

Inflation: Ignore It at Your Own Peril

One of the few silver linings of the current economic crisis is that a slowing global economy has put the brakes on inflation, at least for now. Consumer prices dropped 0.4% in the 12 months ended in March, the first decline in a 12-month period since 1955. Falling prices are a pretty good indication that the global economy remains weak, but lower costs—particularly for food and energy—help ease pressure on consumers who have been pinched by shrinking incomes and investment portfolios.

Yet, even if inflation is on the back burner for the next three to five years—as many economists believe is the case—you don't need a Ph.D. in economics to recognize that the threat of higher prices isn't gone for good. With the government spending massively to revive the economy, it's very likely that it will overshoot and inflation could get cooking again. That view is shared by several money managers I admire, including Vanguard's Ken Volpert and PIMCO's Vineer Bhansali. Also, increased demand from emerging markets is apt to stoke long-term demand for commodities, even if many developing markets have cooled down considerably of late. For those reasons, I think it's important for every portfolio to include some inflation protection, especially if you have some or all of your portfolio in fixed-income investments.

Moreover, the time to purchase inflation protection is when other market participants aren't concerned about it—not when there's panic in the streets, as there was last year. When I wrote about inflation

in *PracticalFinance* a year ago, the key inflation-fighting investment types, Treasury Inflation-Protected Securities and commodities, seemed downright frothy to me. I didn't have any special insight into the direction of the global economy, but I was concerned that some investors were performance-chasing and I was also sure that higher prices would eventually check demand for commodities. Lo and behold, both types of investments suffered big losses in 2008's closing months, with TIPS funds dropping 8%, on average, between July and year-end, and commodities indexes shedding a painful 62% of their value over that stretch.

In this issue, I'll examine the attractiveness of these instruments, discuss how much of your portfolio you might consider devoting to inflation-fighting investments, and share some of our best ideas for adding inflation protection to your portfolio.

Treasury Inflation-Protected Securities

As I've said before, I'm a big fan of TIPS for your portfolio because they are the most precise and least expensive way to hedge against inflation. Inflation is one of the natural enemies of conventional bonds and bond funds because it eats away at the purchasing power of your interest payments. TIPS safeguard against that risk by adjusting their principal values to keep pace with inflation.

My colleagues at Ibbotson Associates, the asset-allocation specialists, clearly agree about the benefits of TIPS. Morningstar has recently created target-date indexes based on Ibbotson's asset-allocation methodologies, and the indexes' TIPS allocations ramp up with their bond stakes. For example, the 2020 index, featuring an asset mix appropriate for someone retiring 10 years from

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Christine Benz,
Director of Personal Finance

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now, includes a 7% allocation to TIPS (14% of its fixed-income weighting) and the 2010 index devotes fully 14% of its total assets (and nearly one fourth of its total fixed-income weighting) to TIPS. Clearly, the larger the share of your portfolio that you've dedicated to fixed-rate investments, the more you need to take steps to keep inflation from gobbling up your purchasing power.

Nonetheless, I would be careful about initiating a sizable new position in TIPS all in one go. While TIPS don't appear to be nearly as frothy as they were last year, they have rebounded strongly in 2009's first few months following a terrible showing in 2008's second half. In fact, the Barclays Capital U.S. Treasury TIPS Index has gained more than 5% for the year to date through mid-April. It's hard to say whether TIPS have gone up because investors are concerned about inflation or because the government has been actively buying up government securities. (It's probably a little bit of both.) Either way, a smart strategy at this point would be to slowly build a position in the asset class over the coming year by dollar-cost averaging.

It's possible to buy individual TIPS, and I-bonds, inflation-protected bonds available to individual investors, can also make sense for some investors because their tax treatment is generally more favorable than TIPS. However, yields on newly issued I-bonds have recently plunged due to the decline in consumer prices. For most investors, I would recommend using a TIPS fund to gain exposure to inflation-protected bonds. Morningstar's two favorites for do-it-yourselfers are **Vanguard Inflation-Protected**

Securities VIPSX and **Harbor Real Return HARRX**.

The former is a plain-vanilla TIPS fund with very low costs, whereas the PIMCO-managed Harbor fund is a flexible offering that sometimes includes exposure to bonds other than TIPS. Be sure to shelter TIPS in your tax-sheltered accounts, if possible.

Commodities

When I wrote about commodities last year, I was concerned about all the hot money that had recently moved into these investments. What a difference a year makes! Commodities of all stripes fell sharply in the second half of 2008 amid the dramatic slowdown in the global economy, cooling demand for funds and exchange-traded products dedicated to tracking the prices of products like metals, oil, timber, and agricultural products.

Given that we're currently in the midst of at least a mild deflationary environment and demand for commodities from once-scorching emerging markets has cooled considerably, I think there's a good chance that commodities could remain down for some time, and may even fall further. However, I do think a small slice of commodities exposure can make sense as a long-term hedge in a broad portfolio, and, as with TIPS, you're certainly better off building a position now than you would've been a year ago. The above-mentioned Morningstar/Ibbotson target-date indexes include a 5% position in commodities for investors of all time horizons. I'd also urge you to bear in mind other commodities-related exposure that you might already have in your portfolio. For example, natural-resources stocks like **ExxonMobil XOM** are an imperfect way to track commodity-price movements,

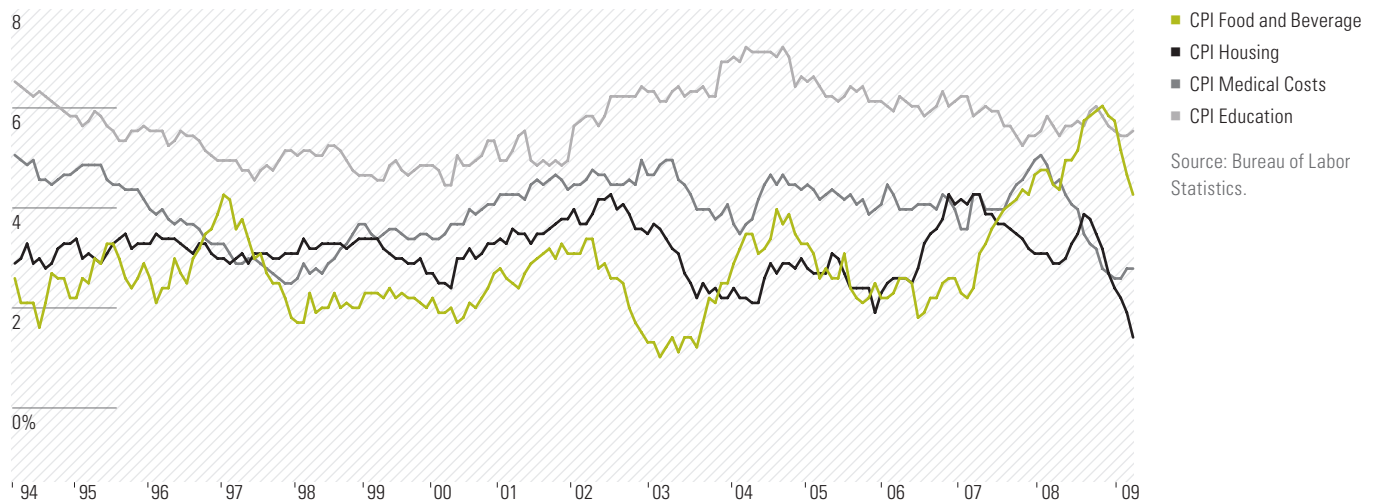
Morningstar's Best Bets for Inflation Protection

Fund/ETF Name	Category	1-Year Return (%)	5-Year Return (%)	Expense Ratio	Comment
Vanguard Inflation-Protected Securities VIPSX	Inflation-Protected Bond	-1.35	4.71	0.20	No-nonsense TIPS fund provides inexpensive exposure.
Harbor Real Return HARRX	Inflation-Protected Bond	-0.86	N/A	0.57	Fund stumbled in 2008, but we like PIMCO's expertise.
iPath Dow Jones-AIG Commodity Indx DJP	Natural Resources	-48.28	N/A	0.75	Replicates index well, but beholden to Barclays' health.
Elements S&P CTI ETN LSC	Long-Short	N/A	N/A	0.75	ETN provides short and long commodities exposure.
Harbor Commodity Real Return Strategy HACMX	Natural Resources	N/A	N/A	0.94	New fund but PIMCO has been running strategy for years.

Data through April 24, 2009.

Inflation Under Control, for Now

Rolling 12-month inflation rates for various goods and services. Housing and food/beverage costs have dropped sharply of late.



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but there is some correlation. In addition, many emerging-markets stocks relate to commodity extraction and production.

Exchange-traded funds and notes provide the most direct, least expensive route to commodities exposure. **IPath Dow Jones-AIG Commodity Index** DJP provides broad-based exposure to a diversified basket of commodities and is cheap; it's also more tax-efficient than some other commodities investments, though the IRS is currently reviewing ETNs' favorable tax treatment. (Unlike exchange-traded funds, which make taxable distributions, ETN holders pay only capital gains tax when they sell their shares.) The big negative is that the exchange-traded note structure subjects holders to risks associated with the notes' issuer—in this case, Barclays Bank. In issuing the notes, Barclays promises to pay holders a return that's equal to the commodity index's return, less expenses. But were Barclays to become impaired and unable to pay its obligations, the value of the notes could drop. Another commodities ETN that our exchange-traded team has been recommending is **Elements S&P CTI ETN** LSC. Whereas conventional commodities funds track commodities prices, for better and for ill, this one tracks the

S&P Commodity Price Trends Indicator Index, which shorts commodities as well as takes long positions.

Investors uncomfortable with the credit risk of the abovementioned two ETNs might instead look to a traditional mutual fund; our favorite is the PIMCO-managed **Harbor Commodity Real Return Strategy** HACMX. It uses derivatives to mirror the performance of the Dow Jones-AIG Commodity Index, but because shadowing the index requires only a small outlay of cash, it uses the remainder of its assets to buy TIPS. PIMCO's expertise in fixed-income gives it a fighting shot at besting passively managed commodities investments over time. ■■■

What Happened to My 529 Plan?

Investment Insights | Greg Brown

It's a dismal scenario: As college tuition continues to shoot up at an alarming rate, investors brave enough to open their 529 college-savings account statements have likely seen a precipitous drop in assets.

Several plans struggled due to too-aggressive asset allocations for students nearing or in college, while other plans were hamstrung by their allegiances to floundering investment options.

Although we still think 529 plans make sense for many college savers, particularly those with a lot to sock away for college, problems at some of these plans highlight the importance of choosing carefully. Here's an overview of what went wrong at some of these plans. See the table on the facing page for our annual summary of the best and worst 529 plans.

A Major Player Stumbles

OppenheimerFunds is the poster child for how badly some 529 players went awry in 2008. Over the past few years, the company had firmly established itself in the 529 college-savings universe. Oppenheimer currently manages nine separate college-savings plans, both advisor- and direct-sold, in five states. Unfortunately, all of those plans had exposure to some of the worst bond-fund blowups in 2008.

Oppenheimer Core Bond OPIGX (or separate accounts managed in the same style), a fixture in most of the Oppenheimer-managed 529s, caused the most pain, losing more than 35% in 2008 due to management's bets on non-agency mortgages. But it didn't stop with just Core Bond. Many of the Oppenheimer plans also had exposure to **Oppenheimer Limited-Term Government** OPGVX and **U.S. Government** OUSGX, two other troubled fixed-income funds that were run by the same management team as Core Bond. Government bonds were the only pocket of strength in 2008, but these funds managed to finish last year in the red despite their focus on that asset class.

The reason? The funds owned mortgage-related securities and derivatives that weren't backed by the U.S. government, including commercial mortgage bonds that dropped precipitously last year. (Like most government funds, these two have the ability to invest up to 20% of their assets in nongovernment securities.)

The worst part for investors in these plans is that the Oppenheimer portfolios positioned closest to college were the ones holding the largest positions in these bond funds. Thus, even though fixed-income investments are typically considered more conservative than equities, the plans' bond options didn't provide the ballast that one might have expected—far from it. For example, Texas' direct-sold College Savings Plan's "Blended Age-Based 15–17 Years Portfolio," which had half its assets in Core Bond, fell nearly 30% in 2008, compared with less than half that amount at many peers in a similar age-band. A similar pattern of losses can be found in the same age band at nearly every Oppenheimer-managed 529 plan.

Risky Age-Based Options

Unfortunately, the Oppenheimer-managed plans weren't the only ones with problematic age-based options. Age-based options are designed to transition from mostly equities in a younger child's account to more conservative investments—bonds and cash—as the beneficiary approaches college. There's no consensus on the precise asset allocation for a given time horizon, but it's clear that some plans didn't move out of equities fast enough given that they were geared toward students getting close to college. After all, most students deplete their 529 assets in four years, leaving little time to recover from a serious market downturn like 2008's.

The most striking example of an overly aggressive asset allocation comes from one of Utah's five age-based options. That plan's "S&P and Bonds" age-based option stashes a dangerously bold 65% of assets in equities for a college-enrolled beneficiary. It's important to note, however, that this best-in-class plan features four other age-based options with much more sensible structures.

An overly aggressive asset-allocation framework becomes a more serious issue when investors are only offered a single age-based choice. For example, Oregon's OppenheimerFunds 529 Plan has just one age-based option, and until March 30, 2009, the plan's "1–3 Years to College" portfolio had 40% devoted to equities, with more than 5% in foreign stocks. Additionally, New Jersey's direct-sold plan has just one age-based option that can have as much as 35% in equities—including up to 12% in international and 6% in smaller-cap fare—for a beneficiary already enrolled in college. The critical lesson for investors is to pay particular attention to the latter stages of a plan's age-based option, and be sure you are comfortable with the risk your plan is taking.

When evaluating 529 plans, we favor those that have sensible allocations between stocks, bonds, and cash that are appropriate for the age of the beneficiary. We also like to see plans that are not only well diversified across the major asset classes but are also exposed to such areas as real estate investment trusts and Treasury Inflation-Protected Securities for added diversification benefits.

Fees are another important item to consider. Morningstar and others have consistently found that costs are the best predictors of a mutual fund's long-term success, and one can safely extrapolate

those findings to the 529 universe as well. Expenses are especially important for the growing number of index-centric plans, which have little else besides expenses to distinguish them.

Flexibility is also an essential ingredient in a 529 plan. In addition to multiple age-based options with differing levels of risk, we also like to see a few fixed-allocation offerings (the level of stocks, bonds, or cash does not change over time) and a good selection of single-fund options for do-it-yourself investors or for advisors looking to tailor-make a portfolio for clients. Finally, the quality of the underlying investments is an important consideration. We look for funds that have experienced managers, a history of good stewardship, and sensible strategies.

Of course, the decision about whether to stick with your home state's 529 plan (and possibly receive a state tax break) or go out of state for your plan is a personal one. Some of you may choose to eschew the 529 altogether and instead save in your taxable accounts, a Roth IRA, or a Coverdell Education Savings Account. However, the travails of some 529s in 2008 make clear that 529 plans vary broadly in their quality and composition. For more details on individual plans, click the Personal Finance tab on Morningstar.com and select "529 Plans" in the left navigation bar. ■■■

The Best and Worst 529 College-Savings Plans

The Best 529 Plans

Ohio CollegeAdvantage 529 Savings Plan Multiple Managers
Plan boasts top managers, sensible asset allocations, low costs.

Indiana CollegeChoice 529 Direct Savings Plan Multiple Managers
Offers top managers, broad breadth, low costs.

Utah Educational Savings Plan Trust Vanguard
Top choice for index enthusiasts, boasts ultralow expenses.

Virginia Education Savings Trust Multiple Managers
Repeat winner boasts best-of-breed funds, low costs.

Virginia CollegeAmerica Multiple Managers
Broker-sold plan is heavy on funds from American Funds.

The Worst 529 Plans

Nebraska State Farm College Savings Plan (broker-sold) Oppenheimer
Plan made ill-timed switch into Oppenheimer funds.

New Jersey Best 529 College Savings Plan Franklin Templeton
Overly aggressive age-based options, high costs, lack of flexibility.

Montana Pacific Life Funds 529 Pacific Funds/Multiple Managers
High costs, lack of flexibility, limited menu of single funds.

Ohio Putnam CollegeAdvantage* Putnam
Putnam has been plagued by stewardship problems, manager turnover.

Nebraska AIM College Savings Plan* Union Bank (AIM)
Repeat appearance on worst list due to high costs, lack of flexibility.

* Broker-Sold

Planning Advice for Every Life Stage

Expert Interview | Christine Benz

Ross Levin, founding principal of Minneapolis-based Accredited Investors and one of the top financial planners in the United States, understands that successful investing depends as much upon understanding his clients' personal needs and goals as it does on selecting appropriate investments for their portfolios. To help discuss the recent financial crisis and its impact on how individual investors should be managing their portfolios, I recently sat down with Ross for an interview.

Let's talk about a couple of different types of investors and get your best advice to them at a juncture like this. So let's start with someone who's in the accumulation phase, someone who's in his or her 40s or 50s and still has a good 10-plus years until retirement. What are your key tips for them right now?

A key thing to think about at all stages of your life is when you are going to use the money. The reason that's so important is that if you are in the accumulation phase and you're going to live off of your portfolio and you're 40 years old and your parents have great longevity, and you're partnered, you probably have 55 years that you have to plan for; your money has to last 55 years. Sometimes people get caught up in where they are in their life as opposed to where they are in their life span. I think that's an important distinction.

The other thing to think about is how much your accumulation matters relative to the size of your portfolio. So for those who are just starting out in their 20s, and they're putting money in their 401(k) and it's being matched, their contributions probably mean a lot more than what they've accumulated to date. For them, they're automatically sort of conservative because the cash is sort of like a bond holding, so they always have more in fixed income than someone that age would ever need. That person can be 100% invested in equities.

Once you're 40, 45, or 50, at that point you've probably accumulated more assets, so your contributions have less of an impact over what you've actually accumulated. So if you see a 15% drop in your portfolio, even if you're putting \$20,000 into the portfolio each year, that can cause the portfolio to fall in value, because those contributions don't make up for the 15% you've lost. For sure at that phase you want to have some percentage in bonds. If you're in your 40s and contributing on a regular basis, we like to say you should hold at least 20% in bonds. If you're saving for other things—for example, kids' education—the different pockets may need to be invested differently.

Do you find in your practice that people want to prioritize investing for kids' college at the expense of retirement?

People at this life stage are often dealing with three things. Some people feel like they need to take care of their parents; they've got their kids' college; and they've got their own retirements to think about.

There are two main things to remember about education planning as opposed to retirement planning: First, you really can't borrow for retirement but you can borrow for college, and there are a lot of different resources to do so. And second, what you really need to determine is some of the "whys" of what you're doing. The fact that you had college paid for by your parents, is that why you're paying for your

kids' college? Or the fact that you didn't have college paid for, do you feel like you need to pay for your kids' college because you resented the fact that your college wasn't paid for? You need to get into your reasons for doing things rather than just saying, "This is what I'm going to do." And you have to think about it on a whole host of different levels. The first is what do you think is best for your kid? The second is what are the stated and unstated agreements that you have with your children? And third, what are the consequences of over-sacrificing at any stage in your life for your children? Are you ultimately going to end up—ironically—being put in the worst of all situations, where your kids have to take care of you because you did too much for them too early?

We use 529 plans all the time in our practice, and I've got them set up for my kids. There are some advantages to 529s if the money is going to be invested for a really long period of time. But you could also choose to own relatively tax-efficient investments in your own name. You give up the tax-free buildup and full tax advantages on disposition, but you gain more flexibility both in terms of investment options and the ultimate use of the money.

money into the 401(k), they may be able to raise \$40,000, \$60,000, or \$80,000 in cash over the next few years; that would allow the rest of the portfolio to do what it needs to do to build back.

The key thing for everyone who's thinking about retirement is where are the sources of income going to come from. And there have been a couple of misconceptions that have affected retirees. One is that they thought that their home was going to be a great source of money. What we've found from our clients, and our clients are a little bit more affluent, is that when they retire, almost none of them have "bought down." They've either stayed in their homes longer than they thought they would or they've bought an equivalent place, and even though it's smaller they're not saving that much money on the buy.

The other thing that people misperceive is what their retirement is going to look like. Most people, and especially after this market, are going to either work a little bit longer or find a way to earn a little bit of money in retirement. And that is so significant. If you use a spending policy and let's say you spend 5% of your assets in retirement, and you could make \$20,000 working, that's equivalent to having \$400,000 of investment assets.

We also love to see those who are in the pre-retirement phase pay off their mortgages, even with interest rates as low as they are. The reason is that we're trying to drive down cash flow, or fixed costs, as much as we can because that creates the most flexibility for people. And what we have found in retirement is that clients need to be flexible because no matter how good your planning is, when clients feel poor, they don't spend as much money, and when they feel rich, they spend more than they're supposed to be spending. So you really want to manage the fixed costs. If the clients' fixed costs are low, then you can encourage them to do things that matter, like take vacations and visit the kids while they still have their health.

What advice do you have for those who are already retired?

“We also love to see those who are in the pre-retirement phase pay off their mortgages, even with interest rates as low as they are.”

So what about pre-retirees? Many in this group have been dealt a huge blow.

Our guiding philosophy for those who are retiring is that once you're living off your portfolio, you need to have three years' worth of spending in cash or cashlike instruments. So if you're very close to retirement, you might have thought that, "Once I retire I'll raise the cash." For those people, it may make sense to put the monthly money that's going into the 401(k) into a risk-free option rather than raising cash in this environment. If they're three years away from retirement and they're putting maximum

I've been doing this since 1982, and I will say that not one of my clients' retirements looked the way they thought it was going to look. They lived longer than they thought, they lived shorter than they thought, they were healthier than they thought, they were less healthy than they thought they would be. Almost all of our clients died with too much money. One thing that we've been experiencing a lot lately is one healthy spouse and another spouse has Alzheimer's or ALS or something along those lines. That changes everything for everyone.

The other thing that we've noticed is that clients who are retired may not notice all the sources of investments they have. For example, we have clients who own a home up in Minnesota and a home down in Florida or Arizona. Once they are retired, they choose to only live in one place versus the other—maybe not right away but when they're 75 or 78. So suddenly we sell a home and those proceeds end up coming into the portfolio and that buys us time. One of the things that is really important for those who are retired is to recognize that your picture changes all the time. And again, it's one of the key reasons we stress flexibility.

So right now, immediate annuities are being bandied about in this kind of environment. And we're not big fans of immediate annuities because they are an answer to only two questions: How do I get the most income right now from my portfolio and how do I know that I will always have some income? While these are important considerations, there are many other things to think about. There are so many different things that can change during retirement. So we're big fans of making sure we stay flexible and we're also big fans of having experiences in the early years of retirement, because none of our clients, except for health-care expenditures, end up spending more in their 80s than they did in their 60s or 70s.

Of all the products that are out there, the one that's most intriguing to me is longevity insurance, which is not really good yet. But that's where you put some money away and it doesn't pay off until you're 80, and then it creates an income stream from age 80 for the rest of your life. The advantage of that kind of product is that it allows you to do planning with the rest of your assets using a fixed time horizon. So the major question that all of us have is how long we will live, and longevity insurance allows you to not worry so much about that. For much less cost than an

Ross Levin's Financial-Planning Tips for Investors at Every Life Stage

FOR EVERYONE

Always invest at least enough to earn any company matching funds.

ACCUMULATORS

Many years until retirement

Invest in a combination of large, small, and international mutual funds. No real need for bonds here as your contributions tend to be very significant compared with the portfolio size.

Look at the Roth 401(k) if it's available. The years of totally tax-free accumulation and distributions are the most valuable for those with the longest time horizons. Remember, though, it won't save you any current taxes.

PRE-RETIREES

Have at least four investments: Large, small, and international stocks, and bonds.

Rebalance at least twice a year back to your desired asset allocation.

RETIREES

Be aware of when your restrictions for selling company stock are lifted and be sure to diversify.

If you will be living off your retirement plan when you retire, make sure that you begin building three years' worth of cash. The rest of the portfolio should be invested more for growth, as volatility represents a smaller risk than inflation over the next 30 years!

immediate annuity, you can lock in a future income stream, which we think is really intriguing.

The other thing that we've become much more appreciative of is long-term care coverage. For our wealthy clients, from a financial standpoint, long-term care often doesn't make sense, but we're finding clients who want to own the policies even if it doesn't make sense because it allows them to spend more of their assets on other things that are more important, because they know they won't have to rely on their assets for long-term care. So there are other reasons than financial why that kind of product can make sense.

Any other thoughts on longevity risk and how to safeguard a nest egg?

The most important thing you can do is make sure that you understand where your cash is coming from and think about your time horizon. We have a client who has been very nervous about the market and feels terrible about what's going to happen. What we've done—and this is a framing issue—is said, "Let's take 10 years' worth of your cash flow and buy bonds with it, and every year those bonds will come due and you're going to spend those bonds. We're not going to worry about the return; you're going to spend that entire bond, that's going to represent your cash flow." That gives them peace of mind, and it allows them to do what's best for them. Most people have a couple of competing goals. One is that they know they don't want to outlive their assets, and a secondary goal is that they would love to have some money go to charity or their kids.

You said that a lot of your clients died with too much money. How do you work against that?

The way we try to manage that is to ask "What is it that you're spending your money on?" So when we see someone with too much money, we're not encouraging them to buy another Rolex. We're encouraging them to see whether there are things that are going to make a difference in their lives, things that they could have done with their money that they'll regret not doing.

So, for example, one of our clients, when they were 69, took their grown kids and their grandkids on a cruise together. The parents paid for it, and it was a big deal. And, by coincidence, unbeknownst to either of the parents, the mother was diagnosed with Alzheimer's about six months later. That cruise could not have happened at a different point in time. Now they're worried about her care and what's going to happen, but that cruise got a tremendous amount of mileage for them. That experience with the whole family was such a wonderful thing, and should she pass away from Alzheimer's, the kids will always have that experience to talk about. If she passed away with another \$50,000 in the bank, would that have been more significant than what they did with that money?

Are there any financial-planning maneuvers that you use that you think are underutilized by investors or other planners?

We do a lot of lifetime gifts, and a lot of people don't do that. We also do a lot of work on the ethical will, and we find that to be very powerful and enriching. A traditional will describes how you should dispose of your valuables, and an ethical will is a letter that describes the values that you want to impart to different people. So you get to talk about the things that matter to you and why they matter. We try to use them in a form where they're not prescriptive; sometimes parents try to rule from the grave. Instead, we have them say, "This is what this means to me and why it means this to me. This is what you have meant to me and what I've tried to teach you and show you and why that matters." It helps on both sides. For the people we're working with, it helps them understand what their motivations have been. And for the recipients, the letters or videotapes or whatever are a wonderful way for them, in posterity, to be reminded of the impact that their parent or loved one had.

From our end, the most important thing that we can do for our clients is treat them as the individuals they are. Every client is unique. ■■■

Leaving a Legacy

Portfolio Makeover | Christine Benz

Unlike many of their newly retired peers, Ginnie and Alan Davidson aren't feeling particularly anxious about their ability to fund retirement, even though they're only in the early 60s and their retirement could last another 30 years or more. Both are former educators, and they're lucky enough to be drawing on pensions that cover their day-to-day living expenses. Ginnie notes that they have a frugal lifestyle and have no debt. So while the market downturn has hurt their investment portfolio, they've so far been enjoying a fairly carefree retirement, pursuing their hobbies as well as spending more time with their two adult children, both of whom live nearby.

As idyllic as this sounds, the pair isn't completely worry-free. They've recently been repositioning some of their assets, having lost a sizable amount in a brokerage account, and they haven't yet invested a \$250,000 inheritance that Alan received when his father passed away. Given the market downturn and its recently sharp snapback, they're unsure what their next steps should be. The bulk of their investment assets are sitting in cash, and Ginnie and Alan would like guidance on an appropriate asset mix for people in their situation. They'd also like advice on when to begin taking Social Security.

More important, they'd like to make sure they leave a legacy for their two daughters. While both are single and living and working on their own, their oldest daughter has special needs. She receives Social Security to supplement the income she earns, but a key priority for Ginnie and Alan is making sure that their daughter's financial future is as secure as it can possibly be. They've set up a special-needs trust for their daughter, and would like advice on investing the assets in the trust.

The Before Portfolio

Ginnie and Alan's assets are in a few different silos.

They both have IRAs, consisting mainly of cash currently and totaling roughly \$200,000. Additionally, Ginnie has a small amount in a 403(b), also in cash.

The rest of the Davidsons' assets are in their taxable accounts. They hold a smattering of stock and bond funds, including some solid funds from Fidelity. In aggregate, their equity holdings skew toward the growth column of the Morningstar Style Box, while their bond funds are generally high-quality offerings. The bulk of their taxable portfolio consists of the inheritance, which is idling in a money market fund. Their daughter's special-needs trust is also in cash.

The After Portfolio

The couple's pension currently covers their living expenses. For that reason, I would recommend they defer receipt of Social Security for as long as possible, presuming that living on the pension income alone doesn't seriously cramp their ability to pursue the activities they'd like early in their retirement years. True, they could take Social Security sooner and invest the proceeds, but Social Security benefits increase at a guaranteed rate of return. Just as important, deferring Social Security will ensure that they'll receive full pension payments for the next several years. (Their pension income will be reduced by 10% once they begin taking Social Security.)

Given that generating current income and preserving capital are lesser concerns than growing their assets for their daughters, the Davidsons can hold more equities in their investment portfolio than would be typical for other retirees of the same age. Still, I would recommend holding some bonds for ballast as well as some cash in the portfolio to cover emergencies, and also keeping the bulk of their equity assets in more-conservatively positioned stock funds. Fidelity, where the Davidsons currently have most of their equity assets, fields some of the lowest-cost index funds in the business, but I would favor Vanguard for their assets because I prefer the latter's taxable-bond funds.

I would also urge this couple to check with an accountant about converting their traditional IRA assets to a Roth IRA. Because they may not tap their IRA assets

Positioning for Growth

Ginnie and Alan's Portfolio: Before

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Fidelity Export & Multinational FEXPX	★★★★	LG	13,000	0.81
Fidelity Capital Appreciation FDCAX	★★★	LG	6,000	0.82
Fidelity International Discovery FIGRX	★★★★	FB	18,700	1.05
Fidelity Ginnie Mae FGMNX	★★★★	GI	22,400	0.45
Fidelity Mortgage Securities FMSFX	★★★	CI	28,000	0.45
Fidelity Short-Term Bond FSHBX	★★★	CS	11,800	0.45
Transamerica Premier Equity TEQUX	★★★	LG	10,500	1.15
Gabelli Equity Income GABEX	★★★★	LV	4,800	1.43
Cash	N/A	N/A	548,200	N/A
Total (including 25 holdings not shown)			663,400	

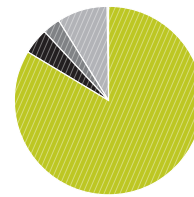
Super Sector Weighting (%)

Information	17.71
Service	45.57
Manufacturing	36.73

Top Three Sectors (%)

Industrial Matls	16.85
Financial Svcs	16.15
Health Care	15.20

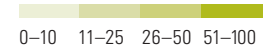
Asset Allocation (%)



Cash	83.73
U.S. Stock	4.44
Foreign Stock	3.00
Bonds	8.73
Other	0.09

Equity Style (%)

Value	Blend	Growth	
21	20	40	Large
4	5	8	Medium
1	1	0	Small



Ginnie and Alan's Portfolio: After

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Vanguard Selected Value VASVX	★★★★	MV	50,000	0.38
Vanguard Total Bond Market Index VBIMFX	★★★★★	CI	75,000	0.2
Vanguard International Explorer VINEX	★★★★	FR	25,000	0.36
Vanguard Inflation-Protected Securities VIPSX	★★★★	IP	25,000	0.2
Vanguard Tax-Mangd Captl Apprctn VMCAAX	★★★	LB	150,000	0.15
Vanguard Tax-Managed International VTMGX	★★★	FB	50,000	0.18
Vanguard Total Stock Market Index VTSMX	★★★	LB	75,000	0.16
Vanguard High-Yield Corporate VWEHX	★★★★	HY	22,500	0.27
Vanguard Wellington VWELX	★★★★★	MA	75,000	0.29
Cash	N/A	N/A	115,900	N/A
Total (including 21 holdings not shown)			663,400	

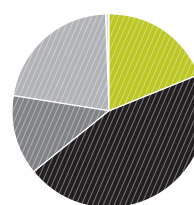
Super Sector Weighting (%)

Information	15.46
Service	43.57
Manufacturing	40.97

Top Three Sectors (%)

Industrial Matls	15.53
Financial Svcs	13.88
Health Care	13.16

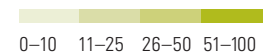
Asset Allocation (%)



Cash	19.20
U.S. Stock	45.23
Foreign Stock	13.32
Bonds	22.02
Other	0.49

Equity Style (%)

Value	Blend	Growth	
25	21	21	Large
10	10	7	Medium
2	2	2	Small



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Categories

CI Intermediate Bond	IP Inflation-Protected Bond
CS Short-Term Bond	LB Large Blend
FB Foreign Large Blend	LG Large Growth
FR Foreign Small/Mid Growth	LV Large Value
GI Intermediate Government	MA Moderate Allocation
HY High-Yield Bond	MV Mid-Cap Value

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Leaving a Legacy
Continued from Page 10

during retirement, converting them to a Roth means they wouldn't have to take mandatory distributions at age 70 1/2, unlike with a traditional IRA. In turn, they would be able to stretch out the tax benefits of the IRA and leave some or all of those assets to their daughters. The bear market of the past 18 months has dramatically reduced investment gains in IRA portfolios, thereby making an IRA conversion quite beneficial for many individuals right now. (When you convert, you pay ordinary income taxes on any deductible contributions and investment earnings.)

Additionally, I think long-term care insurance could be a good idea for this couple. Some financial planners argue that long-term care insurance is usually "sold, not bought," and there's certainly an element of truth to that. Yet given that leaving an inheritance for their daughters is a key priority for the Davidsons, I would recommend it here. Although Alan has a health

condition that could affect the pricing of this insurance, the fact that the pair is still quite young will work in their favor. In addition to improving the likelihood that the couple will be able to leave assets to their daughters, having this insurance could also provide this couple valuable peace of mind.

Finally, setting up a special-needs trust is a great step toward leaving a legacy for their daughter with special needs; Alan and Ginnie could also make the trust a beneficiary of their IRAs, if they so choose. Were they to leave assets outright to her, it could jeopardize her eligibility for government benefits such as Social Security. The assets in the special-needs trust are there to pay for extras such as hobbies, trips, and even caregiving—not for the basic living expenses that are covered by government programs. ■■■ Contact Christine Benz at christine_benz@morningstar.com

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