, emotional stability, and some even want social status from their investments. But at their core, what investors want from their investments at a practical level is a mixture of hope for riches and freedom from poverty.

There is a method to give you what you want as an investor that is simple, effective, time-tested and requires very little work on your part. The approach to investing that gives you all of what you want is called structured investing using **model portfolios**.

A model portfolio is a diversified system of mutual funds that are grouped together to provide an expected return with a corresponding amount of risk. There are six Smart Money Rules Model Portfolios and they range from defensive in purpose to maximum growth. The mutual funds the model portfolios hold invest in a variety of assets like large and small stocks from companies inside and outside the U.S., bonds and Real Estate Investment Trusts (REITs). Each model portfolio is automatically rebalanced regularly to sell funds that have gone up in value and buy funds that have gone down in value. You make one decision: which model portfolio fits your goals. The rest is done automatically.

I call this "auto pilot investing." A skilled pilot (me as your trusted advisor) helps you to "take off" by choosing the right model portfolio for you, watches over the portfolio for you as you fly along and is ready to answer questions you may have or help you change course if your situation changes. And I'm there to help you "land" your portfolio when the time comes.

A model portfolio is an incredible way to help you get what you want as an investor. With a model portfolio, you receive:

- ☐ Market returns
- ☐ Efficiency and effectiveness through passive investing
- ☐ Time efficiency for you because on-going portfolio management (including rebalancing) is done for you
- ☐ Effectiveness because rebalancing is done regularly (studies by Vanguard and others show that rebalancing improves portfolio performance, especially when it comes to managing a portfolio's overall risk)
- ☐ Consistency because a model portfolio investor does not change approaches when markets soar or dip. Independent research by Dalbar Associates shows that ***individual investors historically earn 5% less per year than those who buy and hold a simple passive index.***

Passive investing is the general term that refers to an investment approach that uses market forces to give the investor market returns. Passive investing is the opposite of active investing in which the investor (or her/his investment advisor) tries to predict the future and buy securities that the investor believes will go up in value. Passive investors believe two things:

1. The future is unknowable so it's a waste of time and money to try to guess it; and
2. Securities are accurately priced at any time so it's useless to try to take advantage of any possible pricing mistakes. Remember: for every trade there is a buyer and a seller; one thinks the security will go down in value in the future and the other thinks it will go up in value sometime in the future. They can't both be right.

Passive investing has several applications of its principles including index funds and Exchange Traded Funds (ETFs) that are available to investors. Another way that passive investing is applied is through "structured investments" which are like index funds on steroids. If you want to learn more about structured investing as it's applied by the premier mutual fund company, DFA, visit their web site at www.dfaus.com.

Let's see how the Smart Money Rules model portfolios work.

How It Works

1. We sit down together to identify your goals, time horizon, risk tolerance and income requirements.
2. You choose the model portfolio that works for you. Your choices are (the percentages are approximate and may vary slightly when you actually invest):
   a. **Defensive** (73% cash & fixed income/27% equity)
   b. **Conservative** (60% cash & fixed income/40% equity)
   c. **Balanced** (50% cash & fixed income/50% equity)
   d. **Moderate** (34% cash & fixed income/66% equity)
   e. **Capital Appreciation** (15% cash & fixed income/85% equity)
   f. **Equity** (1% cash/99% equity)
3. Your funds are invested in the model portfolio. Your future contributions will also invested in the model portfolio you've chosen. .
4. Your model portfolio is rebalanced regularly to return it to the target allocation.
5. You monitor the portfolio as often or as infrequently as you wish via on-line access to your account.

The Pros Who Support Your Investment Success

You have four investment professionals supporting your model portfolio investing success:

- □ **Me**, as your trusted advisor
- □ **Your custodian** who actually holds your money (it's usually the institutional groups at Charles Scwhab and Company or Fidelity)
- □ **Loring Ward Financial**, an SEC-registered advisor based in San Jose California, makes the purchases and sales to rebalance your portfolio for you
- □ **DFA Mutual Funds.** DFA is one of the most respected passive mutual fund companies. Their unique approach to using the principles of the efficient market theory has proven extremely successful for its investors. Investors can only purchase DFA funds through investment advisors who are approved by DFA. Visit the DFA website for more on their unique and highly successful approach to investing success at www.dfaus.com.

What Have the Results Been?

(all data as of 2/28/2011)

	% Average Annual Returns as				
	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Std. Dev. (10 Yr.)
Defensive	9.36	4.59	4.69	5.58	4.90
Conservative	12.61	4.88	4.91	6.13	7.05
Balanced	15.13	5.17	5.28	6.66	8.84
Moderate	19.48	5.07	5.16	7.08	11.87
Capital Appreciation	24.62	4.3	4.67	7.30	15.65
Equity	28.3	3.31	4.17	7.35	18.55
S&P 500 Index*	22.57	2.19	2.87	2.62	16.12

*The S&P 500 Index is an un-managed index made up of the 500 largest U.S. stocks

A Word About Risk and Returns

Standard Deviation refers to how much a portfolio's return varies from its average annual return over a certain time period. The higher the number, the more ups and downs you can expect from a portfolio.

For example, based on the 10-year standard deviation of the S&P 500 Index, we would expect the return of the S&P 500 Index to vary between -29.62% and +34.86% each year. Similarly, based on the 10-year standard deviation of the Balanced Portfolio, we would expect the annual returns to be between -11.02% and +24.34%. As the SEC warns, past results are no guarantee of future returns. However, standard deviation is useful because it gives us a way to quantitatively evaluate the past volatility of a portfolio.

Using the S&P 500 Index and the Balanced Portfolio for comparison, **the Balanced Portfolio has 2.5 times better annual average return and about half the volatility**. Put another way, if an investor had put $100,000 into the Balanced Portfolio in February 2001 she would have had $190,553 at the end of January 2011. If she had put the $100,000 in an index fund that tracks the S&P 500 Index, she would have had $129,515 at the end of January 2011 or <u>**over $61,000 less**</u>.

Investment Costs

Several academic studies, including one recent one by Morningstar, the giant independent investment information company, clearly show that costs are one of the biggest determinants of a portfolio's overall returns.

While most other financial advisors will do everything they can to hide investment costs*, I believe in disclosing and evaluating investment approaches based on **total investment cost**.

For a portfolio valued at $250,000, here is what an investor might expect to pay:*

	Total Cost %	**Total Cost in $$**
Do-it-Yourself (using retail index funds)	.80%	$2,000
Model Portfolio	1.51%	$3,775
Custom Portfolio	1.8%	$4,500
Broker-Assisted Portfolio	2.4%	$6,000

*These are typical costs and your actual costs will vary depending on a number of factors including the amount you have to invest and the investment vehicles that your choose. If you'd like to read more about the individual parts that make up total cost, please refer to the special report ***"Everything Your Broker Doesn't Want You to Know About Investing Costs"*** available on the Free Resources page of my web site at www.finpath.com.

Why Not Model Portfolios

Now that you know a little more about model portfolios, why would you **not** choose this smart, sound and simple way to invest?

- ☐ If you don't believe in passive investing and instead choose to gamble with your investment dollars by trying to pick individual stocks, time the market or use track record investing to choose heavily-marketed and actively managed mutual funds then a model portfolio is not for you.
- ☐ If you think of investing as a game that you must win, then a model portfolio is not for you because your model portfolio will never "trounce" the portfolio of your neighbor. You'll receive market returns, but there won't be any triple digit returns.
- ☐ If you want your investments to add to your social status, then this is not for you either because no one brags about a model portfolio and anyone can join, not just the super rich.

- ☐ If you like to spend lots of time pouring over arcane and mostly in-decipherable investment reports and listening to the all the latest talking head investment gurus on television, then model portfolio investing is not for you because it's simple to set-up and maintain.

But:

- ☐ If you want your investments to help you achieve your future goals in a way that gets you there simply and effectively, then model portfolio investing **is** for you.
- ☐ If you want market results achieved in a time-efficient, safe and sound way, then using a model portfolio **is** for you.
- ☐ If you want to use your time for things other than investing, then model portfolio investing **is** for you.
- ☐ If you want to use the approach that is based on the work of Noble Prize winning economists, is supported by numerous academic studies and has even been endorsed by Warren Buffet, then model portfolio investing **is** for you.

Model portfolios may not be for everyone, but they are a **simple, effective and time-efficient way for many investors to succeed**. Are you ready to start following the Smart Money Rules to get what you want as an investor?

About Steve Juetten, CFP®

Steve is a fee-only financial planner and investment manager fiercely dedicated to helping his clients take care of their money so they can do more of what they love. Clients seem to like what he does for them because they have made him a 5 Star Investment Manager according to ***Seattle Magazine*** for the last two years. You can reach Steve by email at steve@finpath.com or by calling 425-373-9393. You can visit his web site to learn more about how Steve's approach to financial planning and investment management might help you achieve your life's goals.