

Model Portfolios for Retirees and Pre-Retirees

Stocks have rebounded sharply over the past five months, but the scars of the bear market, both financial and psychic, remain. With even moderate portfolios losing a fourth of their value in 2008, many investors—particularly those nearing or in retirement—have been questioning their game plans.

Rock-bottom yields—an outgrowth of the weak economy and the Fed's aggressive interest-rate-lowering campaign—have compounded the challenge for retirees. Whereas not invading their principal may have been a key challenge for affluent retirees a few decades ago, most retirees today have a more straightforward goal: finding a way to live comfortably without running out of money.

Because so many of you are re-evaluating your portfolios in the wake of the bear market, this month's issue features three portfolios geared toward retirees and pre-retirees. For the portfolios' asset allocations, I relied on Morningstar's Lifetime Allocation Indexes, which in turn use research from asset-allocation specialist Ibbotson Associates. I then populated them with some of Morningstar's favorite investments. Even if you aren't interested in remaking your portfolio, you can still use the portfolios and their asset allocations to guide your decision-making.

Of course, there's no such thing as a one-size-fits-all asset allocation, so you'll want to bear your own situation in mind as you review these portfolios and compare them to your asset mix. (As always, I'd

suggest that you check out Morningstar's Instant X-Ray tool to help determine your asset allocation starting point.) Your age and the number of years you expect to be retired are big swing factors, of course, but there are a host of other considerations to bear in mind, including your need for liquidity, the amount you have saved, and whether you can rely on other sources of income during retirement.

Long life spans and paltry bond yields mean that even risk-averse retirees need the appreciation potential of stocks in their portfolios. But don't go overboard, even if your retirement portfolio has taken a big hit over the past few years and you're feeling pressure to make up lost ground. 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%) 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.

As with stocks, the percentage of your portfolio that you hold in cash is also highly dependent on your own situation. The cash stake in all of these sample portfolios is in the single digits, but yours may be higher or lower depending on the size of your portfolio and your own income needs. Every retiree should have two to five years' worth of living expenses set aside in highly liquid investments (that is, checking, savings, money market, CDs) 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

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Christine Benz,
Director of Personal Finance

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case, the amount of assets you should keep in cash should range between \$60,000 (\$30,000 times two years) and \$150,000 (\$30,000 times five 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, why should you 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.

In-Retirement Portfolio: 10-Year Time Horizon: Conservative

Asset-Allocation Targets

U.S. Stock: 16.0%

Foreign Stock: 4.4%

Bond (ex TIPS): 46.4%

TIPS: 21.3%

Commodities: 5.8%

Cash: 6.1%

The portfolio shown here is based on the conservative version of Morningstar's Lifetime 2000 Index, geared toward risk-averse individuals who retired in 2000. Because capital preservation and stability are likely to be key goals for retirees at this life stage, this portfolio stakes roughly 70% of its assets in bonds and cash and the remainder in stocks. (The stock positions of the moderate and aggressive versions of this portfolio step up to 38% for the former and 47% equity for the latter.)

The conservative 10-year portfolio's emphasis on inflation protection is also notable: Roughly a third of the bond position is in inflation-protected securities, and another 6% of the total portfolio is parked in commodities. 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. (While inflation is currently under control, Morningstar's economic team thinks it's a substantial concern for the future.)

Note that the equity portion of this very conservative portfolio is well diversified by investment style, and includes exposure to growth, foreign, and small-cap stocks. These areas are often considered more risky than U.S. large-cap value names, but they're fine as part of a well-diversified mix.

Investment Specifics: Ibbotson's asset allocation calls for exposure to bonds of varying maturities, but you needn't buy dedicated short-, intermediate-, and long-term holdings. Instead, the lynchpin of the portfolio shown here is a flexible core bond fund that I've recommended many times in the past: **Harbor Bond HABDX**, run by Bill Gross at PIMCO. (I'm also a fan of **Metropolitan West Total Return Bond MWTRX**, which fills a similar, utility-player role.)

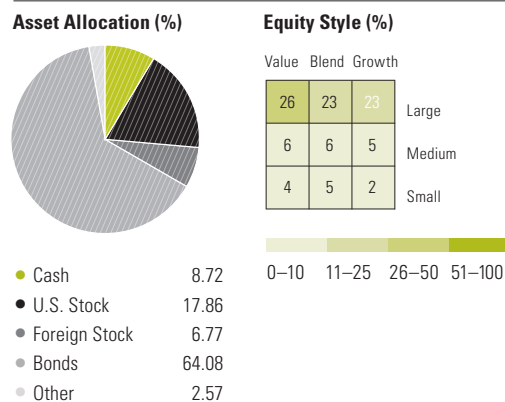
For shorter-term exposure, I like **T. Rowe Price Short-Term Bond PRWBX**, which focuses on high-quality corporates and has generally done a good job at limiting losses. I didn't put a dedicated long-term bond fund into the portfolio, largely because their long-term returns are similar to what you'd earn from an intermediate-term fund, but the volatility has been extreme. I've recommended another PIMCO-managed Harbor fund for exposure to Treasury Inflation-Protected Securities, **Harbor Real Return HARRX**. (**Vanguard Inflation-Protected Securities VIPSX** and **iShares Barclays TIPS Bond TIP**, an ETF, are worthy substitutes.) **Loomis Sayles Bond LSBRX** provides exposure to corporate bonds, including some lower-rated debt, as well as smaller slices of foreign government debt, including emerging markets.

On the equity side, I've included **Dodge & Cox Stock DODGX**, which remains a high-conviction pick for Morningstar despite its steep losses in 2009. I've also included a lesser-known fund, **Dreyfus Appreciation DGAGX**, which I've often recommended for retiree portfolios. Thanks to its focus on blue-chip firms with sustainable competitive advantages, the fund has managed to deliver strong long-term returns with low volatility. **Sequoia SEQUX** and **Jensen Portfolio JENSX**, as well as **Vanguard Dividend Appreciation VIG** (an ETF discussed in depth in the interview that begins on Page 6) would all be solid

In-Retirement Portfolio: 10-Year Time Horizon: Conservative

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Harbor Bond HABDX	★★★★★	CI	25	0.55
Harbor Real Return HARRX	★★★★	IP	22	0.57
T. Rowe Price Short-Term Bond PRWBX	★★★★	CS	12	0.55
Harbor Commodity Real Return HACMX	NR	SN	6	0.94
Dodge & Cox Stock DODGX	★★★	LV	5	0.52
Dreyfus Appreciation DGAGX	★★★★	LB	5	0.96
Harbor International HAINX	★★★★	FV	5	0.79
Loomis Sayles Bond LSBRX	★★★	MU	5	0.94
Royce Total Return RYTRX	★★★★	SV	5	1.12
Vanguard GNMA VFII	★★★★★	GI	5	0.22
Vanguard Total Stock Market Index VTSMX	★★★	LB	5	0.16
Total			100	

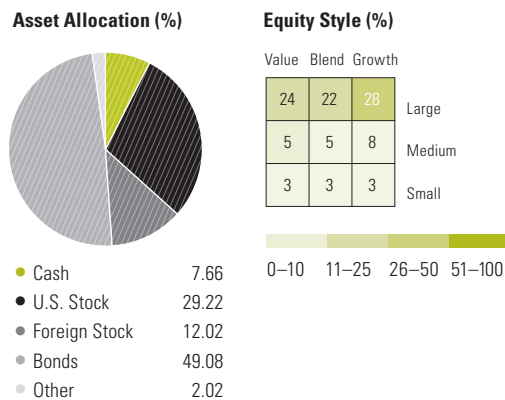
Super Sector Weighting (%)	Top Three Sectors (%)
Information 15.46	Financial Svcs 15.42
Service 39.38	Energy 13.93
Manufacturing 45.16	Consumer Goods 16.22



In-Retirement Portfolio: 15-Year Time Horizon: Moderate

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Harbor Bond HABDX	★★★★★	CI	23	0.55
Harbor Real Return HARRX	★★★★	IP	15	0.57
T. Rowe Price Short-Term Bond PRWBX	★★★★	CS	8	0.55
Harbor Commodity Real Return HACMX	NR	SN	6	0.94
Selected American SLADX	★★★	LB	13	0.59
Harbor International HAINX	★★★★	FV	10	0.79
Vanguard Primecap Core VPCCX	★★★★★	LG	5	0.5
Vanguard Total Stock Market Index VTSMX	★★★	LB	10	0.16
Loomis Sayles Bond LSBRX	★★★	MU	5	0.94
Masters' Select Smaller Companies MSSFX	★★	SB	5	1.39
Total			100	

Super Sector Weighting (%)	Top Three Sectors (%)
Information 17.14	Financial Svcs 17.91
Service 43.59	Energy 14.10
Manufacturing 39.27	Consumer Goods 11.84



Categories

LG Large Growth	CS Short-Term Bond	FG Foreign Large Growth	SB Small Blend	SV Small Value
GI Intermediate Government	LV Large Value	LB Large Blend	MB Mid Blend	SN Natural Resources
CI Intermediate Bond	IP Inflation-Protected Bond	FV Foreign Large Value	MU Multisector Bond	

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alternatives to the Dreyfus fund. **Royce Total Return RYTRX** provides exposure to a broad basket of small- and mid-cap stocks, and Chuck Royce's focus on dividend payers has helped limit risk.

In-Retirement Portfolio: 15-Year Time Horizon: Moderate Risk

Asset-Allocation Targets

U.S. Stock: 30.9
Foreign Stock: 8.1
Bond (ex TIPS): 37.7
TIPS: 13.7
Commodities: 5.7
Cash: 3.9

This portfolio is based on the moderate version of Ibbotson's Lifetime 2005 Index, geared toward investors with moderate risk tolerances who retired in

2005. Its target is roughly 55% in bonds and cash, with the remainder in stocks and commodities. (The conservative version of this portfolio holds 70% in cash and bonds, whereas the aggressive version holds just 40% in these two asset classes.) Roughly a fourth of the moderate portfolio's fixed-income weighting is in Treasury Inflation-Protected Securities, and, like the 10-year portfolio above, it also includes a slice of commodities exposure.

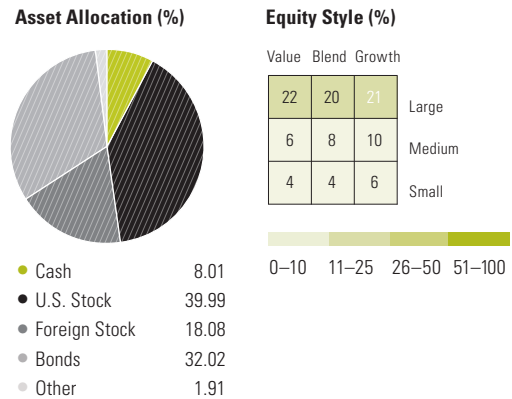
Investment Specifics: This portfolio has many holdings in common with the 10-year portfolio. I've used **Selected American SLADX** here instead of Dodge & Cox, but the two funds fulfill similar roles in their respective portfolios; more risk-tolerant investors might also consider **Oakmark Select OAKLX**, **Longleaf Partners LLPFX**, or **Clipper Fund CFIMX**.

This portfolio also includes my favorite growth fund, **Vanguard Primecap Core VPCCX**. (**Vanguard**

In-Retirement/Pre-Retirement Portfolio: 20-Year Time Horizon: Aggressive

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Metropolitan West Total Return Bond MWTRX	★★★★	CI	15	0.65
Longleaf Partners LLPFX	★★	LB	10	0.90
Osterweis OSTFX	★★★★★	MB	10	1.20
Vanguard Primecap Core VPCCX	★★★★★	LG	10	0.50
Vanguard Total Stock Market Index VTSMX	★★★	LB	10	0.16
Harbor International Growth HAIGX	★★	FG	7.5	0.89
Dodge & Cox International DODFX	★★★	FV	7.5	0.64
T. Rowe Price Small Cap Stock OTCFX	★★★	SB	8	0.93
Loomis, Sayles Bond LSBRX	★★★	MU	5	0.94
T. Rowe Price Short-Term Bond PRWBX	★★★★	CI	4	0.55
Harbor Commodity Real Return HACMX	NR	SN	6	0.94
Harbor Real Return HARRX	★★★★	IP	7	0.570
Total			100	

Super Sector Weighting (%)	Top Three Sectors (%)
Information 24.86	Financial Svcs 14.30
Service 42.70	Health 13.11
Manufacturing 32.44	Consumer Goods 11.07



Categories

FB Foreign Large Blend	IB World Bond	MI Municipal Intermediate	IP Inflation-Protected Bond
FG Foreign Large Growth	LB Large Blend	MS Municipal Short	SB Small Blend
GI Intermediate Government	MA Moderate Allocation	MU Multisector	SH Health
HY High Yield Bond	MB Mid Blend	NR Natural Resources	

Primecap VPMCX and **Primecap Oddysey Growth** POGRX would be fine substitutes.) Owing to the Primecap team’s contrarian approach, their funds can be somewhat volatile on a stand alone basis, but fine when combined with value-minded funds like Selected American and **Harbor International** HAINX. I’ve also included **Masters’ Select Smaller Companies** MSSFX, which provides a broad shot of small- and mid-cap exposure in a single package. As with all of the portfolios, I’ve anchored the equity position with a small stake in **Vanguard Total Stock Market Index** VTSMX.

**In-Retirement or Pre-Retirement Portfolio:
20-Year+ Time Horizon: Aggressive**

Asset-Allocation Targets

U.S. Stock: 45.4
Foreign Stock: 15.6
Bond (ex TIPS): 24.5
TIPS: 6.9
Commodities: 5.5
Cash: 2.0

This portfolio is based on Morningstar’s Lifetime Aggressive 2010 Index, geared toward risk-tolerant investors who are retiring within the next few years. Because it’s targeting more aggressive investors, it features a gutsy 60% in equities and the remainder in bonds and cash. (It also has a small slice of commodities—6%.) Such an asset mix would be most appropriate for a pre-retiree who’s expecting to spend many years in retirement and can tolerate substantial fluctuations in part of his or her portfolio; it’s also an appropriate mix for an individual who’s expecting other income sources during retirement, such as a pension or part-time job. The moderate and conservative versions of this portfolio feature equity weightings of 44% and 28%, respectively.

Investment Specifics

This portfolio has much in common with the other two portfolios on the fixed-income side, in particular. However, its equity sleeve features a few holdings that don’t appear in the other portfolios. Because the

foreign-stock portion of the portfolio is larger, I’ve included two separate holdings: **Dodge & Cox International** DODFX, for foreign value exposure, and **Harbor International Growth** HAIGX for growth. (Harbor International, which I’ve included in the two more conservative portfolios, would be a worthwhile substitute for the Dodge & Cox fund, whereas **Artisan International** ARTIX or **Fidelity International Growth** FIGFX would work well as a substitute in the Harbor International Growth slot.) More intrepid investors at this life stage might also consider a small stake in an emerging-markets or foreign small-cap fund, though that would increase the portfolio’s risk level and may be redundant with any core foreign funds that appear in the portfolio.

I’ve also included a 10% stake in Longleaf Partners, another fund that can be volatile by itself but works well in the context of a broadly diversified portfolio. In addition, one of my favorite go-anywhere funds appears in this portfolio: **Osterweis** OSTFX. Not only does this fund invest in companies of all sizes, but it also moves into bonds when opportunities beckon and holds cash when nothing looks cheap.

Tactical vs. Strategic Allocation

These portfolios are designed to be strategic rather than tactical, meaning that they’re meant to be bought and held rather than traded. In general, advisors, fund managers, and other so-called experts have not made a compelling case for tactical management, which in turn raises questions about individual investors’ ability to time these moves correctly.

That said, I didn’t completely ignore the current market environment in putting them together. You’ll notice that I’ve downplayed Treasury bonds in the fixed-income portfolios, largely because Treasuries still remain pricey relative to other corporate and asset-backed bonds. On the stock side, I’ve emphasized funds with a high-quality tilt; Dreyfus Appreciation is a perfect example. Such stocks haven’t participated as much in the year-to-date market runup, and therefore look compellingly valued right now. They’re a perfect choice for a retiree’s portfolio. ■■■

Exchange-Traded Funds: Where the Opportunities Are Today

Expert Q & A | Christine Benz

Exchange-traded funds have skyrocketed in popularity over the past few years, and Morningstar has been actively building out its exchange-traded fund coverage. I recently sat down with three of our ETF team's senior members, Scott Burns, Paul Justice, and Bradley Kay, to discuss the benefits and drawbacks of ETFs as well as where they're spying the best ETF opportunities right now.

Christine Benz: How do you decide whether to invest in an exchange-traded fund or traditional index mutual fund?

Scott Burns: The biggest determinant is whether or not you're in a taxable account or tax-advantaged account like a 401(k) or an IRA. If you're going to just be putting in small amounts each month, keeping it in a traditional open-end index mutual fund is definitely in your best interest because you won't have the transaction costs that exist in an ETF. On the flip side, if you are in a taxable account, even John Bogle admits that you will save some basis points (and passive investing really is a game of basis points) in terms of tax efficiency by going with an ETF.

Paul Justice: We compared open-end index funds to the ETFs across 27 indexes and we saw that open-end funds had made distributions in 25 of the categories. We only saw ETFs make distributions in two. Those two distributions from the ETFs were much smaller than the comparable index funds.

Burns: Some of the index funds (especially in the small-cap area) had surprisingly large taxable distributions, some on the order of 3% to 4% or even 6% of assets. When you talk about ETFs versus active management, the taxable distributions from ETFs will be tiny. There will be no phantom distributions. I think that's what really irks people who own mutual funds in taxable accounts. They think, "I owned it, I didn't sell it, and I still got a tax bill."

A lot of advisors and individual investors are using ETFs to do more tactical strategies. What do you think about the wisdom of that, and what do you say to people who are saying "Buy and hold did not work for me during the recent downturn, maybe a more active strategy makes more sense"?

Justice: The number of strategies that seemed to fail investors last year are countless. People say asset allocation failed, and now they're taking the famous approach of "Don't just stand there, do something!" And it oftentimes can be very detrimental. What I find with many ETF investors who might rotate out of one sector into another is that they have a half-baked idea most of the time. They'll say, "Well, I think that energy spending is going to go up" but they never take the time to work that backwards and think, "What does the market think about the price of energy stocks right now? Is higher energy spending already reflected in there?"

So they make these trades and it comes back to bite them because they didn't know what those market expectations were. I hope that's where we can step in. We have over 100 equity analysts who are building up all of this data to give us a fair value estimate. So we're getting the consideration of what we think the future will be and what we think the stocks are worth right now.

Burns: We run a tactical trading portfolio in the newsletter, *ETFInvestor*, but we always advise that you keep your portfolio 80% core and 20% satellite.

You can add to or subtract from those portions depending on your risk tolerance, and really more importantly depending on how much time you can put in to doing the research and the monitoring.

There's no reason that people will be any more successful trading ETFs than they were at trading stocks or bonds individually.

Bradley Kay: There has been a lot of undue blame on ETFs as a tool. People think just because ETFs trade throughout the day, this is going to lead a whole bunch of people to more gimmicky, tactical allocation that may not necessarily work, and toward higher-turnover strategies. But I'd argue, look at 1988-89, how many Japan mutual funds were coming out? ProFunds existed before ProShares did, Rydex had an entire lineup of mutual funds which they are really just equaling on the ETF side. Really, the gimmicky investing styles have been with us for a long time, and we are continuing to try to educate people about it, but I don't feel that it's something that's been given further rise with ETFs. It's just another venue in which the same old game is happening again.

urate fair value of a single stock that is materially different from the market price and be able to act on that. I think it's difficult for analysts to do so.

Our stock analyst team does do it.

Justice: They do it, but they spend their entire lives doing it. They will cover a small subset of companies, they will work very diligently in trying to find out the fair value. It's still a difficult task. It can be done with a lot of hard work and dedication and you can make a lot of money doing so, if you are right. As difficult as that is, it would be more difficult to, again, assign a value to 30 stocks that underlie an entire sector. You need the help of some professionals to do so. You need a valuation basis and I think we help out immensely if you're choosing to do tactical allocation. That being said, I still strongly believe that 90% of investor returns are going to come from their asset-allocation positions.

Speaking of valuations, let's talk about the ETF Valuation Quickrank. [Editor's Note: ETF Valuation Quickrank is a Premium feature on the ETF cover page of Morningstar.com.] So those reflect the analyst's price to fair value for all the stocks in an ETF?

Burns: It's weighted proportionately, so if a stock is 5% of the ETF's holdings, then fair-value times .05 gets you that stock's contribution to the fair value estimate. When an ETF's price/fair value ratio is one, that means it's fairly valued. When it's over one, it means it's overvalued to some extent, and less than one, it's undervalued. Then you have to think about the risk. You don't ever want to take price to fair value in and of itself. That's a good starting point, but you want to look at the risks. If a solar fund is trading at 0.8 price to fair value, there could be a lot of risk inherent in it.

So what are you seeing when you look across the price to fair value rankings these days? Are there any pockets of attractiveness or overvaluation?

Burns: Since last October, everything turned pretty negative in price to fair-value land. By negative I mean when we rolled up our stock analyst research, everything across the market looked undervalued, not accounting for the risk level. There are very few areas that we think are overvalued at this

“...the taxable distributions from ETFs will be tiny. I think that's what really irks people who own mutual funds in taxable accounts. They think, 'I owned it, I didn't sell it, and I still got a tax bill.'”

Burns: People often say, "Let's have the ETF and mutual fund debate," but there's actually a secondary debate, and that's the ETFs versus single security debate. By and large, are you better off buying a single stock or are you better off in a nice diversified basket of those stocks which will help minimize your idiosyncratic risks to any particular company or bond or commodity? Having the ability to trade the diversified basket is better if people want to do that.

Justice: I'd say most individual investors would be very hard-pressed to come up with an acc-

time. The tech hardware space may be overvalued now. We've seen consumer-discretionary and retail funds return to fair value. Things like the financials and the home builders have gotten closer to fair value; those are the two big spaces that have benefited the most from the junk rally this year.

Justice: I think it depends on the lens, too, through which you want to look at the market. When we looked for what's high-quality and undervalued, that's when we bought the **Vanguard Dividend Appreciation** VIG fund and I think it remains undervalued. We've seen what we've called the junk rally; a lot of small caps have come up 50% from their lows recently. I don't think you've seen that in the high-quality space. This is a time in regular investors' lives when you can buy high quality at very good prices. I think that's a very good approach.

Kay: The initial sieve for VIG is for companies whose dividends have increased for 10 consecutive years. By itself, that is no mean feat, but on top of that they run some basic balance-sheet and profitability screens to make sure that the company is in very good shape and can continue to improve going forward. So

they end up with a portfolio that looks even better if you look at it in quality terms.

There are other ETFs that do pure dividend screens, but the Dividend Appreciation fund really stands out because it is almost entirely wide- or narrow-moat companies. And if you look at the uncertainty ratings that have been assigned by our analysts, this ETF has one of the largest amounts of low- and medium-risk stocks. So it is really a very low-risk, very stable, and incredibly moaty portfolio. These are a lot of businesses that we are very confident are still going to be earning high returns five years down the line, 10 years down the line. It's also one of the more undervalued ETFs out there at the moment, in terms of broad market exposure.

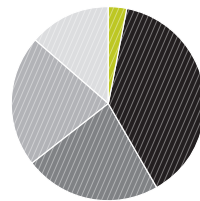
Burns: For 24 basis points, you're getting the kind of screens that **Jensen Fund** JENSX runs. And ETFs can do that. You can really run this quantitative screening strategy that a lot of your favorite managers are probably running, keep the costs low, and keep the churn low, keep the tax efficiency high, and have very similar return results.

Morningstar ETFInvestor's "Hands-Free" Portfolio

Fund Name	Star Rating	Category	Target (%)	Expense Ratio (%)
iShares Barclays TIPS Bond TIP	★★★★	IP	5	0.2
SPDR DB Int'l Gvt Inf-Prot Bond WIP	NR	IB	4	0.5
iShares Barclays MBS Bond MBB	NR	CI	6	0.34
iShares iBoxx IG Corp Bond LOD	★★	CL	10	0.15
Vanguard Mega Cap 300 MGC	NR	LB	22	0.13
Vanguard Mid Cap VO	★★★	MB	9	0.15
Vanguard Small Cap VB	★★★	SB	8	0.15
iShares MSCI EAFE EFA	★★★	FB	12	0.34
iShares MSCI EAFE Small Cap SCZ	NR	FA	5	0.4
Vanguard Emerging Markets Stock VWO	★★★	EM	6	0.27
Elements S&P CTI ETN LSC	NR	SN	8	0.75
iPath VIX Short-Term Futures ETN VXX	NR	SM	5	0.89
Total			100	

Super Sector Weighting (%)	Top Three Sectors (%)
Information 19.62	Financial Svs 16.97
Service 40.56	Industrial Mats 13.56
Manufacturing 39.81	Consumer Goods 11.76

Asset Allocation (%)



● Cash	3.29
● U.S. Stock	38.59
● Foreign Stock	22.80
● Bonds	21.82
● Other	13.50

Equity Style (%)

Value	Blend	Growth	
20	21	18	Large
9	9	10	Medium
5	4	4	Small

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

Categories

IP Inflation-Protected Bond	CL Long Bond	SB Small Blend	EM Emerging Markets
IB World Bond	LB Large Blend	FB Foreign Large Blend	SN Natural Resources
CI Intermediate Bond	MB Mid Blend	FA Foreign Small/Mid Value	SM Miscellaneous Sector

Let's talk about your other favorites for core-type positions, stock or bond.

Burns: We definitely like **iShares Barclays TIPS Bond TIP** and **SPDR DB International Government Inflation-Protected Bond WIP**. We don't think it's back-up-the-truck time, but we are really concerned about inflation, and it should be a concern as people are retiring and they have more and more fixed income in their portfolios. It would be a real tragedy if all the folks who probably didn't have enough fixed income at the end of 2008 and lost 40% of their stock holdings, then increased their fixed-income holdings, only to run the risk that inflation will wipe them out.

TIP also has a really unique structure, as opposed to buying TIP bonds from Treasury direct. In a taxable account with TIP bonds, when they do the CPI adjustment for inflation you will have to pay taxes, even though you don't get any cash from the adjustment. The TIP ETF is structured in such a way that they sell some bonds at the time of the inflation adjustment and then distribute those proceeds as a dividend, so you'll still get taxed on the CPI increase but you'll actually have some cash with which to pay that tax. The SPDR International Government Inflation-Protected ETF is for people who are really concerned about the purchasing power of the dollar.

We also like the **Elements S&P CTI ETN, LSC** is the ticker. It's a commodity fund with brains.

Kay: It's a long-short fund. It covers six different sectors and it independently looks at each sector and essentially asks, has the price momentum been positive or negative over the past three to five months? Because one of the keys with commodities is that they're very driven by persistent macroeconomic patterns. So this can either be, say, supply constraints or supply excesses within a particular sector. If mining companies have been trimming back on their capital expenditures, suddenly you end up with industrial growth throughout the world and there aren't enough miners out there to supply it. So those commodity prices will continue to increase for a while. The same thing can happen in reverse. When all the commodity producers suddenly start

investing, two years down the line, they've got their mines up and running and now the economy's moving on the downturn. So all of a sudden those prices start plummeting.

But the key is that all these things take months to years to rectify. There are these long lag periods, and that's what causes persistent price movements over time. This ETN looks to capture those persistent price movements. It is now long in every type of commodity once again, apart from livestock. So you get that long-only inflation protection but at the same time it doesn't get caught out with periods of persistent deflation, such as we saw in late 2008.

One thing about this ETN is that it's not as liquid as some of the others we've discussed. It's not so illiquid that if you want to move \$100,000 in, you're going to have to trade all day. No, you can really make the transaction within, say, a minute. You just have to put in a limit order so that your brokerage doesn't try to make the whole trade in an instant, so that it'll actually wait and get a fair price.

You're recommending an emerging-markets small-cap fund, right?

Kay: WisdomTree Emerging Markets Small Cap Dividend DGS. It still has a little bit more room to move up. And it's got a huge yield. It really is the area where we feel long-term growth prospects are most exciting, because it is a play on local emerging-markets growth, as opposed to emerging-markets large caps, which are more a play on global growth.

Because these are local businesses, focused on local markets, they are especially focused on local consumers and also local business services. You really are getting the best possible exposure to the actual growth that's happening just in Brazil, or happening just in Malaysia. When emerging-markets large caps take a bath, this fund will as well. But in the long run, these firms are the ones that are going to have the most improved fundamentals on which you'll get the long-term appreciation. ■■■

Pre-Retirees Rebuild, Regroup Following Market Losses

Portfolio Makeover | Christine Benz

Laura and Eric Hansen's investments have been through a lot over the past decade. Like many investors, the couple lost a bundle as the tech bubble burst. They made up some ground from 2003 through 2007, only to see it all come crashing down in 2008. Laura estimates that they lost roughly \$80,000 in the recent downturn.

Along the way, the couple has cycled through a few different investment advisors, and they have also tried their hand at managing their assets on their own. At this stage in their lives, the couple would like to build a low-maintenance portfolio. "We want to enjoy life and stop worrying about our investments, but can't afford to be too conservative," Laura wrote.

This line will resonate with many investors right now, but the couple's situation is somewhat unusual. Eric, now 58, was injured in a work accident 18 years ago and underwent 10 surgeries as a result. He receives a pension and disability payment that, together, fund most of the couple's living expenses. The couple's health insurance costs are also covered by Eric's employer.

Laura has had a series of part-time accounting jobs in the past, but is not currently working. Their son, a new college grad, is currently living with them.

When Eric turns 65, his disability annuity will be reduced. He will still receive about 60% of his current income after he turns 65, though, and that amount will be indexed to the inflation rate. Laura estimates that Social Security will make up for the reduction in the annuity payments once they turn 65.

Nonetheless, the couple is worried about their portfolio's ability to last through their retirement years. They're young, and they periodically tap their principal to pay their property tax and cover household

emergencies. They'll also have to purchase a supplemental health-care policy once they begin taking Medicare, and they have been mulling long-term care insurance.

The Before Portfolio

Laura and Eric's portfolio consists of two Roth IRAs and two taxable accounts, as well as a cash account that they use to fund periodic expenses. The couple is also contributing the maximum to their IRAs per year.

The Hansens currently have about 60% of their portfolio in stocks and stock funds and the remainder in bonds and cash—a reasonable allocation given that their income needs from their portfolio, both currently and after they turn 65, are relatively modest.

Laura notes that their timing was terrible in purchasing some of the holdings in their portfolio, including **Dodge & Cox International DODFX** and **Third Avenue Real Estate Value TAREX**. In all, however, the couple has chosen solid investments, both on their own and with the assistance of their past advisors.

This couple's home is their largest asset. Currently valued at \$550,000, their house is mortgage-free and situated in an area they love. They'd like to stay put, at least for the foreseeable future.

The After Portfolio

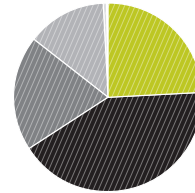
This couple's asset mix of 60% equity/40% bonds and cash is reasonable given that their income needs from their portfolio, both currently and after they turn 65, are relatively modest. However, their cash stake, at roughly 25% of the portfolio, is a bit high. Assuming they won't need the money for a few more years, at most, they could get a little more oomph by deploying a fourth of their cash position into a short-term bond fund and another fourth into a high-quality intermediate-term bond. Their bond portfolio has a high-quality focus, which is why I think they can do without **Fidelity Government Income FGOVX**. Inflation protection is normally a must in a retirement portfolio, but I'm comfortable knowing that Eric's pension includes a measure of inflation protection.

Laura and Eric's Portfolio: Before

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Dominion Resources D	★★★	Utilities	20,377	N/A
Goldman Sachs Mid Cap Value A GCMAX	★★★★★	MV	16,955	1.16
Amer. Funds Income Fund of Amer. A AMECX	★★★	MA	15,461	0.54
Amer. Funds Cap World Growth & Inc A CWGIX	★★★★★	WS	22,316	0.71
Amer. Funds EuroPacific Growth A AEPGX	★★★★★	FB	10,161	0.81
Fidelity U.S. Bond Index FBIDX	★★★★★	CI	10,037	0.32
Fidelity Contrafund FCNTX	★★★★★	LG	9,467	0.94
Dodge & Cox International Stock DODFX	★★★	FV	8,991	0.64
Hartford Capital Appreciation A ITHAX	★★★★★	LB	8,481	1.12
American Capital Income Builder CAIBX	★★★	WA	7,841	0.55
Federated Kaufmann A KAUAX	★★★★★	MG	7,091	1.95
Fidelity Leveraged Company Stock FLVCX	★★	MB	6,853	0.82
Columbia Value and Restructuring UMBIX	★★★	LV	6,830	0.89
Scout Small Cap Fund UMBHX	★★★★★	SG	6,061	1.01
Third Avenue Real Estate Value TAREX	★★★	GR	5,562	1.12
Abbott Laboratories ABT	★★★★★	Drugs	4,756	N/A
Cash	N/A	N/A	50,041	N/A
Total (including 25 holdings not shown)			265,343	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	20.71	Utilities	17.38
Service	37.36	Financial Svs	13.47
Manufacturing	41.94	Health Care	12.36

Asset Allocation (%)



- Cash 24.40
- U.S. Stock 41.70
- Foreign Stock 19.68
- Bonds 13.44
- Other 0.79

Equity Style (%)

Value	Blend	Growth	
32	16	27	Large
6	6	6	Medium
2	2	3	Small

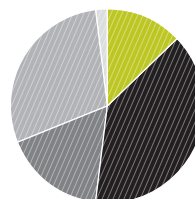
0-10 11-25 26-50 51-100

Laura and Eric's Portfolio: After

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Fidelity Total Bond FTBFX	★★★★★	CI	25,000	0.32
Fidelity Contrafund FCNTX	★★★★★	LG	27,000	0.94
Hartford Capital Appreciation A ITHAX	★★★★★	LB	20,000	1.12
Columbia Value and Restructuring UMBIX	★★★	LV	15,000	0.89
Dodge & Cox International Stock DODFX	★★★	FV	15,000	0.64
Fidelity Short-Term Bond FSHBX	★★★	CS	15,000	0.45
Fidelity Strategic Income FSICX	★★★★★	MU	15,000	0.73
Harbor Bond HABDX	★★★★★	CI	13,000	0.55
Dominion Resources D	★★★	Utilities	10,000	N/A
Goldman Sachs Mid Cap Value A GCMAX	★★★★★	MV	10,000	1.16
Amer. Funds Capital Income Builder CAIBX	★★★	WA	10,000	0.55
Amer. Funds Income Fund of Amer. A AMECX	★★★	MA	10,000	0.54
Amer. Funds Cap. Wrld Grwth & Inc A CWGIX	★★★★★	WS	10,000	0.71
American Funds American Mutual AMRMX	★★★	LV	15,000	0.57
Third Avenue Real Estate Value TAREX	★★★	GR	10,000	1.12
Cash	N/A	N/A	21,952	N/A
Total (including 10 holdings not shown)			265,343	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	20.05	Financial Svs	17.10
Service	42.47	Health Care	13.15
Manufacturing	37.48	Utilities	9.99

Asset Allocation (%)



- Cash 13.01
- U.S. Stock 39.11
- Foreign Stock 16.97
- Bonds 29.05
- Other 1.86

Equity Style (%)

Value	Blend	Growth	
27	19	30	Large
7	5	6	Medium
2	1	1	Small

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

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If you're interested in seeing your portfolio featured in our Portfolio Makeover section, please e-mail me at christine_benz@morningstar.com. Rest assured that we will protect your privacy by using a pseudonym and withholding any other identifying details. Please include the following information: your fund, stock, and bond holdings, as well as the percentage or dollar value you have allocated to each, your age, a brief outline of your life experience, including your family situation and career background, details on the financial goals you would like to achieve, and your assessment of your risk tolerance.

Categories

FB Foreign Large Blend	FV Foreign Large Value
MV Mid Value	LB Large Blend
MA Moderate Allocation	LG Large Growth
WS World Stock	CI Intermediate-Term Bond
WA World Allocation	MB Mid Blend
FB Foreign Large Blend	MG Mid Growth
SG Small Growth	GR Global Real Estate

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Rebuilding Continued from Page 10

I like all of this couple's American Funds, and in any case, they've already paid the sales charges, so it would be hard to make a case for conducting a major overhaul. However, I would recommend some streamlining, because some of their holdings fulfill a similar role in their portfolio. For example, **EuroPacific Growth AEPGX** is a fine fund, but **Capital World Growth & Income CWGIX** fills a similar role and has been less volatile. The couple's Fidelity stock-fund positions could also stand to be consolidated. As always, I'm a big fan of **Contrafund FCNTX**, but **Leveraged Company Stock FLVCX** adds more risk than this couple needs. **Export & Multinational FEXPX** isn't among our highest-conviction Fidelity names, either.

Laura noted that she enjoys selecting and following individual stocks, and several of her picks are highly rated by our stock analyst team. However, I would trim back the couple's position in Dominion Resources D, which is a very large stake as a percentage of their equity portfolio. I would also recommend cutting their position in generic-drug maker **Hospira HSP**, **Google GOOG**, and **Sears Holdings SHLD**. All are small positions but have 3-star ratings and high uncertainty ratings, meaning that their businesses aren't especially predictable.

I would also recommend that this couple price long-term care insurance, given that they have a history of Alzheimer's disease in their families. However, they may find that waiting just a few more years won't make a big difference in their premiums. In the meantime, fully funding their IRAs is a good idea. ■■■
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